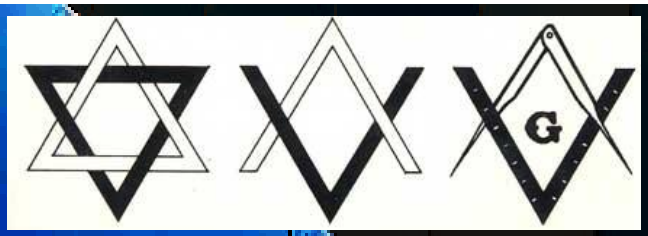
INSIDE THE BANK OF INTERNATIONAL SETTLEMENTS



THE CENTRAL BANK OF CENTRAL BANKS

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"The Bank is completely removed from any governmental or political control."

— Gates McGarrah, first president of the Bank for International Settlements, 1931[1]

The world's most exclusive club has eighteen members. They gather every other month on a Sunday evening at 7 p.m. in conference room E in a circular tower block whose tinted windows overlook the central Basel railway station. Their discussion lasts for one hour, perhaps an hour and a half. Some of those present bring a colleague with them, but the aides rarely speak during this most confidential of conclaves. The meeting closes, the aides leave, and those remaining retire for dinner in the dining room on the eighteenth floor, rightly confident that the food and the wine will be superb. The meal, which continues until 11 p.m. or midnight, is where the real work is done. The protocol and hospitality, honed for more than eight decades, are faultless. Anything said at the dining table, it is understood, is not to be repeated elsewhere.

Few, if any, of those enjoying their haute cuisine and *grand cru* wines—some of the best Switzerland can offer—would be recognized by passers-by, but they include a good number of the most powerful people in the world. These men—they are almost all men—are central bankers. They have come to Basel to attend the Economic Consultative Committee (ECC) of the Bank for International Settlements (BIS), which is the bank for central banks. Its current members include Ben Bernanke, the chairman of the US Federal Reserve; Sir Mervyn King, the governor of the Bank of England; Mario Draghi, of the European Central Bank; Zhou Xiaochuan of the Bank of China; and the central bank governors of Germany, France, Italy, Sweden, Canada, India, and Brazil. Jaime Caruana, a former governor of the Bank of Spain, the BIS's general manager, joins them.

In early 2013, when this book went to press, King, who is due to step down as governor of the Bank of England in June 2013, chaired the ECC. The ECC, which used to be known as the G-10 governors' meeting, is the most influential of the BIS's numerous gatherings, open only to a small, select group of central bankers from advanced economies. The ECC makes recommendations on the membership and organization of the three BIS committees that deal with the global financial system, payments systems, and international markets. The committee also prepares proposals for the Global Economy Meeting and guides its agenda.

That meeting starts at 9:30 a.m. on Monday morning, in room B and lasts for three hours. There King presides over the central bank governors of the thirty countries judged the most important to the global economy. In addition to those who were present at the Sunday evening dinner, Monday's meeting will include representatives from, for example, Indonesia, Poland, South Africa, Spain, and Turkey. Governors from fifteen smaller countries, such as Hungary, Israel, and New Zealand are allowed to sit in as observers, but do not usually not speak. Governors from the third tier of member banks, such as Macedonia and Slovakia, are not allowed to attend. Instead they must forage for scraps of information at coffee and meal breaks.

The governors of all sixty BIS member banks then enjoy a buffet lunch in the eighteenth-floor dining room. Designed by Herzog & de Meuron, the Swiss architectural firm which built the "Bird's Nest" Stadium for the Beijing Olympics, the dining room has white walls, a black ceiling and spectacular views over three countries: Switzerland, France, and Germany.[2] At 2 p.m. the central bankers and their aides return to room B for the governors' meeting to discuss matters of interest, until the gathering ends at 5.

King takes a very different approach than his predecessor, Jean-Claude Trichet, the former president

of the European Central Bank, in chairing the Global Economy Meeting. Trichet, according to one former central banker, was notably Gallic in his style: a stickler for protocol who called the central bankers to speak in order of importance, starting with the governors of the Federal Reserve, the Bank of England, and the Bundesbank, and then progressing down the hierarchy. King, in contrast, adopts a more thematic and egalitarian approach: throwing open the meetings for discussion and inviting contributions from all present.

The governors' conclaves have played a crucial role in determining the world's response to the global financial crisis. "The BIS has been a very important meeting point for central bankers during the crisis, and the rationale for its existence has expanded," said King. "We have had to face challenges that we have never seen before. We had to work out what was going on, what instruments do we use when interest rates are close to zero, how do we communicate policy. We discuss this at home with our staff, but it is very valuable for the governors themselves to get together and talk among themselves."

Those discussions, say central bankers, must be confidential. "When you are at the top in the number one post, it can be pretty lonely at times. It is helpful to be able to meet other number ones and say, 'This is my problem, how do you deal with it?'" King continued. "Being able to talk informally and openly about our experiences has been immensely valuable. We are not speaking in a public forum. We can say what we really think and believe, and we can ask questions and benefit from others."[3]

The BIS management works hard to ensure that the atmosphere is friendly and clubbable throughout the weekend, and it seems they succeed. The bank arranges a fleet of limousines to pick up the governors at Zürich airport and bring them to Basel. Separate breakfasts, lunches, and dinners are organized for the governors of national banks who oversee different types and sizes of national economies, so no one feels excluded. "The central bankers were more at home and relaxed with their fellow central bankers than with their own governments," recalled Paul Volcker, the former chairman of the US Federal Reserve, who attended the Basel weekends.[4] The superb quality of the food and wine made for an easy camaraderie, said Peter Akos Bod, a former governor of the National Bank of Hungary. "The main topics of discussion were the quality of the wine and the stupidity of finance ministers. If you had no knowledge of wine you could not join in the conversation."[5]

And the conversation is usually stimulating and enjoyable, say central bankers. The contrast between the Federal Open Markets Committee at the US Federal Reserve, and the Sunday evening G-10 governors' dinners was notable, recalled Laurence Meyer, who served as a member of the Board of Governors of the Federal Reserve from 1996 until 2002. The chairman of the Federal Reserve did not always represent the bank at the Basel meetings, so Meyer occasionally attended. The BIS discussions were always lively, focused and thought provoking. "At FMOC meetings, while I was at the Fed, almost all the Committee members read statements which had been prepared in advance. They very rarely referred to statements by other Committee members and there was almost never an exchange between two members or an ongoing discussion about the outlook or policy options. At BIS dinners people actually talk to each other and the discussions are always stimulating and interactive focused on the serious issues facing the global economy."[6]

All the governors present at the two-day gathering are assured of total confidentiality, discretion, and the highest levels of security. The meetings take place on several floors that are usually used only when the governors are in attendance. The governors are provided with a dedicated office and the necessary support and secretarial staff. The Swiss authorities have no juridisdiction over the BIS premises. Founded by an international treaty, and further protected by the 1987 Headquarters Agreement with the Swiss government, the BIS enjoys similar protections to those granted to the headquarters of the United Nations, the International Monetary Fund (IMF) and diplomatic embassies. The Swiss authorities need the

permission of the BIS management to enter the bank's buildings, which are described as "inviolable."[7]

The BIS has the right to communicate in code and to send and receive correspondence in bags covered by the same protection as embassies, meaning they cannot be opened. The BIS is exempt from Swiss taxes. Its employees do not have to pay income tax on their salaries, which are usually generous, designed to compete with the private sector. The general manager's salary in 2011 was 763,930 Swiss francs, while head of departments were paid 587,640 per annum, plus generous allowances. The bank's extraordinary legal privileges also extend to its staff and directors. Senior managers enjoy a special status, similar to that of diplomats, while carrying out their duties in Switzerland, which means their bags cannot be searched (unless there is evidence of a blatant criminal act), and their papers are inviolable. The central bank governors traveling to Basel for the bimonthly meetings enjoy the same status while in Switzerland. All bank officials are immune under Swiss law, for life, for all the acts carried out during the discharge of their duties. The bank is a popular place to work and not just because of the salaries. Around six hundred staff come from over fifty countries. The atmosphere is multi-national and cosmopolitan, albeit very Swiss, emphasizing the bank's hierarchy. Like many of those working for the UN or the IMF, some of the staff of the BIS, especially senior management, are driven by a sense of mission, that they are working for a higher, even celestial purpose and so are immune from normal considerations of accountability and transparency.

The bank's management has tried to plan for every eventuality so that the Swiss police need never be called. The BIS headquarters has high-tech sprinkler systems with multiple back-ups, in-house medical facilities, and its own bomb shelter in the event of a terrorist attack or armed conflagration. The BIS's assets are not subject to civil claims under Swiss law and can never be seized.

The BIS strictly guards the bankers' secrecy. The minutes, agenda, and actual attendance list of the Global Economy Meeting or the ECC are not released in any form. This is because no official minutes are taken, although the bankers sometimes scribble their own notes. Sometimes there will be a brief press conference or bland statement afterwards but never anything detailed. This tradition of privileged confidentiality reaches back to the bank's foundation.

"The quietness of Basel and its absolutely nonpolitical character provide a perfect setting for those equally quiet and nonpolitical gatherings," wrote one American official in 1935. "The regularity of the meetings and their almost unbroken attendance by practically every member of the Board make them such they rarely attract any but the most meager notice in the press."[8] Forty years on, little had changed. Charles Coombs, a former foreign exchange chief of the New York Federal Reserve, attended governors' meetings from 1960 to 1975. The bankers who were allowed inside the inner sanctum of the governors' meetings trusted each other absolutely, he recalled in his memoirs. "However much money was involved, no agreements were ever signed nor memoranda of understanding ever initialized. The word of each official was sufficient, and there were never any disappointments."[9]

What, then, does this matter to the rest of us? Bankers have been gathering confidentially since money was first invented. Central bankers like to view themselves as the high priests of finance, as technocrats overseeing arcane monetary rituals and a financial liturgy understood only by a small, self-selecting elite.

But the governors who meet in Basel every other month are public servants. Their salaries, airplane tickets, hotel bills, and lucrative pensions when they retire are paid out of the public purse. The national reserves held by central banks are public money, the wealth of nations. The central bankers' discussions at the BIS, the information that they share, the policies that are evaluated, the opinions that are exchanged, and the subsequent decisions that are taken, are profoundly political. Central bankers, whose independence is constitutionally protected, control monetary policy in the developed world. They manage the supply of money to national economies. They set interest rates, thus deciding the value of our savings

and investments. They decide whether to focus on austerity or growth. Their decisions shape our lives.

The BIS's tradition of secrecy reaches back through the decades. During the 1960s, for example, the bank hosted the London Gold Pool. Eight countries pledged to manipulate the gold market to keep the price at around thirty-five dollars per ounce, in line with the provisions of the Bretton Woods Accord that governed the post–World War II international financial system. Although the London Gold Pool no longer exists, its successor is the BIS Markets Committee, which meets every other month on the occasion of the governors' meetings to discuss trends in the financial markets. Officials from twenty-one central banks attend. The committee releases occasional papers, but its agenda and discussions remain secret.

Nowadays the countries represented at the Global Economy Meetings together account for around four-fifths of global gross domestic product (GDP)—most of the produced wealth of the world—according to the BIS's own statistics. Central bankers now "seem more powerful than politicians," wrote *The Economist* newspaper, "holding the destiny of the global economy in their hands."[10] How did this happen? The BIS, the world's most secretive global financial institution, can claim much of the credit. From its first day of existence, the BIS has dedicated itself to furthering the interests of central banks and building the new architecture of transnational finance. In doing so, it has spawned a new class of close-knit global technocrats whose members glide between highly-paid positions at the BIS, the IMF, and central and commercial banks.

The founder of the technocrats' cabal was Per Jacobssen, the Swedish economist who served as the BIS's economic adviser from 1931 to 1956. The bland title belied his power and reach. Enormously influential, well connected, and highly regarded by his peers, Jacobssen wrote the first BIS annual reports, which were—and remain—essential reading throughout the world's treasuries. Jacobssen was an early supporter of European federalism. He argued relentlessly against inflation, excessive government spending, and state intervention in the economy. Jacobssen left the BIS in 1956 to take over the IMF. His legacy still shapes our world. The consequences of his mix of economic liberalism, price obsession, and dismantling of national sovereignty play out nightly in the European news bulletins on our television screens.

The BIS's defenders deny that the organization is secretive. The bank's archives are open and researchers may consult most documents that are more than thirty years old. The BIS archivists are indeed cordial, helpful, and professional. The bank's website includes all its annual reports, which are downloadable, as well as numerous policy papers produced by the bank's highly regarded research department. The BIS publishes detailed accounts of the securities and derivatives markets, and international banking statistics. But these are largely compilations and analyses of information already in the public domain. The details of the bank's own core activities, including much of its banking operations for its customers, central banks, and international organizations, remain secret. The Global Economy Meetings and the other crucial financial gatherings that take place at Basel, such as the Markets Committee, remain closed to outsiders. Private individuals may not hold an account at BIS, unless they work for the bank. The bank's opacity, lack of unaccountability, and ever-increasing influence raises profound questions—not just about monetary policy but transparency, accountability, and how power is exercised in our democracies.

WHEN I EXPLAINED to friends and acquaintances that I was writing a book about the Bank for International Settlements, the usual response was a puzzled look, followed by a question: "The bank for what?" My interlocutors were intelligent people, who follow current affairs. Many had some interest in and understanding of the global economy and financial crisis. Yet only a handful had heard of the BIS. This was strange, as the BIS is the most important bank in the world and predates both the IMF and the

World Bank. For decades it has stood at the center of a global network of money, power, and covert global influence.

The BIS was founded in 1930. It was ostensibly set up as part of the Young Plan to administer German reparations payments for the First World War. The bank's key architects were Montagu Norman, who was the governor of the Bank of England, and Hjalmar Schacht, the president of the Reichsbank who described the BIS as "my" bank. The BIS's founding members were the central banks of Britain, France, Germany, Italy, Belgium, and a consortium of Japanese banks. Shares were also offered to the Federal Reserve, but the United States, suspicious of anything that might infringe on its national sovereignty, refused its allocation. Instead a consortium of commercial banks took up the shares: J. P. Morgan, the First National Bank of New York, and the First National Bank of Chicago.

The real purpose of the BIS was detailed in its statutes: to "promote the cooperation of central banks and to provide additional facilities for international financial operations." It was the culmination of the central bankers' decades-old dream, to have their own bank—powerful, independent, and free from interfering politicians and nosy reporters. Most felicitous of all, the BIS was self-financing and would be in perpetuity. Its clients were its own founders and shareholders—the central banks. During the 1930s, the BIS was the central meeting place for a cabal of central bankers, dominated by Norman and Schacht. This group helped rebuild Germany. The *New York Times* described Schacht, widely acknowledged as the genius behind the resurgent German economy, as "The Iron-Willed Pilot of Nazi Finance."[11] During the war, the BIS became a de-facto arm of the Reichsbank, accepting looted Nazi gold and carrying out foreign exchange deals for Nazi Germany.

The bank's alliance with Berlin was known in Washington, DC, and London. But the need for the BIS to keep functioning, to keep the new channels of transnational finance open, was about the only thing all sides agreed on. Basel was the perfect location, as it is perched on the northern edge of Switzerland and sits almost on the French and German borders. A few miles away, Nazi and Allied soldiers were fighting and dying. None of that mattered at the BIS. Board meetings were suspended, but relations between the BIS staff of the belligerent nations remained cordial, professional, and productive. Nationalities were irrelevant. The overriding loyalty was to international finance. The president, Thomas McKittrick, was an American. Roger Auboin, the general manager, was French. Paul Hechler, the assistant general manager, was a member of the Nazi party and signed his correspondence "Heil Hitler." Rafaelle Pilotti, the secretary general, was Italian. Per Jacobssen, the bank's influential economic adviser, was Swedish. His and Pilotti's deputies were British.

After 1945, five BIS directors, including Hjalmar Schacht, were charged with war crimes. Germany lost the war but won the economic peace, in large part thanks to the BIS. The international stage, contacts, banking networks, and legitimacy the BIS provided, first to the Reichsbank and then to its successor banks, has helped ensure the continuity of immensely powerful financial and economic interests from the Nazi era to the present day.

FOR THE FIRST forty-seven years of its existence, from 1930 to 1977, the BIS was based in a former hotel, near the Basel central railway station. The bank's entrance was tucked away by a chocolate shop, and only a small notice confirmed that the narrow doorway opened into the BIS. The bank's managers believed that those who needed to know where the BIS was would find it, and the rest of the world certainly did not need to know. The inside of the building changed little over the decades, recalled Charles Coombs. The BIS provided the "the spartan accommodations of a former Victorian-style hotel whose single and double bedrooms had been transformed into offices simply by removing the beds and installing desks."[12]

The bank moved into its current headquarters, at 2, Centralbahnplatz, in 1977. It did not go far and now overlooks the Basel central station. Nowadays the BIS's main mission, in its own words, is threefold: "to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in these areas, and to act as a bank for central banks."[13] The BIS also hosts much of the practical and technical infrastructure that the global network of central banks and their commercial counterparts need to function smoothly. It has two linked trading rooms: at the Basel headquarters and Hong Kong regional office. The BIS buys and sells gold and foreign exchange for its clients. It provides asset management and arranges short-term credit to central banks when needed.

The BIS is a unique institution: an international organization, an extremely profitable bank and a research institute founded, and protected, by international treaties.[14] The BIS is accountable to its customers and shareholders—the central banks—but also guides their operations. The main tasks of a central bank, the BIS argues, are to control the flow of credit and the volume of currency in circulation, which will ensure a stable business climate, and to keep exchange rates within manageable bands to ensure the value of a currency and so smooth international trade and capital movements. This is crucial, especially in a globalized economy, where markets react in microseconds and perceptions of economic stability and value are almost as important as reality itself.

The BIS also helps to supervise commercial banks, although it has no legal powers over them. The Basel Committee on Banking Supervision, based at the BIS, regulates commercial banks' capital and liquidity requirements. It requires banks to have a minimum capital of eight percent of risk-weighted assets when lending, meaning that if a bank has risk-weighted assets of $100 million it must maintain at least $8 million capital.[15] The committee has no powers of enforcement, but it does have enormous moral authority. "This regulation is so powerful that the eight percent principle has been set into national laws," said Peter Akos Bod. "It's like voltage. Voltage has been set at 220. You may decide on ninety-five volts, but it would not work." In theory, sensible housekeeping and mutual cooperation, overseen by the BIS, will keep the global financial system functioning smoothly. In theory.

The reality is that we have moved beyond recession into a deep structural crisis, one fueled by the banks' greed and rapacity, which threatens all of our financial security. Just as in the 1930s, parts of Europe face economic collapse. The Bundesbank and the European Central Bank, two of the most powerful members of the BIS, have driven the mania for austerity that has already forced one European country, Greece, to the edge, aided by the venality and corruption of the country's ruling class. Others may soon follow. The old order is creaking, its political and financial institutions corroding from within. From Oslo to Athens, the far right is resurgent, fed in part by soaring poverty and unemployment. Anger and cynicism are corroding citizens' faith in democracy and the rule of law. Once again, the value of property and assets is vaporizing before their owners' eyes. The European currency is threatened with breakdown, while those with money seek safe haven in Swiss francs or gold. The young, the talented, and the mobile are again fleeing their home countries for new lives abroad. The powerful forces of international capital that brought the BIS into being, and which granted the bank its power and influence, are again triumphant.

The BIS sits at the apex of an international financial system that is falling apart at the seams, but its officials argue that it does not have the power to act as an international financial regulator. Yet the BIS cannot escape its responsibility for the Euro-zone crisis. From the first agreements in the late 1940s on multilateral payments to the establishment of the Europe Central Bank in 1998, the BIS has been at the heart of the European integration project, providing technical expertise and the financial mechanisms for currency harmonization. During the 1950s, it managed the European Payments Union, which internationalized the continent's payment system. The BIS hosted the Governors' Committee of European Economic Community central bankers, set up in 1964, which coordinated trans-European monetary

policy. During the 1970s, the BIS ran the "Snake," the mechanism by which European currencies were held in exchange rate bands. During the 1980s the BIS hosted the Delors Committee, whose report in 1988 laid out the path to European Monetary Union and the adoption of a single currency. The BIS midwifed the European Monetary Institute (EMI), the precursor of the European Central Bank. The EMI's president was Alexandre Lamfalussy, one of the world's most influential economists, known as the "Father of the euro." Before joining the EMI in 1994, Lamfalussy had worked at the BIS for seventeen years, first as economic adviser, then as the bank's general manager.

For a staid, secretive organization, the BIS has proved surprisingly nimble. It survived the first global depression, the end of reparations payments and the gold standard (two of its main reasons for existence), the rise of Nazism, the Second World War, the Bretton Woods Accord, the Cold War, the financial crises of the 1980s and 1990s, the birth of the IMF and World Bank, and the end of Communism. As Malcolm Knight, manager from 2003–2008, noted, "It is encouraging to see that—by remaining small, flexible, and free from political interference—the Bank has, throughout its history, succeeded remarkably well in adapting itself to evolving circumstances."[16]

The bank has made itself a central pillar of the global financial system. As well as the Global Economy Meetings, the BIS hosts four of the most important international committees dealing with global banking: the Basel Committee on Banking Supervision, the Committee on the Global Financial System, the Committee on Payment and Settlement Systems, and the Irving Fisher Committee, which deals with central banking statistics. The bank also hosts three independent organizations: two groups dealing with insurance and the Financial Stability Board (FSB). The FSB, which coordinates national financial authorities and regulatory policies, is already being spoken of as the fourth pillar of the global financial system, after the BIS, the IMF and the commercial banks.

The BIS is now the world's thirtieth-largest holder of gold reserves, with 119 metric tons—more than Qatar, Brazil, or Canada.[17] Membership of the BIS remains a privilege rather than a right. The board of directors is responsible for admitting central banks judged to "make a substantial contribution to international monetary cooperation and to the Bank's activities." China, India, Russia, and Saudi Arabia joined only in 1996. The bank has opened offices in Mexico City and Hong Kong but remains very Eurocentric. Estonia, Latvia, Lithuania, Macedonia, Slovenia, and Slovakia (total population 16.2 million) have been admitted, while Pakistan (population 169 million) has not. Nor has Kazakhstan, which is a powerhouse of Central Asia. In Africa only Algeria and South Africa are members—Nigeria, which has the continent's second-largest economy, has not been admitted. (The BIS's defenders say that it demands high governance standards from new members and when the national banks of countries such as Nigeria and Pakistan reach those standards, they will be considered for membership.)

Considering the BIS's pivotal role in the transnational economy, its low profile is remarkable. Back in 1930 a *New York Times* reporter noted that the culture of secrecy at the BIS was so strong that he was not permitted to look inside the boardroom, even after the directors had left. Little has changed. Journalists are not allowed inside the headquarters while the Global Economy Meeting is underway. BIS officials speak rarely on the record, and reluctantly, to members of the press. The strategy seems to work. The Occupy Wall Street movement, the anti-globalizers, the social network protesters have ignored the BIS. Centralbahnplatz 2, Basel, is quiet and tranquil. There are no demonstrators gathered outside the BIS's headquarters, no protestors camped out in the nearby park, no lively reception committees for the world's central bankers.

As the world's economy lurches from crisis to crisis, financial institutions are scrutinized as never before. Legions of reporters, bloggers, and investigative journalists scour the banks' every move. Yet somehow, apart from brief mentions on the financial pages, the BIS has largely managed to avoid critical

scrutiny. Until now.

PART ONE: **KAPITAL ÜBER ALLES**

"I rather hope that next summer we may be able to inaugurate a private and eclectic Central Banks 'Club', small at first, large in the future."

— Montagu Norman, governor of the Bank of England, to Benjamin Strong, governor of the Federal Reserve Bank of New York, in 1925[1]

One day in the summer of 1929, Montagu Norman, the governor of the Bank of England, picked up the telephone and spoke to Walter Layton, the editor of *The Economist*. Norman excitedly asked Layton to come to his office as soon as possible to discuss a very important matter.

During Norman's term as governor, from 1920 to 1944, he was one of the most influential men in the world, an apparently permanent bastion of the global financial system. His gnomic utterances were scoured for meaning. When he was re-appointed governor in 1932, the *New York Times* described him as overseeing Britain's "invisible empire of wealth." "Gold standards may come and go," the article noted, "but Montagu Norman remains."[2] Such was Norman's power that a single speech could move markets. When, in October 1932, Norman gloomily proclaimed at a bankers' dinner in London that the world's economic disorder was beyond the control of any man, government, or country, stocks, bonds, and the dollar all slid sharply and quickly in New York.

Layton was not surprised by Norman's agitated manner. The governor was a scion of an old and respected banking dynasty, but his mental state was an open secret among financial insiders. Norman was a mercurial figure, a manic-depressive, and a workaholic, notorious among financial insiders for his mood swings. Shy and hypersensitive, Norman was introverted to the point of neurosis. Before the First World War, Norman had consulted Carl Jung, the Swiss founder of analytical psychology, to discuss a course of treatment, with no success. Jung had implied that Norman was untreatable, which did not help matters.

The world's most powerful banker abhorred publicity, being recognized or socializing, and was prone to fainting fits. He once threw an inkpot at the head of an underling who failed to meet his exacting standards. "He was a very unlikely banker. He was more like a seventeenth-century nobleman or painter," recalled his stepson, Peregrine Worsthorne. "He was always very neurotic and had very bad nervous breakdowns. He was very shy and a loner. He had no care for conventions. He came down to dinner without socks and traveled to work on the underground, which was very unusual in those days."[3]

Nor did Norman look the part of a sober financier, with his cape, neatly trimmed Van Dyke beard, and sparkling, jeweled tiepin. But despite his own flamboyant dress sense, he disapproved of showy behavior, said Worsthorne. "He lived very austerely and discouraged all signs of ostentation. He hated cocktail parties." Norman's horror of publicity naturally had precisely the opposite effect. Although when he sailed across the Atlantic he used an assumed name because the press covered his every move, hordes of journalists and photographers still awaited when he disembarked in New York.

The balmy months in 1929 were the last hurrah of the Roaring Twenties. The American bull market was still growing. Share prices kept rising. The value of stock in Radio Corporation of America (RCA) rose by almost 50 percent in a single month. Even Wall Street's shoeshine boys were passing on tips to their broker customers. In August a brokerage firm announced a new service for those heading to Europe on ocean liners: on-board trading during the weeklong crossing.

Layton, responding to Norman's summons, quickly made his way to the bank's headquarters at Threadneedle Street, the epicenter of the city, as London's financial quarter is known. Surrounded by a high wall, covering most of a city block, the bank's headquarters were meant to impress, even to intimidate. Behind the giant bronze door lay a complex of courtyards, banking halls, and a garden with a fountain, a veritable Alhambra of money, crowded with clerks and underlings who were bustling along its corridors. Even the terminology was regal: the bank was ruled over not by a board, but by a "court."

Layton was ushered into Norman's office where he sat at a mahogany table in the center of the wood-paneled room. Norman wanted to talk about a new bank, to be called the Bank for International Settlements. The BIS was being set up in connection with the Young Plan, the latest and hopefully final program for implementing German reparations payments for the First World War. But Norman had much more ambitious ideas. The BIS would be the world's first international financial institution. It would be a meeting place for central bankers. Away from the demands of politicians and the prying eyes of nosy journalists, the bankers would bring some much needed order and coordination to the world financial system. But for the BIS to succeed and properly fulfill its potential, Norman explained, he needed Layton's help. A subcommittee would soon meet in Baden-Baden, in Germany, to draw up the bank's statutes. The editor of *The Economist*, Norman said, was just the man to draft the BIS's constitution, one that must, above all, guarantee the bank's independence from politicians.

TO UNDERSTAND HOW and why the BIS wields such influence today, it is necessary to step back to the early 1920s and the arguments about German reparations payments for the First World War. German war guilt was enshrined in the 1919 Treaty of Versailles. But no amount of money could bring back the dead, whose numbers were almost incomprehensible. In July 1916, on the first day of the Battle of the Somme, Britain lost 60,000 men—the equivalent of a medium-sized town, mown down in a few hours. France lost a total of 1.4 million soldiers during the four years of fighting, and Germany lost 2 million. The United States, which did not enter the conflict until 1917, lost 117,000 men.

Reaching agreement on German reparations was a slow, complicated, and politically fraught task. The First World War had internationalized conflict to an unprecedented degree. Its financial fallout was similarly globalized. The war had exacted a terrible cost on Europe's economies, as well as its populations. The fledgling international financial system was ill-designed to deal with the complex demands that were now being placed on it. Where would Germany find the money to pay? What would be the mechanisms by which it would do so? Who would oversee and regulate the reparations payments? These arcane discussions shaped the role, structure, and privileged legal status of the BIS.

In 1919—just as there would be in 1945—there were, broadly, two schools of thought: the punishers and the rebuilders. France led the punishers. "Les Boches," said the French, must, and will, pay for their crimes, many of which were carried out on French soil. Norman and the rebuilders, who included most of Wall Street, believed otherwise. Europe could be reconstructed, but its future lay in trade and financial cooperation. The aim was not to reduce Germany to penury, but to help it fix its economy and start trading again as soon as possible.

In April 1921 the Reparations Commission announced that Germany would pay a total of 132 billion gold marks ($31.5 billion), payable at 2 billion marks a year. The commission might as well have demanded ten times as much. Germany was still reeling from its defeat, society was collapsing, unemployment soared, and there were severe shortages of food. Right-wing extremists—the Freikorps—battled Marxist militants in the streets. Workers' councils took control of Hamburg, Bremen, Leipzig, and central Berlin. This was not the salon Marxism of Greenwich Village or San Francisco, but the real thing—raw and bloody. Hostages were taken, factories were seized, and prisoners were lined up against walls

and shot.

Karl Marx's predictions about the inevitable destruction of capitalism seemed to be becoming truer by the hour—especially in his homeland. The bankers' fears that Germany was about to follow Russia into Communism seemed entirely justified. Hyperinflation set in as the government printed money to keep the economy functioning. Shoppers used wheelbarrows to move the bundles of notes needed to buy basic staples. The chaos had to be stopped. On November 13, 1923, five days after Adolf Hitler's failed Beer Hall Putsch in Munich, a tall, imperious German started work as Reich currency commissioner. Hjalmar Schacht demanded, and got, near-dictatorial powers. Working out of a former janitor's closet, he set to work on stabilizing the value of Germany's new currency, the rentenmark. Currencies were usually backed by gold, but the rentenmark was backed by the value of Germany's land and holdings since there was no gold available to back the new currency. This was a somewhat hazy idea—how could the bearer of a rentenmark redeem his money? Would he be given a small piece of a field?

This concern did not matter. As long as Schacht was in office, nobody would want to redeem a rentenmark. He brilliantly understood the key point of the psychology of money, which is as valid today as it was in the hyperinflation of the 1920s: *the appearance of financial stability creates monetary value*. If people believed that someone was in charge, that the chaos would end, and that the rentenmark had value, then it would be valued. The first notes were printed on November 15, 1923. One rentenmark could be exchanged for one trillion old marks (1,000,000,000,000). One U.S. dollar cost 4.2 rentenmarks, a return to the pre-WWI exchange rate. The aim, Schacht said, was to "make German money scarce and valuable." Other than the logistics of printing and distributing the bank notes and convincing Schacht's foreign colleagues that order had been returned to the German economy, there was not that much more to it.

When German reporters asked Clara Steffeck, Schacht's secretary, what he did all day, she replied,

> *What did he do? He sat in his dark room, which smelled of old cleaning rags, and he smoked. Did he read letters? No. And he dictated no letters. But he phoned a lot all over the world, about domestic and foreign currency. Then he smoked some more. We didn't eat much. He usually left late and took public transportation to go home. That was all.*[4]

Not quite "all." Taxes were raised, and four hundred thousand German public employees were sacked. But the rentenmark successfully stopped the German inflation so well that on December 22, 1923, Schacht was promoted to be president of the Reichsbank, while retaining his position as currency commissioner. He could now attend cabinet meetings. "Within a few weeks," notes John Weitz, Schacht's biographer, "he had virtually become Germany's economic dictator."[5]

Schacht certainly looked the part of a strict Prussian banker: his hair was parted precisely down the middle, and his moustache flared briefly under his nose before stopping at a determined mouth. His eyes stared out suspiciously through a pair of pince-nez. He walked with a rigid, almost military manner and wore shirts with high celluloid collars. In fact he was not Prussian at all but was born in North Schleswig, in a land perennially shunted back and forth between Germany and Denmark. Whoever ruled the province, its inhabitants were a stubborn, hardy people. They adapted easily to their alternating masters but retained their tenacity and independence—qualities that would serve Schacht well. His grandfather, Wilhelm, was a country doctor who raised twelve children and charged every patient, rich or poor, sixty Pfennigs. Schacht's father, also called Wilhelm, was a schoolteacher who immigrated to the United States. He worked in a German brewery in Brooklyn and became a naturalized citizen. Hjalmar's mother was a feisty noblewoman, Baroness Constanze von Eggers.

The Schachts settled in New York City, but they did not prosper, and Wilhelm brought his family back to Europe. In 1876 they moved to Tinglev, now in Denmark, and the following year their second son was born. At first they wanted to name him in honor of Horace Greeley, an influential New York journalist and politician who campaigned against the slave trade. The baroness was proud of her radical views—her father had worked to abolish serfdom in Denmark. The infant's grandmother argued that the boy should at least have a proper Danish name first, so the family compromised on Hjalmar Horace Greeley Schacht.

The family was constantly on the move. They lived for a while in Hamburg and then relocated to Berlin. Hjalmar proved to be a diligent student. He enrolled at Kiel University and studied political economy. He worked as a journalist, tried public relations, and then joined the Dresdner Bank. His diligence, attention to detail, and austere manner helped ensure he was soon noticed. Schacht traveled to the United States with other bank officials. They met President Franklin Roosevelt and were invited to lunch in the partners' dining room at J. P. Morgan. Schacht's understanding of the world outside Germany, and his fluent English, proved invaluable. He was promoted to be deputy director of Dresdner Bank and joined the board of the Reichsbank.

So in 1923, with the rentenmark established, the next step was to build a gold reserve to give the new currency real backing. This is why, on the evening of December 31, the Reichsbank president stepped off the train at Liverpool Street station in central London. To Schacht's surprise and delight, he was met on the platform by Montagu Norman himself. "I do hope we shall become friends," said Norman, with a shy smile. Schacht told Norman that he wanted the Bank of England to lend $25 million to a new subsidiary of the Reichsbank, the Gold Discount Bank. The new bank would instantly alter global perceptions of the country's financial prospects. The imprimatur of the governor of the Bank of England would open doors throughout Wall Street and the City of London.

Tenacious as ever, Schacht got his money.

SCHACHT HAD SWEET-TALKED Norman, but the reparations question remained unresolved. America was tired of squabbling Europeans who could not get their houses in order and also recognized that there could be no lasting prosperity while Europe lurched from one financial crisis to another. A new reparations committee was set up under the chairmanship of Charles Dawes, an irascible American banker. The Dawes Committee met in Paris in January 1924. Owen D. Young, the president and chairman of the General Electric Company and the RCA, accompanied Dawes. Young was a consummate diplomat and needed to be. His job was to persuade France to ease the terms of the reparations schedule, which was destroying the German economy, and thus preventing a European recovery, and then to persuade Germany to accept much more stringent external control of its finances.

The Dawes Committee issued its recommendations on April 9. Germany's payments would be reduced for a while, and would increase later, after the economy had stabilized. That stabilization would be based in part on a loan of 800 million gold marks, to be floated on the international market. The German government would hold the funds in marks, which would then paid into an escrow account at the Reichsbank. This account would be controlled by a foreign official known as the agent-general, who could decide how the monies would be used and when they would be released—so as not to flood the markets and affect the value of the Reichsmark. The Reichsbank was placed under the control of a fourteen-man board of seven foreigners and seven Germans.

American companies rushed to invest in Germany. The Great War had triggered an economic boom in the United States. Unlike Europe, mainland America had been spared war damage. Its factories and farms and its mines and industrial plants were all untouched and operating at full capacity. The Dawes Plan loan

was floated in New York and London in October and was quickly oversubscribed. American banks soon clamored to finance the companies now investing in the Germany economy.

Between 1924 and 1928, Germany borrowed $600 million a year, half of which was provided by American banks. Much of it swiftly returned from whence it had come. Like modern bailouts, the money swirled back and forth, raising and lowering balance sheets, boosting confidence and keeping the markets happy. As John Maynard Keynes wrote, "The United States lends money to Germany, Germany transfers its equivalent to the Allies, the Allies pay it back to the United States Government. Nothing real passes—no one is a penny the worse. The engravers' dies, the printers' forms are busier. But no one eats less, no one works more."[6] Some, like Schacht, believed that no one was a penny the better—and he was right. The vast sums were merely a financial adhesive strip. And in October 1929, when Wall Street crashed, American investors frantically pulled out of their German investments in droves.

Once again, Germany faced economic disaster. But if Weimar Germany defaulted, the global economy might crash. It was clear that the reparations issue had to be settled. Even Seymour Parker Gilbert, the agent-general in charge of implementing the Dawes Plan, argued that the country needed to take control of its financial destiny. Gilbert was not popular. In 1928 German nationalists staged his mock coronation. Ten thousand people watched his effigy crowned "the new German Kaiser who rules with a top hat for a crown and a coupon clipper for scepter."[7]

The answer to the never-ending German reparations question was, of course, another conference. This one was named after its chairman, Owen Young. The delegations arrived in Paris in February 1929 in the coldest winter for nearly a century. The gap between France and Germany over Germany's reparations bill was as cavernous as ever. Schacht made his opening offer: $250 million a year for the next thirty-seven years. Emil Moreau, the equally stubborn governor of the Bank of France, demanded $600 million a year for sixty-two years. Perhaps even that might not be enough, he informed Young. France might yet settle for nothing less than $1 billion.

Moreau refused to budge, and so did Schacht. Any initial optimism soon soured. The Germans were unnerved by the French secret police, who were tapping the German telephones. Schacht and his colleagues communicated with Berlin in coded telegrams. He traveled back every fortnight to consult with the government. Lord Revelstoke, the second in command of the British delegation, wrote in his diary that Schacht had resumed "his most negative attitude" was "unhelpful to the last degree." With his "hatchet, Teuton face and burly neck and badly fitting collar," he resembled "a sea-lion at the zoo."[8]

Whatever sum was finally agreed upon, there was at least some consensus that a new bank would be needed to manage Germany's reparations. Schacht and Norman argued that the new bank would keep the issue free of politics and manage it on a purely financial basis. This was unlikely, as there were no more politically charged issues than reparations, but it showed how the two governors both saw the benefit of a bank free of political constraints. Years later, Schacht titled his autobiography *The Old Wizard*. He certainly cast his spell over Owen Young. Germany was paying its reparations by borrowing from other countries, Schacht explained to the conference chairman. Such a system was no longer feasible. If the Allies really wanted Germany to be able to pay its obligations, the country needed to become productive again. Instead of lending to Germany, the Allies should lend to underdeveloped countries so they could buy their industrial equipment from Germany.

Young asked how such a plan could be put into practice. Schacht had a ready answer: by setting up a bank. "A bank of this kind," argued Schacht, "will demand financial cooperation between vanquished and victors that will lead to community of interests, which in turn will give rise to mutual confidence and understanding and thus promote and ensure peace." Schacht recalled the setting in his memoirs:

Owen Young, seated in his armchair, puffing away at his pipe, his legs outstretched, his great keen eyes fixed unswervingly on me. As is my habit when propounding such arguments, I was doing a quiet and steady "quarter deck" up and down the room. When I had finished there was a brief pause. Then his whole face lighted up and his resolve found utterance in words: "Dr. Schacht, you gave me a wonderful idea and I am going to sell it to the world."[9]

The Allies then presented their proposal: Germany would pay $525 million a year for thirty-seven years and $400 million a year for the following twenty-one years.

Schacht would have none of it. He proclaimed that to meet these terms Germany must take possession again of all its former colonies, most of which were in Africa. He also demanded the return of the Danzig corridor, which linked Poland to the Baltic Sea, which would tear up the postwar peace treaty. When Moreau heard this he slammed the table with his fist and hurled his ink blotter across the room. A cartoon in a French newspaper summed up the local mood. It showed Moreau asking Schacht, "All right, Excellency, how much do we owe you?"

On April 19, 1929, Lord Revelstoke suddenly died. The Young Conference was adjourned. All sides finally reached agreement on June 7. Germany would pay almost $29 billion, over fifty-eight years. Control of German economic policy was returned to Berlin. A new bank would administer the payments. Schacht wrote of its birth: "In the meantime my idea of a Bank for International Settlements had met with such enthusiastic response from all those taking part in the Young Conference that soon there was not one among them who would not have liked to claim the suggestion as his own."[10] As the delegates signed the final version, the curtains in the meeting hall caught fire.

The Young Plan was accepted in principle at the First Hague Conference, and seven committees were set up to work out the technical details. At Schacht's suggestion, the seventh, the Organization Committee, gathered in Baden-Baden. This was the most important committee, and it was responsible for drafting the statutes of the new bank and its relations with the host country, which would regulate its legal status. The delegates argued about governance, the role of the directors and managers, and even the official language of the new bank's statutes. It was eventually agreed that both the French and English texts would be authentic. The bank would hold central banks' gold and convertible currency deposits. These deposits could be used to settle international payments without having to either physically move the gold between banks or trade the currency through foreign exchange markets. The BIS would be an international clearinghouse for central banks, the world's first. And with the broad outline settled, the next question was where the new bank should be located. Montagu Norman and the British government pushed for London. France objected, on principle, and argued that the new bank should be located in a small country. There was some talk of Amsterdam, and finally the delegates settled on Basel, Switzerland, which was conveniently located on several international railway lines and on the borders of France and Germany.

MEANWHILE IN LONDON, Walter Layton, the editor of *The Economist*, was still grappling with the new bank's constitution. The key point, as Layton recalled, was to "work out some form of words that would place the bank beyond the reach of governments." Layton "struggled hopelessly" and then told Norman that he had failed.

"Why do you insist it can't be done?" Norman demanded, annoyed.

"Because it's the right of every democratic government to reserve its freedom of action," Layton replied—an argument that would resonate through the decades.[11] Layton admitted defeat. The constitution was eventually drafted by one of the many committees set up to establish the BIS. But Norman was

victorious: the bank's statutes, still extant today, enshrined its absolute independence from interfering politicians and governments. As for Schacht, chastened and unhappy about the reparations demands of the Young Plan, he traveled to the spa of Marienbad, in Czechoslovakia, to spend time with his wife, Luise. Narrowminded, rigid, and intensely Prussian (as he later described her), Luise met him at the train station. She shouted, "You should never have signed."

But Schacht, and Montagu Norman, had their bank.

> *"The hangover of secrecy was, indeed, so strong that the attendants would not permit a look into that sacred room even after all the directors had left."*
>
> — Clarence K. Streit, on the BIS boardroom after the directors' meeting, writing in the *New York Times Magazine*, July 1930

In September 1930, a few months after the BIS opened for business, an American lawyer named Allen Dulles sat down in his office at 37 Rue Cambon, in Paris, to write a letter to Leon Fraser. Fraser, a fellow American, was also a lawyer. A former reporter for the *New York World* newspaper, Fraser had served as general counsel for the execution of the Dawes Plan and had taken part in the negotiations at Baden-Baden on the structure of the BIS. Fraser was now a board member of the BIS and the bank's alternating president.

Dulles was confident that his request, which was simple enough, would be granted. After all, he was a scion of one of the most powerful families in the United States. His uncle, Robert Lansing, had served as secretary of state, as had his grandfather, John W. Foster. Born in 1893, in Watertown, New York, Dulles had graduated from Princeton University and joined the US Foreign Service. He was posted to Vienna, Austria, until the United States entered the war in 1917, when he moved to Bern, Switzerland, to work as a junior intelligence officer at the US Legation. Neutral Switzerland, home to squabbling émigrés, businessmen, and revolutionaries, provided a bountiful harvest of information. "It is almost impossible to stop for any length of time in Switzerland," Dulles wrote, "without coming into contact with questionable characters. Bern is just full of agents and representatives of all nationalities."[1]

Dulles relished the world of shadows. Even as a precocious schoolboy, he had shown an insatiable appetite for intrigue and geopolitics. He wrote his first book at the age of seven. *The Boer War* was short treatise on how the Boers, the Dutch settlers, had first claim on southern Africa, as they had arrived there before their British overlords. (Montagu Norman, who fought in the Second Boer War, at the start of the twentieth century, might have disagreed.) Seven hundred copies were privately printed and sold at fifty cents each, with the proceeds being donated to a Boer charity.

But the future director of the CIA did not always know how to assess a potential source. He later loved to recount the story of how one day in April 1917 the telephone rang at the US Legation in Bern. Dulles took the call. A Russian émigré leader urgently wanted to meet with an American diplomat. Dulles refused, as he wanted to play tennis instead. The next day the man who had telephoned left Switzerland on a sealed train for the Finland Station—a railway station in St. Petersburg, Russia. The city would later be renamed Leningrad in his honor. From Bern, Dulles was dispatched to Paris, as part of the US team at the 1919 Paris Peace Conference. Officially, he was included as a member of the commission drawing up the boundary of the new state of Czechoslovakia. In fact, Dulles was running the American diplomatic intelligence operation for central Europe and courting and monitoring its émigrés, exiles, and revolutionaries.

By 1930, when Dulles wrote to Leon Fraser, Dulles had left the Foreign Service. He and his brother, John Foster Dulles, became partners at Sullivan & Cromwell—the most powerful law firm in the United States, if not the world—headquartered at 48 Wall Street, in New York. Allen Dulles ran Sullivan & Cromwell's office in Paris and knew Hjalmar Schacht well. In Paris in 1919, Dulles had learned about

diplomacy. And in Paris in 1930, he would learn about the world of high finance and the BIS. Dulles, wrote biographer Peter Grose, was "plunged into a realm where sovereign frontiers were transparent and the trappings of democracies seldom allowed to penetrate. Like beguiled readers of Eric Ambler or Graham Greene, Allen discovered that only a thin line divided respectable high finance from a shadowy underworld."[2]

While Montagu Norman and Hjalmar Schacht had exploited the chaos around the German reparations question to finesse the world's leading powers into creating the BIS, the Dulles brothers used Europe's disorder to broker deals and monetary instruments to refinance Germany that were so complex that few outside their offices at Sullivan & Cromwell could understand them.

Much of this web was connected to the BIS, via the Dulles brothers and their friends on Wall Street and in London and Germany. New York banks had led the way during the 1920s in raising money for Germany, and the City of London had also provided significant funds. Foremost among the British banks was J. Henry Schröder, the London operation of the well-established German banking firm of the same name that was based in Hamburg. Schröder, in London, set up a trust to invest in numerous German firms, including IG Farben, Siemens, and Deutsche Bank. Frank Tiarks, who was a partner in the London branch of Schröder, set up a subsidiary in New York, called Schrobanco. It opened for business in October 1923 and was an instant success. The president of Schrobanco was an American banker named Prentiss Gray, who was a close friend of John Foster Dulles's, whom Gray had met at the Paris Peace Conference. Schröder's historic German connections and contacts made that country a natural focus of Schrobanco's. The company quickly became one of the leading agents for doing business in Germany and later, for processing loans under the Dawes and Young reparations plans. Among Schrobanco's shareholders were a number of German, Swiss, and Austrian private banks, which included, naturally, the Hamburg branch of J. Henry Schröder, as well as a bank called J. H. Stein of Cologne. One of J. H. Stein's partners, who was a scion of the Schröder dynasty, would later join the board of the BIS and use J. H. Stein to funnel money from German industrialists to Heinrich Himmler's personal slush fund.

Frank Tiarks was a director of the Bank of England and a close colleague of Montagu Norman. Tiarks had his eye on an American financier named Gates McGarrah, whom Tiarks wanted to recruit to the board of Schrobanco. McGarrah, whom Tiarks described as "one of the most important American bankers," was a director of the Federal Reserve Bank of New York. He also had excellent connections in Germany—he had represented the United States at the Reichsbank when it was held under international control. McGarrah stayed on the Schrobanco board until 1927 when he returned to the Federal Reserve Bank of New York as chairman. He stayed there until 1930—when he was appointed the first president of the BIS. As for Schrobanco, its complicated German investments were in good hands: the bank's lawyer was Allen Dulles. The links were so close that in 1929 Schrobanco moved into spacious new offices at 48 Wall Street—the same building that housed Sullivan & Cromwell.

ALLEN DULLES HAD a simple request for Leon Fraser that autumn of 1930. His sister, Eleanor Lansing Dulles, had received a scholarship from Harvard University to write a book about the BIS. Eleanor Dulles was a well-regarded academic and currency expert, who had previously written a book about the French franc. Allen Dulles wrote, "Anything you can do for her would be greatly appreciated, and I can assure you she is a very discreet person."[3] Like her brothers, Eleanor Dulles also had easy access to the world's most powerful bankers and financiers.

Allen Dulles's letter was not the first Fraser had received that asked him to assist Eleanor. Owen Young had written in May of that year. And Gates McGarrah, the BIS president, was also getting letters about Eleanor Dulles. Paul Warburg, the eminent banker, had written to McGarrah from the headquarters

of M. M. Warburg at 40 Wall Street, in New York. Warburg explained that Eleanor was a "sister of my good friend John Foster Dulles, whose name is well known to you as a writer on international questions and whom you undoubtedly know personally."[4]

Jackson Reynolds, president of the First National Bank of New York, who had chaired the BIS Organization Committee in Baden-Baden, wrote to McGarrah from 2 Wall Street. He asked McGarrah to assist Miss Dulles—especially as she was the sister of Reynolds' friend, John Foster Dulles.

There were few, if any, people in the United States then with a more powerful and influential set of friends than John Foster Dulles, who served as legal counsel to the US delegation at the Paris Peace Conference, where he had specialized in German war reparations. His time in Paris gave him a privileged insight into the workings of international finance and diplomacy and a network of coveted contacts. Dulles's client list during the 1920s read like a who's who of American finance: J. P. Morgan; Kuhn, Loeb & Co.; Harris, Forbes & Co.; Brown Brothers; W. A. Harriman; and Goldman Sachs. Dulles arranged tens of millions of dollars' worth of loans to clients, including to the cities of Munich, Frankfurt, Nuremberg, Berlin, and Hanover, and to the Union of German Mortgage Banks, the Berlin City Electric Company, Hamburg Street Railways, and the State of Prussia. Dulles also worked on the Dawes Plan German Loan in 1924 and the German Government International Loan of 1930 that had been instigated by the Young Committee.[5]

Wall Street in the 1920s was possessed by a near-mania to lend to Germany. In 1923 American banks and finance houses sent abroad $458 million in long-term capital. By 1928 that sum had risen to $1.6 billion. The German credit bubble reached ludicrous extremes. A small village in Bavaria, which needed around $125,000, was persuaded to borrow $3 million.[6] But the real significance of this flow of capital was not just financial. The bonds between the American bankers, businessmen, and industrialists, and their German counterparts, would prove far more durable than the doomed Weimar Republic, and even the Third Reich. With the BIS as the central point of contact, these links would endure during the Second World War and reshape Europe after 1945.

Allen Dulles returned to Bern during the Second World War, as a far more experienced, powerful, and influential spymaster, harvesting much information through his assets at the BIS. John Foster Dulles went on to become US Secretary of State for the Eisenhower administration during the 1950s at the height of the Cold War. The Dulles brothers would help ensure that Nazi bankers, businessmen, and industrialists—many of whom should have been tried for war crimes—were seamlessly integrated back into powerful positions in the new Federal Republic of Germany.

FOR HJALMAR SCHACHT and Montagu Norman, January 20, 1930, was a date to savor: they had created a bank beyond the reach of either national or international law. On that date the governments of the United Kingdom, France, Germany, Belgium, Italy, Japan, and Switzerland signed an extraordinary document. The Hague Convention guaranteed that the BIS would be the world's most privileged and legally protected bank. Its statutes, which remain in force to this day, essentially make the BIS untouchable. Article 10 of the BIS Constituent Charter noted,

> *The Bank, its property and assets and all deposits and other funds entrusted to it shall be immune in time of peace and in time of war from any measure such as expropriation, requisition, seizure, confiscation, prohibition or restriction of gold or currency export or import, and any other similar measures.*

The BIS enjoys the legal privileges of an international organization, but, arguably, it is not one as usually understood by the term. It is a highly profitable bank that is accountable to, and controlled by, its members: central banks. Under the cover of the Young Plan, as well as the need for an impartial financial institution to administer German reparation payments, Norman, Schacht, and the central bankers had by brilliant sleight of hand created a bank with unprecedented powers and privileges. As Gianni Toniolo, the official historian of the BIS, notes,

> *It was no accident that, although the settlement of the reparations problems had been the immediate cause for setting up the BIS, the bank's statutes defined its actual purpose much more broadly:*
>
> *To promote the co-operation of central banks and to provide additional facilities for international financial operations; and to act as trustee or agent in regard to international financial settlements entrusted to it under agreements with the parties concerned.*[7]

In February 1930, the governors of the central banks of Britain, France, Italy, Germany, and Belgium gathered with representatives from Japan and three American banks to sign the BIS's instrument of foundation. As the Federal Reserve Bank of New York was not permitted to own shares, for political reasons, a consortium was formed—J. P. Morgan, the First National Bank of New York, and the First National Bank of Chicago—to represent the United States. The BIS formally came into existence on February 27, 1930. The bank's initial share capital was set at 500 million Swiss francs, which was divided into 200,000 shares of 2,500 gold francs. The governors of the founding central banks were ex officio members of the board of directors. Each could appoint a second director of the same nationality. The second director did not have be a central banker. He could be drawn from finance, industry, or commerce—a provision that would later prove crucial in ensuring Nazi influence over the BIS.

The BIS was incorporated under Swiss law. Its authorized activities included the following:

- buying, selling and holding gold for its own account or for central banks
- buying and selling securities other than shares
- accepting deposits from central banks
- opening and maintaining deposit accounts with central banks
- acting as an agent of or correspondent for central banks
- entering agreements to act as a trustee or agent in connection with international settlements

There were some restrictions that were intended to prevent the BIS from becoming a competitor of commercial banks. The bank could not issue banknotes, open accounts for individuals or commercial organizations, own property other than its headquarters or offices, or have a controlling interest in a business. (The immunities granted under international treaty for reparations settlements did not apply to all of its banking operations to ensure that it maintained the confidence of the international markets.)

Even better, although the BIS was protected by international treaty, unlike the League of Nations, it was not dependent on budgetary contributions from its members. It enjoyed a guaranteed revenue stream from the reparations payments that it would manage under the Young Plan, as well as from the highly profitable services it would carry out for its clients, the central banks. In the final analysis, notes Toniolo, the BIS, "although founded by an international treaty sanctioned by national governments, was very much tailored to the views and requirements of the national banks."[8] The key provisions of the bank's statutes

were given "protected" status and so could only be changed with the consent of all signatories to the Hague Convention.

The BIS was quickly inundated with job applications, even though it was located in humdrum Basel. Its comparatively modest headquarters at the Grand Hôtel et Savoy Hôtel Univers, next door to Basel main railway station at least offered convenient direct connections to Paris, Vienna, Milan, and Geneva. An article in the *New York Times Magazine*, headlined "The Cashless Bank that Deals in Millions," reported,

> *There is only one bank in Basel that does not look like a million dollars. It is the super-bank. Indeed, it is doubtful if there is anywhere a bank that looks less like a bank than does the Bank for International Settlements. . . . There is no "Bank for International Settlements" stretching in big solid letters across its façade. There is no ostentatiously small bronze plaque at the door. There is nothing at all to reveal its identity to the passer-by.*[9]

Nor did the building sound like a bank. There were no counters where banknotes rustled, no adding machines, nor even the sound of a pen scratching on a ledger. The monies did not physically move through the BIS. When Germany made a reparations payment, it informed the BIS that the Reichsbank had credited the BIS's account in Berlin. The BIS then informed the national banks of those countries receiving reparations, such as, for example, Britain, that the monies were available to draw on, if they so wished. If they did not, in case the movement of substantial sums might affect exchange rates, the funds remained in the BIS's account. In the meantime, the BIS used the funds earmarked for Britain to buy securities—which it could sell if and when Britain wanted to draw its monies.

That was the theory. The practice, at least at first, was not quite so smooth. In February 1931, Gates McGarrah, the bank's American president, wrote to H. C. F. Finlayson, in Athens, asking about the Bank of Greece's gold. Finlayson, a former British financial attaché in Berlin, was now an adviser to the Bank of Greece. Some of the Greek bank's gold may have gone missing. Rather like nowadays, it seemed the accounting at the Bank of Greece left something to be desired. "What has ever happened to the gold of the Bank of Greece, some of which you thought might be left in our custody in Paris or elsewhere?" inquired McGarrah, who, as the president of the BIS might have been expected to know what it held and where.[10] It might, McGarrah suggested, be a good time to find the Greek gold and place it with the BIS.

The BIS, wrote McGarrah, could give the Bank of Greece "all sorts of facilities, rather greater than those of a local Central Bank."[11] For example, if the Bank of Greece held gold at the Bank of France and wanted to buy another currency, it first had to buy francs from the Bank of France. The Bank of Greece then converted the francs to the second currency, with all the usual losses of exchange rates and commissions. However, if the Bank of Greece held gold at the Bank of France in the name of the BIS, the BIS could "give the Bank of Greece any currency it desires at any time and can fix an agreed rate without going through the actual exchange operation."[12] And, the BIS did not charge any commission.

Thirteen thousand people applied for jobs at the BIS, and by the end of 1930 ninety-five people worked there. However, few were bankers—many were lawyers or economists who had previously been employed at international organizations such as the League of Nations or the Dawes Plan Agent General's office. Salaries were comparatively high: the president received $36,000 plus $14,000 entertainment allowance. Heads of department were paid between $15,000 and $20,000 a year, all tax free. (The average American salary in 1930 was about $2,000 a year.) The management reflected the balance of nationalities: the general manager, Pierre Quesnay, was French and a former member of the Young

Committee. His German deputy, Ernst Hülse, had worked for the Reichsbank.

But not everyone was happy. Hjalmar Schacht, who loved to refer to the BIS as "my bank," continued to rage over the scale of reparations under the Young Plan. In December 1929 he wrote to J. P. Morgan that he would not take up his directorship at the BIS. The following March, Schacht resigned from the Reichsbank. Hans Luther, a former minister of finance and former German Chancellor, replaced him. Schacht returned to his old métier: public relations. That autumn he went on a lecture tour across Europe and the United States. He passed the time during the journey across the Atlantic by reading Adolf Hitler's *Mein Kampf*. The style was crude and hectoring, he believed, but the author displayed a "keen brain."[13] Wherever Schacht spoke, he gave the same address: fulminating against the Young Plan, the Versailles Treaty, and reparations. He even appeared with John Foster Dulles at a dinner hosted by the Foreign Policy Association at the Astor Hotel in New York. Dulles played down the German elections in September 1930 in which the Nazis won 107 seats, making them the second largest party. The "difficulties" claimed Dulles, "are of a character which are largely psychological and consequently subject to ready reversal."[14]

Dulles's prediction was widely shared by his fellow financiers, especially those in Germany. Hans Luther, the new Reichsbank president, was especially keen to reassure his American colleagues that the surge in Nazi support would not disrupt the smooth flow of international finance. On September 22, eight days after the German election, Gates McGarrah, the BIS president, wrote to his friend and former colleague at the New York Federal Reserve, George Harrison, who was now its president:

> *We have the strongest assurances from Dr. Luther that we need not be disturbed about the result of the election. . . . The German people are not revolutionary and in our opinion anything beyond occasional street brawls will be summarily dealt with.*[15]

Not everyone shared McGarrah's faith. Investors rushed to sell Reichmarks. Paradoxically, the political and financial uncertainty was good for the BIS, giving the new bank an early opportunity to intervene in the money markets. The bank launched a rescue operation for the German currency. The next day, on September 23, McGarrah sent a telegram to Harrison: "Confidentially we intervened today on several markets to the tune of £300,000 with very helpful psychological effect, including cessation of offer of marks."[16] But in thinking that the reparations issue would settle down in Germany under the BIS's influence, Luther and McGarrah were wrong. The Young Plan, like German democracy, was a terminal case.

ON MAY 19, 1931, McGarrah presented the BIS's first annual report to the first general meeting. He noted that the bank had assisted with international financial operations and capital movement, where the "opportunities for constructive service are almost boundless,"[17] then he turned to the numbers. Profit making, noted McGarrah demurely, had "never been a primary object" of the BIS—which surely made him a banker unique in history. But he was pleased to report that thrifty investing during the bank's first ten and half months of existence had brought net profits of 11,186,521.97 Swiss francs. He noted that shareholders had increased from the original seven to twenty-three, including the national banks of Greece, Romania, Hungary, Latvia, Lithuania and Estonia, Sweden, and Czechoslovakia. The small, new European countries such as Czechoslovakia—a fragile construct carved out of the remains of the Austro-Hungarian empire—doubtless hoped that a stake in the BIS would bring stability, credibility, an improved standing in the sinternational community, and even a measure of defense against predatory neighbors. It

would prove to be a faint hope.

But for now the bankers were celebrating. Norman and Schacht had invented a perpetual money machine.

"The post of Head of Section in the BIS is for Germany's foreign policy definitely as important as the posting of many ambassadors accredited with foreign governments."

— Karl Blessing, Reichsbank official, 1930[1]

Schacht's colleagues in Berlin had a very particular view of the role of the BIS—one quite different to that which the Allies had envisaged when signing the Hague Convention. The bank set up to administer reparations was to be used to wreck them. Karl Blessing, a protégé of Schacht, wrote a lengthy memorandum in April 1930, setting out policy on the BIS. "Opinion on how the Reichsbank should conduct itself in the BIS" called for Germany to gain as much influence at the BIS as possible. German employees of the bank, Blessing wrote, should make sure that "no important business decisions are made without a German representative having knowledge of them or having had an opportunity to express their opinion."[2] Blessing recognized the bank's importance for Germany's national interest. He called for Germany to fill its posts in the bank with the most able and perceptive individuals.

All BIS member states wanted to protect their national interests in the new international forum. But Blessing understood what many bankers did not: that while the BIS might portray itself as neutral, objective, and technocratic, the bank was an inherently political institution, dealing with one of the most contested and bitter issues in politics—German war guilt and reparations. Blessing wrote, "The fact that the reparation question has been delegated to a banking institution naturally turns this bank into a political institution, even if this is officially denied."[3]

France and Britain might believe that the establishment of the bank settled the reparations issue, but Blessing understood that the existence of the BIS actually offered a forum to open up the issue once again. Blessing's savvy ruthlessness was in sharp contrast to Montagu Norman's notion of a cozy club. The Reichsbank, Blessing argued, should certainly cooperate with the BIS in its new role as the bank for central banks. As a trading nation that relied on exports, Germany could only benefit from an improved international economy. Reparations, however, were an entirely different matter.

Blessing called for German officials to undermine the new bank by making impossible demands that would sour the atmosphere and weaken its credibility. He demanded a sophisticated form of psychological warfare against the BIS. German officials there must "time and again refer to the completely utopian objectives of the bank." German bankers should repeatedly ask the BIS to guarantee export credits for high-risk ventures, even when it was clear that the credits would never be granted. The aim was to "gradually create an atmosphere in the Bank in which the anti-reparation bacillus finds fertile ground."[4] If the bank began to lose legitimacy, then so surely would the Young Plan, which the bank was mandated to administer. In 1931 Blessing left the Reichsbank to take up a senior post at the BIS.

But even with Blessing on board, the BIS could not solve the German financial crisis. The elections in 1931, which saw the Nazis and Communists win one-third of the seats in the Reichstag, had made the country almost ungovernable. That political instability triggered capital flight, which caused a further rise in unemployment and a lack of confidence in both government and the banking system and led to further capital flight, higher unemployment, and more support for the Nazis and the Communists. The Weimar Republic had entered its death spiral.

In June 1931 Chancellor Heinrich Bruning declared that he doubted if Germany could meet the next payment due under the Young Plan. The situation was so grave President Herbert Hoover called for a moratorium on all war debts and reparations. It was agreed, for one year. The Bank of England, the Bank of France, the New York Federal Reserve, and the BIS agreed on an emergency loan to Germany of $100 million.

As Toniolo notes, the "newborn BIS was at the heart of the first experiment ever of a multilateral attempt at managing an international financial crisis."[5] It was not successful, but then it was never likely to be. Fixing the German debt crisis was a task far beyond the BIS, even if the BIS had been created expressly for the purpose of facilitating reparations.

In December 1931 the German minister of finance wrote to the BIS, saying that as Germany was suffering a "crisis without parallel" the bank must re-examine the whole question of reparations. The BIS set up a committee, headed by an Italian board member, Alberto Beneduce, to examine the matter. Carl Melchior, a prominent German Jewish banker and vice chairman of the BIS, represented Germany. Melchior had served as a captain in the German army in the First World War, in which he was badly wounded. A skilled diplomat and financier, Melchior had been a member of the German delegation at the Paris Peace Conference in 1919. He had represented Germany on the Young Committee and chaired the finance committee of the League of Nations. His tact and skills had helped Germany re-enter the community of nations. The Beneduce Committee's conclusions, published just before Christmas 1931, were a triumph for Berlin. All intergovernmental reparations and war debts must be "adjusted" to ensure peace and economic stability. "Adjustment" was a euphemism for abolition. Six months later, in 1932, European governments met in Lausanne to consider the Beneduce Committee's recommendations. They agreed to cancel German reparations, except for one final payment.

THE BIS PRESENTED itself as a new and modern institution, but central banks and war had been entwined through history. The Bank of England had been founded in 1694 in part to raise funds for King William III's war against France. The bank accepted deposits and issued personal notes against the funds, which could be redeemed for gold. Clerks added the customer's personal details to the document, the precursor of today's banknotes. A little more than a century later, in 1800, Napoleon Bonaparte founded the Bank of France. The emperor aimed to bring about stability and economic growth after the wars and revolutionary turmoil of the late eighteenth century. The Reichsbank was founded in 1876 in part to finance future German expansionism, after the Franco-Prussian war of 1870 had triggered a liquidity crisis. The German bankers had planned ahead. A law suspending gold convertibility of Reichsmarks in time of war was drafted in 1904.[6] By the summer of 1914, the approaching war had triggered a run on the Reichsbank reserves. In July the Reichsbank lost 103 million marks in a week. The bank suspended gold convertibility, which was an illegal act. Parliament passed an act retrospectively authorizing that decision four days later.[7]

Yet there was also an argument in favor of empowering the financial technocrats to get on with running the global economy, unbound by political considerations. It was the politicians and governments, some of them democratically elected—not the bankers—who had led the world to war and caused the deaths of millions. The bankers would finance their political masters' conflicts, as they were required to do, but they had no desire to order men to walk into a hail of bullets to gain an inch of mud-soaked field in Belgium. Rather, the central bankers shared similarly benign aims: stability, economic growth, and increased prosperity for all. The central bankers formed a global brotherhood, united by common bonds that transcended parochial national interests. In an era when nationalism had ripped apart the old European order, perhaps the bankers' transnationalism could bring peace. The BIS, had after all, been

specifically designed in the aftermath of war for that purpose. By managing Germany's reparation payments and acting as a trustee for the Dawes and Young loans that had allowed Germany to meet its international obligations, the bank should, theoretically, defuse the explosive German question.

The bankers' personal friendships could be deep and enduring. The bond between Norman and Schacht, for example, lasted for almost thirty years, until Norman died in 1950. It outlasted the hyperinflation of the early 1920s, the stock market crash of 1929, the collapse of the Weimar Republic, the rise and fall of the Third Reich, Schacht's trial at Nuremberg for war crimes, the disintegration of the British Empire, the onset of the Cold War, and the division of Germany. Such deep connections between powerful men were rare and potentially valuable.

Even the BIS's more nebulous mandate of central bank cooperation had its defenders. Economists and bankers had long argued that as the world economy became more sophisticated, and central banks became more powerful, there was a need for some kind of coordinating body to ensure financial stability. Julius Wolff, a professor at the University of Breslau, had proposed in 1892 that a new financial institution in a neutral country be set up to issue an international currency. The new unit would be backed by central banks' gold reserves and be used for emergency lending to countries in crisis. Luigi Luzatti, an Italian politician, wrote in 1907 in the Viennese newspaper *Neue Freie Presse* that central banks were waging an unnecessary "monetary war" by competing for gold supplies by raising interest rates and other devices. It would be far better, he posited, for banks to adopt a policy of "cordial cooperation" by supplying gold to those banks that needed it. He called for a new commission to coordinate "international monetary peace," since even when central banks did lend to each other, national interests colored those loans. Thus there was a need for a technical, apolitical institution to handle these transactions, a financial equivalent of the postal and telegraph unions. The BIS seemed to fit the bill.

The bank was also a creature of its time, of new multilateral institutions run by apolitical technocrats. The League of Nations, which was the forerunner of the United Nations, would defuse the world's political crises, while the BIS would ensure financial stability. Pierre Mendes-France, a French Socialist politician, wrote in July 1930, that the BIS, after administering the Young Plan, "will progressively increase its patch and little by little the experience will show the areas that it may approach safely."[8] Mendes-France, who served as prime minister in the 1950s, praised the BIS and the League as the potential harbingers of peace. "In the mists of the future, the mystical purpose of a union in financial order . . . under wise and prudent management," he wrote, "may become a potent aid for the preservation of world peace."[9]

The US government took a very different view. The BIS was born out of reparations negotiations chaired by two Americans, Charles Dawes and Owen Young. Its first presidents, Gates McGarrah and Leon Fraser, were American. But Henry Stimson, the secretary of state, proclaimed that the United States did not wish to "directly or indirectly participate in the collection of German reparations through the agency of a bank or otherwise."[10] The United States had never asked for reparations, thus it had no reason to participate in the BIS. It had not even joined the League of Nations, even though President Woodrow Wilson had practically invented the institution. The State Department's opposition to the BIS was so strong that George Harrison, the governor of the New York Federal Reserve, even avoided Basel when he traveled to Europe. Washington, DC, refused the BIS directorship offered to the Federal Reserve. The consortium of American banks—J. P. Morgan, the First National Bank of New York, and the First National Bank of Chicago—that had bought shares at the bank's founding took up the directorship instead.

Eleanor Lansing Dulles, however, was firmly in the internationalist camp. She published her book on the BIS in 1932, despite some difficulties when she was rumored to be an American spy and then lost her office and access to internal documents. McGarrah, the bank's president, wrote of his regret to John

Foster Dulles that the bank could not have been more open to her. "I am sorry not to have been able to be more useful to your sister, and we would have been glad to open everything up to her, including an office here, but . . . the work of this bank, like that of any other is in large measure confidential."[11]

Eleanor Dulles was by far the most attractive of the Dulles siblings. She was a feisty career woman with a sharp mind of her own in an age that did not welcome such women. Her personal life was marked by tragedy—a pronounced anti-Nazi, she fell in love with David Blondheim, a Jewish intellectual, and married him, to the dismay of her family. He later committed suicide. Eleanor Dulles went on to enjoy a stellar career in the US Foreign Service, specializing in Germany. In *The BIS at Work*, she described a smooth-running institution, a kind of financial League of Nations, where different nationalities worked in harmonious cooperation. The bank was a future model for the world and should have been granted stronger powers to prevent national interests asserting each themselves. "If the BIS is not given the power and the facilities to work at this problem the result will be the emergence of financial rivalries," she warned.

> *One central bank after another will gain a predominating influence and as this central bank is threatened from time to time by rival financial influence, the stability of the economic system will be strained to the breaking point again as it has been in 1931. It is to avoid such catastrophes that the BIS should be strengthened to meet the urgent needs which lie before it.*[12]

Unfortunately for Eleanor Dulles and her fellow idealists, Blessing and Schacht's plan for the BIS was about to come to fruition. The new regime in Germany would exploit the BIS's supranational reach to advance its own national interests. By April 1933 the Nazi terror had begun in earnest. Legalistic as ever, the German legislators had voted their democracy out of existence. The Enabling Act, passed by the Reichstag the previous month, removed citizens' rights to free speech, assembly, travel, and protest. It permitted arbitrary arrest, torture, and detention. Germany was now a racially based dictatorship. On April 1 Nazi stormtroopers ran riot across the country, barricading the entrances to Jewish shops, daubing them with Stars of David and slogans that called on shoppers not to buy from Jews. The first prisoners began arriving at Dachau, the SS's prototype concentration camp.

Soon after the April pogrom—the clearest signal yet of the Nazis' intentions for Germany—Hitler asked Schacht if he would return to his old job as president of the Reichsbank. Schacht accepted and so regained his seat on the board of directors of the BIS. Schacht was a conservative German nationalist, rather than a believer in Aryan racial supremacy. Jews, he believed, were rather too pushy, but could still be useful for the economy. Schacht tolerated, rather than advocated Hitler's anti-Semitism. Schacht used his privileged position to occasionally speak out against the campaign against the Jews, but he was no anti-Nazi. He wanted a strong, economically independent Germany. If Hitler offered the best chance for that, then so be it. Back in 1930 Schacht had told Bella Fromm, a Jewish society columnist, "Why not give the National Socialists a break? They seem pretty smart to me."[13] Now he had the opportunity to do so.

The Nazis also seemed "pretty smart" to the BIS's American management. "Order and discipline in Germany are at the present time exemplary," wrote Gates McGarrah to Leon Fraser in 1933. "The vast majority of the population has the feeling that the fortunes of Germany are in the hands of strong leaders who are inspired by goodwill, so that an optimistic view as regards the future development is justified."[14] The German order, discipline, and goodwill that McGarrah so admired came at a high price, although he did not have to pay it. Carl Melchior did.

As McGarrah eulogized the new Germany, his colleague Melchior, the vice president of the BIS, was forced by the Nazis to resign. The fate of the eminent Jewish banker was regrettable, they murmured in Basel, especially after three years of loyal service, but there was nothing to be done—and certainly not by the BIS, which must remain neutral in its members' internal affairs. Leonardus Trip, the president of the Bank of the Netherlands, swiftly replaced Melchior. The Dutch banker's elevation left a vacancy on the bank's board, which was filled—as it was noted in the BIS 1933 Annual Report—by "Baron Curt von Schröder of the banking house of J. H. Stein, Cologne."

This terse description rather undersold the German nobleman. Kurt Freiherr von Schröder (his name is usually spelled with a "K") was one of the most powerful and influential bankers in Nazi Germany, a scion of the dynasty whose empire included J. Henry Schröder in London and Schrobanco in New York, whose board Allen Dulles joined in 1937. Sociable, cosmopolitan, and well-traveled, von Schröder was known as a reliable, international financier, part of the new global elite who were equally at home in the gentlemen's clubs of London or the dining rooms of Wall Street. The German banker was especially close to Frank Tiarks, the director of the Bank of England who was a partner in J. Henry Schroder bank in London. Tiarks had set up Schrobanco in New York, recruiting Gates McGarrah to its board. Between 1923 and 1939 Kurt von Schröder regularly traveled to London and frequently met Tiarks. The two men had "many business talks together," von Schröder later testified. While in London, von Schröder arranged loans for the Flick industrial concerns, whose head, Friedrich Flick, was pouring money into the Nazi party. The loans, like most of Kurt von Schröder's arrangements, went through his relative Baron Bruno von Schröder, the head of the London branch of J. Henry Schröder banks. Kurt von Schröder also did business with several other major British banks, including Guinness Mahon, Kleinwort, and Lloyds, all on behalf of J. H. Stein, the influential private bank in Cologne where he was a partner.[15]

Hjalmar Schacht personally appointed von Schröder to the BIS board. The summons came out of the blue. "Mr Schacht called me up one day in Berlin and said that they must have a new man for the BIS and told me he thought I was the right one. . . . I was very surprised," von Schröder told Allied interrogators in 1945.[16] Such modesty was unconvincing. Von Schröder enjoyed close personal links with the highest reaches of the Nazi party. He had helped to bring Hitler to power. In January 1933 von Schröder had hosted a meeting at his villa in Cologne between Hitler and Franz von Papen, the former chancellor, who later served as Hitler's vice chancellor. Rudolf Hess, Hitler's deputy in the Nazi party; Heinrich Himmler, the chief of the SS; and Wilhelm Keppler, Hitler's fundraiser and liaison with German businessmen were also there. Keppler later ran the Himmlerkreis, the circle of businessmen who channelled money to Himmler's slush fund at the J. H. Stein bank.

At the meeting, Hitler outlined his plans for economic autarky.[17] Germany could no longer be dependent on foreign countries for any of its needs. The country must be self-sufficient—especially in synthetic oil and rubber. Without these Germany could not wage war, Hitler announced. Production of synthetic oil and rubber was the responsibility of IG Farben, the giant Nazi chemicals conglomerate, which is why Hermann Schmitz, the CEO of IG Farben, would later join Schacht and von Schröder on the board of the BIS. During the war Schmitz channeled money to Himmler via Schröder into special account "S" at J. H. Stein bank, British intellience documents reveal. In 1941 alone, Schmitz transferred 190,000 Reichsmark into the SS leader's personal account. Himmler appreciated Schmitz's generosity, Schröder wrote to his fellow BIS board member, asking Schmitz to transfer a similar sum:

> *I, therefore, take the liberty of asking you again, this year, to remit the same amount for the Reichsführer-SS to the Special Account "S" with the banking firm of JH Stein, Cologne. I would be grateful to you if you complied with this request. As you know, the Reichsführer has*

always particularly appreciated this contribution and you may be sure of his gratitude.[18]

Carl Melchior, who had served his country and the BIS so diligently, had been long plagued by ill health, and he died in December 1933.

ON WALL STREET, Hitler's rise was watched with fascination and concern. Fascination because the advent of an extreme nationalist, one-party state in Germany seemed to have finally banished the specter of Bolshevism. But were Wall Street's investments and holdings really safe? Substantial sums were at stake, involving the most powerful companies in America, several of which were deeply entwined with IG Farben. The German firm operated in the United States as General Aniline and Film (GAF). GAF's founding board members included Walter Teagle, Standard Oil's president; Edsel Ford, the president of Ford Motors; Charles E. Mitchell, chairman of the National City Bank; and Paul Warburg, of the banking dynasty. Standard Oil was GAF's most important partner, and the two firms signed a research and development agreement on oil production. (Standard Oil was also on excellent terms with the BIS—Robert Porters, the bank's chief administrative officer, left to become an adviser to the oil company.)

Standard Oil owned the patents on synthetic rubber, known as Buna, but had ceded control of them to IG Farben. In 1929 Walter Teagle had agreed to a "division of fields" cartel arrangement with its German partner. "The IG are going to stay out of the oil business and we are going to stay out of the chemical business," explained one Standard official.[19] The Standard Oil–IG Farben agreement set the pattern for a series of powerful cartels. John Foster Dulles carried out much of the pioneering legal work for these. Sullivan and Cromwell represented General Aniline and Film, IG Farben's American subsidiary.

Dulles was a director of the International Nickel Company (INKO), the largest producer of the metal in the world. In 1934 INKO signed a cartel agreement with IG Farben, swapping supplies of nickel sources for the license rights to a newly patented nickel-refining process.[20] Dulles also arranged chemical cartels. He represented the Solvay American Investment Corporation, the American subsidiary of a Belgium firm that was a partner of IG Farben. Solvay American held 25 percent of the stock of the Allied Chemical & Dye Corporation, an American company. In 1936 Allied entered a cartel agreement with IG Farben on dyestuff production. And so it went, all through the 1930s, as American financiers and lawyers —none more than John Foster Dulles—ensured that American money, commodities, and expertise flowed steadily into the Third Reich.

But there was still some unease in the boardrooms and clubs, not because of the persecution of the Jews or the concentration camps, but because the Nazi party seemed to still have some dangerous tendencies: its full name, for example, translated as the German Nationalist Socialist Workers' Party. The Brownshirts, the Nazi "leftist" faction, remained powerful. The bankers and industrialists needed fresh, firsthand reassurance. They needed a meeting with Hitler.

Wall Street's envoy was Sosthenes Behn. On August 4, 1933, the *New York Times* reported that Hitler had held his first meeting with "representatives of American finance." The newspaper noted, "Chancellor Hitler, who is resting at his mountain retreat on the Salzburg, today received Sosthenes Behn, a director of the National City Bank of New York, and Henry Mann, its resident vice president for Germany. . . . There was no hint of the motive." But there did not need to be. Behn had founded the International Telephone and Telegraph Company (ITT) in 1920. ITT had grown to be one of the most powerful companies in the world. It had substantial holdings in Germany, some of which were engaged in armaments production. ITT needed a well-connected banker there to look after its interests and subsidiaries. It found one—in Kurt von Schröder.

SCHACHT SOON TURNED on the bank he had helped create. The 1932 Lausanne conference had canceled Germany's obligations to pay reparations to the Allied victors. But the loans Germany had taken out under the Dawes and Young plans to meet those obligations were still outstanding. It was of little concern to the Wall Street financiers whether Germany used their funds to pay for reparations or to fund a new armaments drive. They wanted to know that they would get their money back. Schacht told the BIS governors at the June 1933 board meeting that he supported paying the Dawes loan but not the Young loan. Germany simply did not have sufficient resources to pay them both. Schacht was under intense political pressure from the Nazi leaders, who wanted both loans written off, seeing them as the final vestiges of Germany's humiliation at Versailles.

The creditors, naturally, disagreed. Another conference was called, this one chaired by Leon Fraser, the BIS president, and hosted by the Reichsbank in Berlin in May 1934. The Berlin gathering was a total failure. Soon afterward Germany announced a complete moratorium on all medium- and long-term debts, including the Dawes and Young loans. The announcement caused fury as bondholders saw their assets vaporize. J. P. Morgan even suggested that the BIS stake a claim to German funds held in Switzerland. That was neither realistic nor practical. The BIS could do nothing except issue a protest against what Fraser called the "thoroughly arbitrary way in which the German government has disregarded its engagements."[21]

It had no effect, for the old fox, as Schacht was known, had outmaneuvered everybody with a high-stakes game of international poker. The Reichsbank governor understood that a blanket default would severely damage Germany's international standing and credit-worthiness. Yet it was imperative to disentangle Germany from the obligations of the Dawes and Young plans and all the political and emotional baggage that they brought in their wake. The policy of economic autarky outlined at the meeting at Kurt von Schröder's house and the memo written by Karl Blessing back in 1930 demanded no less. So as soon as Germany had broken free from the BIS, Schacht swiftly concluded bilateral agreements with Dawes and Young loan bondholders in seven countries, including Britain, France, and Italy, albeit at reduced rates of interest. It was the old principle of divide and rule, brilliantly applied to the new field of international finance. Just as the rule of law had been torn up in Germany, so had the country's international financial obligations.

Schacht's arbitrary rewriting of Germany's debt obligation proved that Germany's commitments were not worth the paper they were written on. At the same time, the dealings of some of those working in the BIS also seemed less than scrupulous: the combination of secrecy, insider information, and vast amounts of money sloshing around was having unwelcome effects. Some of the BIS staff were, it seems, insider trading. Basel was full of rumors that BIS officials were using their privileged knowledge of the bank's activities to speculate against the Swiss franc. A hard-hitting article in the *Berner Tagblatt*, a Swiss newspaper, in May 1935, had caused uproar, especially as it appeared to be based on documentation or a high-level source inside the BIS. Swiss bankers widely believed that the BIS had no confidence in the Swiss franc. A Swiss MP had even raised the conduct of the BIS in the Swiss Parliament. The situation was getting uncomfortable for the BIS management.

The following month the staff was questioned one by one. Gates McGarrah, who had stepped down as president, but remained on the board, wrote to Johan Willem Beyen, his Dutch colleague and fellow board member, that the investigation had turned up some alarming information. One of the bank's "higher officials" had bank accounts in both London and Switzerland, both of which had been overdrawn on the security of stocks and shares. The staff member had been shorting sterling and Swiss francs—selling the currencies when strong and buying them back when they weakened. "This, of course, is a clear case of currency speculation," admitted McGarrah, but there was no need to take any action, he wrote. If the

banks do not object and the overdrafts were long-standing, "it might be difficult to criticize too harshly or to interfere with any vigor in the private affairs of a man of some standing who is endeavoring to look after his own fortune in the way he considers best."[22] In other words, even though the senior BIS official was indeed speculating, nothing should be done, especially as he was a man of "some standing."

Another case, which even the emollient McGarrah noted "calls for comment," involved a member of staff who borrowed money in London to buy gold. Alarmingly, the BIS staffer did this, he explained when questioned, "at the same time as his chief." Such practices were "highly undesirable," argued McGarrah, especially as the staffer's chief was a member of the BIS management (it is not clear who from the documents).[23] Thus, the BIS was in no position to issue an official denial about speculation, McGarrah continued. The bank's best option was to inform the Swiss National Bank that it had received the assurance of its management and staff that no speculation had taken place (even though it had) and that the bank would take measures against the possibility of it happening in the future. Bankers in the 1930s, like many of their present-day contemporaries, wanted any potential scandal about their personal probity shut down as soon as possible. "It might be best to endeavor to let the matter die a natural death outside the house and to proceed only with a further internal investigation," McGarrah noted.[24]

> *"The above-mentioned young Nazi and his friends believe that the BIS offers them their best contact with the outside world. They want to have capable representatives in the BIS in order to break the way for [an] approach to more normal business and monetary relations with the important countries of the world."*
>
> — Merle Cochran, an American diplomat who monitored the BIS, in a telegram to the State Department, May 9, 1939[1]

The *Berner Tagblatt* newspaper's revelations about the murky goings-on inside the BIS highlighted the growing questions about the bank's role and function. Insider trading during the 1930s was often the rule rather than the exception, but there were wider issues at stake. The BIS had been established for three main purposes. The first, and ostensibly the most important, was to manage German reparations payments under the 1930 Young Plan. The second was to facilitate cooperation between central banks. And the third was to act as a bank for central banks. The BIS was barely five years old in 1935, but it had already had lost its primary reason for existence and the second reason was under threat. How long would it be before the third reason—to act as a central bank for banks—was called into question?

The Young Plan had collapsed almost as soon as it was agreed to. The Hoover Moratorium, announced a year later, had paused reparation payments. The 1932 Lausanne Conference had confirmed that Germany's war debts would be written off. Thus, there were no more reparations payments. The BIS was also the trustee for the loans that Germany had taken out under the Dawes and Young plans to make those reparations payments. But Gemany had stopped using the BIS to repay the Dawes and Young plan loans. Instead Schacht had blackmailed Germany's creditors into signing new bilateral agreements. The Reichsbank, a cofounder of the BIS, had broken its legal, financial, and moral obligations with complete impunity and delivered a serious blow to the BIS's credibility as a neutral interlocutor.

So for what other reasons did the BIS continue to function? It acted as a facilitator of central bank cooperation for countries whose currencies were on the gold or gold exchange standard. (The gold standard valued a national currency at a set amount of gold. The gold exchange standard included the country's holdings in US dollars and British pounds as part of its national reserves.) The statutes of the BIS assumed that international finance was based on the gold and gold exchange standard and so would continue to grow smoothly and steadily, facilitated by the bank. As Toniolo notes, "The gold standard was embedded in the very DNA of the BIS."[2] The bank kept its accounts in Swiss gold francs, with each franc worth 0.29 grams of fine gold. But the central banks were losing their enthusiasm for gold. Even Britain had come off the gold standard. By the end of 1932 only seven of the forty-six countries that had been on the gold standard remained, including France, Italy, and the United States, which left the following year.

With no more reparations and the collapse of the gold standard, why did the BIS stay in business? In part—as others who wished to dissolve the bank would find in later years—because it was founded under an international treaty, and its statutes were essentially immutable. Schacht and Norman had designed their bank superbly. It was not possible to close the BIS. In fact, the end of reparations and the collapse of the gold standard proved a boon for the BIS. It allowed the bank to focus on its founders' intentions: to

build a new transnational financial system of large capital movements, free from political or governmental control. Gates McGarrah, the bank's first president, had explained as much soon after the bank was founded. Writing in *Nation's Business* magazine, McGarrah admitted that German reparations payments were a "routine operation," which any trust company could administer.

> *The conception seems to have formed in the popular mind that the Bank for International Settlements, which began at Basel, Switzerland, May 20, 1930, was organized merely to handle German reparations payments and the so-called inter-allied debt and that its principal operations are concerned with the German debt payments. That is a mistaken, although an understandable, view.*
>
> *Although the prime reason for the bank's creation was to administer the monthly sums paid into it by Germany, this duty has already become the smaller side of the Bank's activities. The handling of the German reparations payments is a routine operation, which any trust company could carry on. Within six months after opening for business the Bank has developed much larger and more important activities and has become a medium of service, which is one of the saving features in a tense world situation. . . .*
>
> *The Bank is completely removed from any governmental or political control. No person may be a director who is also a government official. The Bank is absolutely non-political and is organised and operated on a basis purely commercial and financial, like any properly managed banking institution. Governments have no connection with it nor with its administration.*[3]

McGarrah, like every international financier, regarded the Bolshevik Revolution with horror. Yet he and Vladimir Lenin had much more in common than either could know. The BIS president and the Russian revolutionary both understood that the twentieth century would be the bankers' century. The new mechanisms of transnational capitalism allowed the bankers to send vast sums of money quickly and easily around the world and harvest vast profits from doing so, free from oversight.

The bankers could save a country from collapse and revive its economy—as they did in Germany in the early and mid-1920s, dispatching hundreds of millions of dollars and underwriting the Dawes loan—or they could help send it into a tailspin, by stopping the flow of cash and then pulling out, as they did at the end of the 1920s.

Massive capital movements were now increasingly common. The BIS, as the bank for central bankers, institutionalized that new power. In the first six months of 1931 the BIS advanced £3 million to the Bank of Spain to stabilize the peseta; gave a credit of 100 million Austrian schillings to the national bank when the Credit Anstalt bank went bust; and advanced $5 million to the Hungarian National Bank and arranged a further $10 million credit for Budapest. A small clique of financiers, unaccountable to any government, most of whom knew each other well, had somehow amassed unprecedented economic and political power. Lenin had understood the rising power of finance capital while he was living in exile in Zürich and working in his epic study of imperialism. "The old capitalism has had its day. The new capitalism represents a transition toward something," he wrote. "Thus the beginning of the twentieth century marks the turning point at which the old capitalism gave way to the new, at which the domination of capital in general made way for the domination of finance capital."[4]

ON JANUARY 5, 1939, almost two months after *Kristallnacht*—the state-sponsored pogrom against

Germany's Jews—Montagu Norman stepped off the train at the Zoologischer Garten station in Berlin and was met by Hjalmar Schacht. Norman was the guest of honor at the christening of Schacht's grandson, and he was swiftly driven to Schacht's apartment in the Reichsbank building where the ceremony took place. The baby boy was named Norman Hjalmar. Numerous articles in the German press welcoming Norman to Berlin heightened the friendly atmosphere. The two bankers then traveled to Basel together for the monthly board meeting at the BIS.

As Europe slid inexorably to war, British journalists and politicians were asking increasingly pointed questions about the close ties between Norman and Schacht. The Reichsbank president had been in London just before Christmas and had visited Norman at home. What had been discussed? The *News Chronicle* newspaper, for example, suspected that Norman might be an envoy, not just for the Bank of England, but for the pro-appeasement government, led by Prime Minister Neville Chamberlain. Why had he gone? What was Norman saying to the Nazi leaders in Berlin?[5] The newspaper demanded to know. Ernest Bevin, a powerful trade union leader, also wanted answers. "One cannot enter into financial arrangements between these great central banks involving the economic life of the respective countries, without it having a direct reaction on the liberties and rights of the people,"[6] he thundered—sentiments that are as true today as in 1939.

Bevin and the journalists were right to be suspicious of Norman's relationship with Schacht. The Reichsbank president, more than anyone else, had rebuilt Germany, a country that would soon be at war with Britain. Schacht had wrought a miracle—a centrally planned economy that was not ravaged by inflation, a worthless national currency, or unemployment. In the six years since Hitler had taken power, unemployment had been reduced from six million to around three hundred thousand. Armies of the jobless were diverted to massive programs of public work—building the new network of motorways, gigantic public buildings, and planting forests. Arms production was soaring. Trade unions no longer existed and were replaced by the state-run German Labor Front (DAF). The work-shy, along with Jews, leftists, and others viewed as undesirables were dispatched to concentration camps.

Germany adored its miracle maker. In January 1937, on the occasion of his sixtieth birthday, Schacht had stood for four hours receiving hundreds of guests. Hitler himself sent a personal message praising him. Schacht told Hitler's adjutant, who had brought the message, "Tell the Führer that he has no more loyal co-worker than I." Schacht's admirers believed, correctly, that without him, Germany would still be weak, poor, and, worst of all, humiliated. "Every branch of German finance, commerce, industry, and society and the armed forces was represented. There were bankers, manufacturers, merchants of all grades, big and little," the *New York Times* reported. Hitler gave Schacht a painting by Carl Spitzweg, a German romanticist painter. Montagu Norman sent a mahogany clock.[7]

Schacht's real job was to prepare Germany for war. In his correspondence with Hitler, Schacht repeatedly emphasized the importance of the armaments program. In May 1935 he wrote,

> *The following comments are based on the assumption that the accomplishment of the armament program in regard to speed and extent, is the task of German policy, and that therefore everything else must be subordinated to this aim, although the reaching of this main goal must not be imperiled by neglecting other questions.*[8]

That same month Hitler appointed Schacht General Plenipotentiary for the War Economy. For all his old-world manners and elegant appearance, Schacht was a state-sanctioned crook, licensed by Hitler to tear up contracts, steal, extort, and fiddle the Reichsbank's books, which was why he got the job. Schacht funded rearmament by inventing a piece of financial chicanery known as the "MEFO" bill, which allowed

the state to illegally borrow billions of Reichmarks from the Reichsbank—a policy Schacht later described as "daring." He hijacked the blocked funds of foreign depositors in the Reichsbank. He requisitioned German residents' foreign currency holdings and ruled that all foreign currencies received as payments for exports must be sold to the Reichsbank. He fiddled the capital markets so that foreign firms could not compete on equal terms with German competitors. He could outsmart anyone, even the wily Jews, proclaimed Hitler:

> *Before each meeting of the International Bank at Basel, half the world was anxious to know whether Schacht would attend or not, and it was only after receipt of the assurance that he would be there that the Jew bankers of the entire world packed their bags and prepared to attend. I must say that the tricks Schacht succeeded in playing on them really provide that even in the field of sharp finance a really intelligent Aryan is more than a match for his Jewish counterparts. In spite of his ability I could never trust Schacht for I had often seen how his face lit up when he had succeeded in swindling someone out of a hundred mark note.*[9]

Schacht was a creature of his time. The dreams of the internationalists who believed that the BIS, like the League of Nations, would engender global peace and harmony were dead. Invasion, annexation, and mass murder were the new tools of international empire building. The Third Reich was rising and would last a thousand years, proclaimed Hitler. Austria had been forcibly incorporated into the Third Reich in the Anschluss of March 1938—with little objection from its citizens. Italy had invaded Abyssinia (now Ethiopia) and was dropping poison gas on defenseless civilians. Japan was laying waste to Manchuria, having murdered hundreds of thousands during the Rape of Nanking in 1937. Neville Chamberlain, the British prime minister, had signed the Munich agreement that ceded the Sudetenland, a province of Czechoslovakia, to Germany. The Spanish civil war, with its flattened, charred cities, its savage brutality and atrocities, was a precursor of Europe's fate.

Yet even as he rebuilt Germany's economy, Schacht must have asked himself if the price was really worth paying. He did not believe in the Nazis' ideas of racial supremacy and refused to join the party. Rather, he was an authoritarian national conservative. He had made a deal with the devil to see his homeland rise again from, as he saw it, the humiliation of the Treaty of Versailles and the penurious obligations of the Dawes and Young plans. Like many Germans of his class, Schacht tried to rationalize the Nazis' brutality and anti-Semitism until the contradictions could be borne no longer. In the summer of 1938, he turned to his partner at an elegant dinner in Berlin and asked, "Madam, how could I have known that we have fallen into the hands of criminals?" He might have been addressing the question to himself, for after five years of Nazi rule the answer was there in front of him—if he had chosen to look.

By 1938 Schacht had begun to play a perilous game, using the BIS as a secret back channel to Britain to try and bring down Hitler and stop the march to war, or so he claims in his memoirs. Schacht first approached several senior military leaders to encourage them to launch a coup. None would agree. That left the monthly meetings at the BIS. "The more conditions in Germany approached a climax, the greater my desire to make use of my connections in Basel as a means of preserving peace," he wrote.[10] The Reichsbank president took Montagu Norman aside at a BIS meeting and asked him to approach Chamberlain to set up a channel between London and the anti-Nazi Germans. Four weeks later Norman and Schacht met again in Basel. Norman told Schacht that he had discussed his proposal with Chamberlain. Schacht asked what was his reply. Chamberlain had said, "Who is Schacht? I have to deal with Hitler."[11]

After Kristallnacht, even Schacht's self-deception and rationalization began to fade. The attack on Germany's Jews, Schacht proclaimed in his speech to the Reichsbank Christmas party, was "such a wanton and outrageous undertaking as to make every decent German blush for shame. I hope none among you had any share in these goings-on. If any one of you did take part, I advise him to get out of the Reichsbank as quickly as possible."[12] Schacht's indignation, whether real or feigned, was wasted. His Reichsbank was the Nazis' most important instrument for looting the assets of German Jewry. After Kristallnacht, the Nazis imposed a fine of one billion Reichmarks on German Jews, to be paid in four installments.

Schacht then proposed to Hitler a bizarre plan to help German and Austrian Jews to emigrate, the kind that only a banker could dream up. Jewish holdings in both countries would be placed in an international trust. The trust would sell twenty-five-year bonds—which would pay dollar dividends—to world Jewry. Part of the dividend would finance the emigration of German and Austrian Jews, and part would be used to boost German exports. Hitler agreed to the plan, but, not surprisingly, nothing came of it. Schacht did help save Bella Fromm, the high society Jewish journalist. Fromm had continued her acerbic observations of Berlin society, politics, and diplomacy, until the summer of 1938 when it became clear she had to flee. She was packed and ready to go when the paperwork got stuck for the transfer of her personal funds—this was a disaster, as without the monies she would not be allowed into the United States. She asked Schacht for help, and he rushed her case through the Foreign Exchange Office. Fromm immigrated to New York.

MEANWHILE, AS EUROPE slid to war, the atmosphere in Basel between the central bank governors remained "entirely cordial," reported Merle Cochran. Cochran traveled to Basel every month from his base at the United States embassy in Paris, to meet Montagu Norman and Hjalmar Schacht at the governors' meeting. He was not allowed to attend, but Norman and Schacht briefed him afterward on the discussions. Cochran then sent on the information to Henry Morgenthau, the Treasury secretary, and to the State Department. Cochran had excellent sources at the BIS, including Paul Hechler, the German assistant general manager, who signed his correspondence "Heil Hitler." Most of the central bankers had "known each other for many years, and these reunions are enjoyable as well as profitable to them," Cochran reported to Washington on May 9, 1939. "The wish was expressed by some of them that their representative statesmen might quit hurling invectives at each, get together on a fishing trip with President Roosevelt or at a World's Fair, overcome their pride and complexes, and enter into a mood that would make comparatively simple the solution of many of the present political problems."[13]

If only things were that simple. Basel at least was a safe haven from the world's vicissitudes. The governors' monthly meeting took place at 4 p.m. on Sunday, without notes or minutes being taken, after which high tea was served. The rest of the two days were busy with breakfasts, lunches, dinners, concerts, receptions, and walks along the Rhine and in the Black Forest. Bank officials' wives were also drafted to lighten the atmosphere at social events. Each governor—just as nowadays—was provided with his own office. The doors were closed while the governors were in discussions with their staffs but were otherwise left open so that bank staff and other governors could make social calls or drop by to exchange news and information.

The bankers began to see the broader picture—the global linkages between their decisions and their consequences. "As they sat down around the table for two days, you could almost see their point of view change as they began to realize the effect of their own actions," reported W. Randolph Burgess, deputy governor of the New York Federal Reserve.[14] Norman and Schacht were still the star attractions. Johan Willem Beyen, a Dutch banker and BIS president in the late 1930s, recalled,

Norman's prestige was overwhelming. As the apostle of central bank cooperation, he made the central banker into a kind of arch-priest of monetary religion. The BIS was, in fact, his creation. He came on Saturday night and left on Monday night, accompanied by his retinue. The other governors invariably flocked to his room. He had an unbounded admiration for Schacht (in every respect the opposite of himself) and a thorough dislike for one or two others.[15]

And Norman also had his hat—a beautifully crafted, black silk Homburg with a red silk lining embroidered with a golden bee. When Beyen commented on the detail, Norman quipped, "Oh yes, that's the bee I wear in my bonnet."[16]

In 1939 the BIS board welcomed one of the world's most powerful industrialists: Hermann Schmitz, the CEO of IG Farben—the giant German chemical conglomerate. IG Farben was much more than an ordinary business. It was a virtual parallel state, which would soon evolve into an unprecedented synthesis of finance capital and mass murder. Born out of a merger in the 1920s between Bayer, BASF, Hoechst, Agfa, and other companies, IG Farben was the fourth-largest concern in the world (after US Steel, General Motors, and Standard Oil). It produced pharmaceuticals, chemicals, high explosives, film, plastics, fuel, rayon, paint, pesticides, car tires, poison gases, lightbulbs, aspirin, margarine, detergents, fertilizer, and much more. IG Farben provided the nickel for the engines of the Heinkel and Stuka bombers, the aluminum for their bodies, the magnesium for their wings, and the artificial rubber to hold the windshields together.[17] It refined the fuel, oils, and greases that let the Wehrmacht unleash the Blitzkrieg. The firm once attacked by the Nazis as "Isadore G. Farber"—a macabre reference to the former presence of prominent Jewish financiers such as Max Warburg on its supervisory board—was now the centerpiece of the Nazi war machine.

IG Farben had a liaison office with the Wehrmacht to plan its takeover of competitors in newly occupied countries. It ran its own intelligence service, known as "Buro IG," from its headquarters on the Unter den Linden in Berlin. During the war, IG Farben managers built and ran the company's private concentration camp at Auschwitz, known as "IG Auschwitz," which manufactured Buna, or synthetic rubber.

The presence of Hermann Schmitz on the BIS board highlighted how deeply the bank was entangled with the Third Reich. Nazi Germany benefited immeasurably from its relationship with the BIS. By 1939 the BIS's investments in Germany totaled 294 million Swiss gold francs ($96 million), a substantial sum. But the BIS brought much more than money. As the "Young Nazi" quoted at the start of this chapter in Merle Cochran's telegram explained, the BIS gave the Third Reich the chance for a more "normal" type of business relations with foreign countries. It provided the Reichsbank with a ready-made network of contacts and business channels. It gave Schacht, the architect of the German war economy, a regular opportunity to meet his peers and gain intelligence, both financial and political. It legitimized a national bank engaged in state-sponsored financial chicanery, theft, and appropriation of Jewish businesses through state-organized terror. The BIS thus ensured that the Reichsbank, which should have been a pariah institution, remained a central pillar of the global financial system. Schacht's status and prestige and his regular attendance at the Basel meetings made the criminal actions of the Reichsbank seem acceptable. The personal connections of the central bankers, fostered at the BIS's lunches, dinners, cordial receptions, and strolls in the woods, were crucial in this acculturation of Nazi methodology.

The BIS reports during the 1930s and the buildup to war are especially illuminating in this respect—for what they do not discuss, as much as the information they do impart. The bank's access to figures provided by the world's leading central banks allowed it to collate and analyze statistics, to dissect

global trends, and to make policy recommendations in a unique, new format. The BIS annual reports, wrote John Maynard Keynes, the influential British economist, were now "the leading authority for certain statistics, not easily obtainable," and the staff were to be congratulated. The reports were supervised and written by Per Jacobssen, who had joined the bank in 1931 as economic adviser.

Born in 1894, in Tanum, Sweden, Jacobssen had made his name while working at the Economic and Financial Section of the League of Nations from 1920 to 1928. He was far more than an adviser. He shaped the bank's policy recommendations of laissez-faire economics and the importance of individual responsibility over state provision. He supported European federalism and supranationalism. His legacy has shaped our world. Jacobssen was also a kind of global economic troubleshooter with a much-envied contacts book. During his time at the BIS, he oversaw numerous financial and economic inquiries into troubled countries and was especially well connected in the United States. As a perceptive observer, Jacobssen also co-wrote two thrillers, fusing his knowledge of international finance and diplomacy. *The Death of a Diplomat*, which was set in the League of Nations, was published in eight languages, and the film rights sold to a German company. *The Alchemy Murder* was macabrely prescient—especially when Hermann Schmitz, the CEO of IG Farben, joined the board of the BIS. The book's storyline focused on chemical companies producing poison gas.

But Jacobssen's reports for the BIS, no matter how detailed on economic and financial analysis, gave scant attention to the wider context in which the central bankers operated. It was their job, the bankers believed, to focus on finance, rather than on the complex moral and political issues that shaped nations and the world's economy. In this they succeeded so well that an article in the *Bankers' Magazine* in 1943 described the BIS reports as documents "whose emotionless neutrality would do credit to a visitor from Mars." The Nazi persecution of the Jews and the systematic, state-organized theft of Jewish-owned firms and businesses is reported purely as a technical question. Page 101 of the 1939 annual report notes that some German firms had experienced a reduction in liquidity and were asking banks for credit to improve their liquidity. But this was not the only cause of the growth in requests for loans. "Other reasons for the demand for advances are to be found in the changes in the ownership of private enterprises due to the Aryanization of private firms." There is not a word of condemnation, merely a dry noting of the changed circumstances.

The Anschluss, the Nazi annexation of Austria, is noted on pages 100 and 101 of the 1938 report as follows: "In connection with the incorporation of Austria in the German Reich in March and April 1938, the Austrian National Bank entered into liquidation and a series of measures were promulgated transferring most of its assets and liabilities to the Reichsbank." These assets included the Austrian National Bank's gold reserves and their 4,000 BIS shares. The BIS accepted their "transfer" to Berlin, the first of many decisions that the bank's leadership would take to legitimize Nazi plunder and looting.

The BIS's 1939 report does devote more space to the Third Reich's methods, but mainly as a question of technical banking interest. The report notes with typical understatement that "Territorial changes in Europe in 1938 left their impress on the banking and credit structures of the countries concerned." There was perhaps a note of relief in the statement that "the absorption of Austria into the German Reich presented comparatively few difficulties for the German banking system as Austria itself had a unified banking structure." However, the report observed, "much more intricate questions were involved in the taking over of the Sudetenland," the border province that Czechoslovakia had been forced to cede to the Nazis in September 1938. The Czechoslovak banks had 143 branches in the Sudetenland. These banks had to change their currency from crowns to Reichmarks. These 143 branches, the report notes, had to be "severed from their old head offices and adapted to the German system"—an adaptation that the BIS was finding very easy indeed.

The bankers gathered at Basel were not burdened with idealism except in one respect: they wanted to work together to facilitate the free flow of international capital. They sought economic stability, low inflation, and global free trade that would provide political stability and control unemployment—reasonable aims that were shared by much of the world. The bankers may not have been immoral (apart from Schacht), but they were certainly amoral. They believed that financial considerations existed in a vacuum, away from troublesome politics and national interests. Ethical considerations of right and wrong simply did not exist in their universe. What counted was the bottom line and the interest of the banks themselves, especially, now, the BIS. As Merle Cochran noted, "The Directors prefer to view the BIS as a long-term proposition, and insist that its field of usefulness need not be analyzed or altered with every shift in world monetary and economic conditions."[18]

It was a peculiar arrogance that granted such self-belief to a clique of unaccountable financiers. A clique that had, by sleight of hand, built its own bank that was untouchable and beyond the reach of any government—and then proclaimed its existence to be something of virtue for the rest of mankind. The most important thing, the bankers agreed, was that transactions were properly authorized and formal procedures followed. It was not the bank's business to ask where the money came from or how it had arrived. It was this obsessive formalism, repackaged as "neutrality," that would soon lead the BIS to become, in the words of Henry Morgenthau, the US Treasury Secretary, "a symbol of Nazi instrumentality."[19]

TRANSNATIONAL CAPITAL HAD decided the fate of Spain. The Spanish civil war lasted from July 1936 to April 1939, when the Nationalist army, led by General Franco, finally captured Madrid, the capital, from the left-wing Republicans. Spain is often described as a trial run for the Second World War. It was an exceptionally savage conflict, marked by atrocities on both sides. The airplanes of Germany's Condor Legion bombed Spanish cities and strafed civilians, perfecting the strategies that would soon be deployed in the Blitzkrieg. But the conflict was also a trial run for newly honed techniques of economic warfare.

Money, as much as superior numbers and military forces, helped Franco to victory. Nazi Germany and Fascist Italy provided hundreds of millions of dollars worth of aid. The nationalists understood that finance was a weapon as effective as bullets. They set up their own rival economy, complete with a separate national bank that issued its own currency, also called the peseta. This was a psychological as well as economic assault on the Republic. It was chillingly effective. By July 1937, a year into the war, the Republican peseta was worth three times less in French francs than the fascist version, even though the Republicans were the legitimate government of Spain and controlled the national economy, its currency, and the country's gold reserves.[20] Inflation was far higher in the Republican zone. Between July 1936 and March 1937 prices doubled in the Republican zone, while in the nationalist zone they rose by only 15 percent. The nationalists steadily corroded the Spaniards' belief in their currency and, by extension, in their government.

Yet arguably, the Republican government's peseta should have been worth three times the nationalists' scrip. At the end of 1935 Spain had the fifth-largest gold reserves in the world, after the United States, France, Britain, and the Soviet Union. The BIS annual report for 1936 notes that Spain had gold reserves of 2,225 million gold Swiss francs, nearly three times that of Italy. Much of this had been accumulated during the First World War when Spain remained neutral. For the previous four years the country had enjoyed a current account surplus, much of which had been invested in gold.

The country should have been in a prime position to issue bonds, backed by the abundant gold reserves, to finance the economy and the war. Yet as Pablo Martín-Aceña, Elena Martínez Ruiz and

María A. Pons, the authors of the paper "War and Economics: Spanish Civil War Finances Revisited," note the Spanish government did not do so. "The reasons for this decision are controversial: either they were not able to do so because of the political aversion of international banks and financiers, or it was a deliberate policy decision."[21] Probably it was a mix of both. The country was under an arms embargo. And where would the bonds have been sold? Allen Dulles and his friends on Wall Street had no desire to buttress a government that—from their perspective—was composed of dangerous leftists. Nor would London have been more enthusiastic. Britain also preferred Franco's fascists to the Republic.

So Spain simply sold its gold reserves. France bought 175 tons and the remainder was purchased by Moscow. The BIS report for 1937 records a fall in Spain's holdings to an estimated value of 1,600 million gold Swiss francs.[22] The money was used to pay for weapons, aircraft, tanks, food, and other supplies. As neither Spain nor the Soviet Union were members of the BIS, they were not able to use its special facilities for crediting and debiting national banks' accounts. Instead the gold was physically moved. Spain's gold reserves were held in the subterranean vaults of the Bank of Madrid. As Franco's forces advanced on the capital the reserves were transferred to a naval store in Cartagena, on the Mediterranean coast. From there the reserves were loaded onto four Soviet ships and taken to the port of Odessa, to be transported to Moscow on a special train. When the gold was gone, the Bank of Spain sold its silver reserves of 1,225 tons to the United States and France.

The Republicans' chaotic politics also weakened their economy and currency. The nationalists were centralized, authoritarian, well-organized, and united around one ideology—fascism—with one leader: General Francisco Franco. The Republicans were a kaleidoscope of competing creeds: socialism, communism, and anarchism. Numerous local, regional, and revolutionary authorities printed their own banknotes, which had no credible backing. The Republican government did not centralize the issuing of bank notes until autumn 1937. In contrast, the nationalists fought a currency war as well organized as their military campaigns. They declared all Republican banknotes issued since 1936 to be illegal. The only legal tender was to be the notes issued by the nationalists' own rival Bank of Spain. The Republicans blocked all current and deposit accounts in their zone that had been opened or increased in value since the start of the war. So as Franco's troops advanced, bank account holders cashed in their savings and quickly spent the money on whatever they could. One bank, Banco Zaragozano, even sent its chairman to the front. As soon as each city fell, he entered the newly captured territories with the military leaders to reorganize the local banks.[23]

This, as much as the Blitzkrieg, was the real lesson of the Spanish Civil War: the nationalists' sophisticated fusion of financial and military power. The Nazis would hone this model, using the BIS to underpin their economic empire.

"The Bank for International Settlements is the bank which sanctions the most notorious outrage of this generation—the rape of Czechoslovakia."

— George Strauss, Labor MP, speaking in the House of Commons, May 1939[1]

When Nazi Germany annexed the Czechoslovak border province of the Sudetenland in September 1938, it immediately absorbed a good part of the country's banking system as well as most of Czechoslovakia's strategic defenses. By then the country's national bank had prudently transferred most of its gold abroad to two accounts at the Bank of England: one in the name of the BIS, and one in the name of the National Bank of Czechoslovakia itself. (Countries had deposited some of their gold reserves in a sub-account at the BIS account in London to ease gold sales and purchases.) Of the 94,772 kilograms of gold, only 6,337 kilograms remained in Prague. The security of the national gold was more than a monetary issue. The Czechoslovak reserves, like those of Republican Spain, were an expression of nationhood. Carved out of the remains of the Austro-Hungarian Empire in 1918, the Czechoslovak Republic was a new and fragile nation. A good part of the gold had been donated by the public in the country's early years. Josef Malik, the governor of the national bank, and his fellow Czechs believed that, even as the Nazis' dismembered their homeland, if the national gold was safe, then something of the country's independence would endure.

They were wrong. The Czechoslovaks' faith in the probity of the BIS and the Bank of England was tragically misplaced. The gold was sacrificed, with barely a second thought, to the needs of transnational finance and the Third Reich.

The Nazis' first demand came in February 1939 when Berlin ordered Prague to transfer just over 14.5 metric tons of gold, supposedly to back the German currency now circulating in the Sudetenland. This was certainly an innovative idea—first invade a neighboring country, annex part of it, and then demand that the newly truncated state supply the gold to pay for the loss of its territory. The following month the question became academic. On March 15 the Wehrmacht marched into Prague. The German protectorate of Bohemia and Moravia was declared, and Czechoslovakia no longer existed. But the gold reserves did. Three days later a Reichsbank official was dispatched to the National Bank of Czechoslovakia and ordered the directors, under the threat of death, to issue two orders. Thanks to diligent detective work by Piet Clements, the BIS archivist, we have a clear picture of what happened next. The first order instructed the BIS to transfer the 23.1 metric tons of Czechoslovak gold held at the BIS account at the Bank of England to the Reichsbank BIS account, also held at the Bank of England. The second order instructed the Bank of England to transfer almost 27 metric tons of gold held in the National Bank of Czechoslovakia's own account to the BIS's gold account at the Bank of England.

Malik and his fellow directors hoped that it would be obvious that the instructions had been issued under duress and so would not be implemented. The Nazis had just invaded Czechoslovakia and would obviously target the national gold reserves. But Malik had not reckoned on Montagu Norman. The governor of the Bank of England had no interest in whether Czechoslovakia was free or a Nazi colony. "Political" considerations must not affect the BIS's transactions. The transfer order, he said, must go through.

Meanwhile, in Basel, Johan Beyen, the Dutch president of the BIS, wavered. Beyen discussed the matter with the BIS's legal adviser, Felix Weiser. But like Norman, Weiser took the most formalistic approach possible. As long as the paperwork was in order, the monies must go through. Weiser argued, somewhat bizarrely, that there could be no legal grounds to claim that the transfer order had been issued under duress, as such a plea could be brought before a Swiss court only by the persons who had acted under duress. Clearly, the directors of the National Bank of Czechoslovakia were unlikely to travel to Switzerland to present their case. Therefore any decision not to authorize the transfer would be one of BIS policy, rather than administration. The board of the BIS made policy. Thus Beyen would have to consult the board to stop the payment. (This was poor advice for another reason—under the terms of the BIS statutes the Swiss authorities anyway had no jurisdiction over gold transfers between states.)

Beyen was unwilling to take a decision without authorization. But who could he ask? The chairman of the BIS board, Sir Otto Niemeyer, of the Bank of England, was traveling to Egypt and so was incommunicado. At 6 p.m. on March 20, Roger Auboin, the bank's general manager, told Beyen that the governor of the Bank of France had discussed the matter with London. The Bank of England and the Bank of France would not be taking any action to stop the transfer, because they felt that there were no grounds for action. The BIS transfer order went through.

With London, Paris, and Basel's compliance, Nazi Germany had just looted 23.1 metric tons of gold without a shot being fired. More than two-thirds of that gold was traded with the Dutch and Belgian national banks and was eventually transported from Amsterdam and Brussels to the Reichsbank's vaults in Berlin. Czechoslovakia's diligent planning to safeguard its national gold reserves, together with its misplaced faith in the integrity of the new international financial system, had come to nothing. The second transfer order for the 27 metric tons held in the National Bank of Czechoslovakia's own account at the Bank of England did not go through. Sir John Simon, the chancellor of the Exchequer, had instructed banks to block all Czechoslovak assets. But Czechoslovak gold held in a BIS account at the Bank of England, it seemed, was not defined as a national asset and was beyond the reach of UK laws.

Norman and Beyen's decision caused despair and incomprehension in Prague and uproar in London. The loss of the Czechoslovak gold was all "Norman's fault," exclaimed the *Daily Herald*.[2] Paul Einzig, of the *Financial News*, ran a stream of stories exposing the complicity of both the treasury and the Bank of England in the affair. Einzig demanded to know why the treasury had not stopped the transfer, as it was in clear violation of the law known as the Czechoslovakia Act. Brendan Bracken, a journalist and ally of Winston Churchill, declared in the House of Commons that "the Bank of England after what has happened may no longer be looked on as the safest place in the world and the phrase 'Safe as the Bank of England' may no longer apply."[3] Churchill himself demanded to know how the government could urge people to enlist in the military when it was "so butter-fingered that six million pounds of gold can be transferred to the Nazi government."[4]

The real villain of the affair was Norman. Beyen, who later served as Dutch foreign minister and as executive director of the International Monetary Fund, was an ineffectual bureaucrat, paralyzed by the idea that he might have to take responsibility for a decision. Norman could have stopped the transfer immediately. He was the governor of the Bank of England, which held the two BIS accounts involved. At the very least he could have asked for the transfer to be referred to the BIS board for a decision, which would also have been a face-saving measure. He chose not to do so. It was clear that war was coming, one that Britain would have to fight. The Nazi invasion of Czechoslovakia had destroyed the last hopes of peace. That country's gold reserves, held in London, were now a British national security issue.

Yet Norman's priority was not the best interests of his homeland, but rather the independence of his beloved BIS. Even as the shells were loaded into the German tanks, Norman still believed that for the

bankers it could be business as usual. Nothing could interfere with the bankers' sacred neutrality and gentlemanly trust in one other, not even the coming conflagration with a regime whose evil was now plain to see. The Bank of France had refused to stop the transfer but had also asked Norman to block it. Norman was adamant. There could be no political interference in the operations of the BIS, even, it seemed, when they were ordered at gunpoint.

Norman did not express any regret at all over the Czech gold transfer. In fact, he was positively indignant at the very idea that the British government might have some say in the bank's actions. He wrote, "I can't imagine any step more improper than to bring government into the current banking affairs of the BIS. I guess it would mean ruin. I imagine the Germans would never have paid any interest to the BIS, and at the board we would have then likely have found the Germans, Italians, and Japs standing together!"[5] Norman then lied to Sir John Simon, the chancellor of the Exchequer, albeit with a very telling falsehood. Simon asked Norman if he could not have warned the government that, thanks to the BIS, Germany was about to acquire "large additional financial strength." Norman told Simon that while the Bank of England held gold for the BIS, it did not know if the gold was actually owned by the BIS or was held by the BIS for other central banks. This was untrue, as Norman later admitted. Norman then made a significant, even shocking, admission. He told Simon that "he was very doubtful that he would have thought it his duty, as Director of the BIS, to make a statement about its transactions to the British government."[6]

Norman even wrote to Beyen to clarify the matter and to assure the BIS president where his ultimate loyalties lay in Basel. Norman did not want to publicly correct the minutiae of what was being reported in the press and *Hansard*, the British parliamentary journal—that the Bank of England did not know whose gold was held in the BIS accounts—as that would expose him. "The difficulty is that if I point out to the Treasury that this is incorrect, I lay myself open to being asked details of BIS transactions, which I do not consider the Treasury are entitled to know."[7] This was little short of treason. As Norman's compatriots were enlisting in the military, preparing to risk their lives for the freedoms and luxury that he enjoyed, as his country prepared for the war against the Nazis that all knew was coming, Norman blithely announced that his primary loyalty was not to Britain, but to a hyper-privileged, international bank that was not even a decade old.

The mistake of Malik, the director of the National Bank of Czechoslovakia, was to believe that either Norman, Beyen, or indeed any of the BIS management could conceive of any moral or political dimension to their decisions. The world's most powerful international bankers were not only unwilling to obstruct the Nazi seizure of Czechoslovak—or Austrian—assets. They simply could not conceive of any reason why they should do so. As long as the formalities were observed, the necessary papers were stamped and the gold was re-assigned. Norman's precious independence for both the Bank of England and the BIS had been bought at a high price—in mountains of gold ingots to pay for steel to build bombs that would soon rain down on London.

THE SAME OBSESSIVE legalism governed the response of the US Federal Reserve to requests from American banks to transfer Czechoslovak assets. On March 16, 1939, the day after German tanks rolled into Prague, Henry Morgenthau, the US Treasury secretary, called George Harrison, the president of the New York Federal Reserve, to say that the principal banks in New York had been asked—voluntarily—not to make any "important or unusual" transactions involving Czechoslovak assets until Monday, March 20, when the situation might become clearer.

By Tuesday, March 21, the situation was as clear as Bohemia's famed crystal: Czechoslovakia no longer existed. The country had been absorbed into the Third Reich. Harrison called Morgenthau to find out what the US position was. Morgenthau consulted the State Department and told Harrison that the banks

and the lawyers should decide for themselves what to do if they were asked to move Czechoslovak funds. On Thursday, John Wesley Hanes, Morgenthau's undersecretary, called Harrison and asked him to inquire from the New York banks about the deposits they held for the Czech National Bank. The information would be passed to the State Department, which would give it in turn to the Czechoslovak ambassador. Harrison did not agree with the banks' handing over the information voluntarily. That would not be a good idea, as it might trigger retaliation in Germany against American interests. The treasury should compel the banks to surrender the information rather than request it. And if the Czechoslovak ambassador wanted the information, he could look it up himself, in Thomas Skinner's *Bankers' Almanac and Yearbook*.[8]

A few days later, on April 1, the New York Federal Reserve received a cable that ordered the transfer of $35,000 from the Czechoslovak National Bank account into the BIS. Harrison wrote Marriner Eccles, the chairman of the Federal Reserve Board, in Washington, DC, and set out the chain of events. The request, he wrote, was "properly tested in every way." For most observers, the simplest test showed that as Czechoslovakia no longer existed, it was obvious that the request should be blocked. But not to Harrison and Eccles. For them, like Norman in London and Beyen in Basel, the most important thing was to keep the money moving. Harrison could see "no reason, regardless of the possible motive for the transfer, for refusing to honor it." Even worse, was the possibility that there "might be greater liability on us for refusing to honor the transfer than in honoring the order."[9]

The Czechoslovak ambassador thought otherwise. He wrote a letter pointing out that the transfer requests may have been made under duress and asked that such requests not be honored. Ever the bureaucrat, Harrison made sure to guard his back. Just as Beyen had done in Basel, Harrison consulted a lawyer on how to proceed further. The crucial issue was not the Nazi takeover of Czechoslovakia, but the potential risk to the New York Federal Reserve. All drafts against the account of the Czech National Bank's account were to be honored, provided they were properly drawn and tested. "It is our opinion that there is less risk to the bank in following this procedure than in refusing to honor a draft merely because, as the Czechoslovak minister says, it might or might not have been drawn 'under duress.'"[10]

UNUSED TO PUBLIC scrutiny of their decisions, the BIS bankers were taken aback by the depth of the anger against them over the Czechoslovak gold affair. There were recriminations and buck-passing at the BIS board meeting in June that year. Fournier, the governor of the Bank of France, protested that the decision had been taken without consulting the board—which was rich, considering that he had told Beyen that neither the Bank of France nor the Bank of England had any objections to the transfer. Sir Otto Niemeyer, the chairman of the BIS board, defended himself, falling back on the usual excuses. "The Bank had satisfied itself that there was no legal reason why the instructions should not be executed, and the transaction was therefore carried out in the usual manner. There had, in fact, been no alternative but to carry out the instructions received."[11] One director (unnamed) suggested that in future the board should be consulted on "important matters," as the board was responsible for policy. Niemeyer quickly shot down the proposal. Not surprisingly, Niemeyer wholeheartedly took Norman's position. As the BIS was an international institution, it could not concern itself with "political questions." This was nonsense, for the decision to authorize the transfer was profoundly political, executed in a Europe that had never been more politicized and which was about to erupt in war.

Malik left Prague in August 1939 and fled first to Basel, to explain the facts of the Czechoslovak gold transfer to the BIS management before eventually finding refuge in London. There remained the question of the Czechoslovak National Bank's four thousand shares in the BIS. By the end of that year their status, the bank's 1939 report noted, had not still "yet been determined." After the war ended, Malik claimed that

he had to dissuade Paul Hechler, the German head of the BIS banking department and Nazi loyalist, from distributing the Czechoslovak BIS shares to the Reichsbank, the Hungarian National Bank, and the national bank of the new Slovak Nazi puppet state (the banks of the three states that now controlled the former Czechoslovak territories). The "plan was then contemplated by him in all seriousness," Malik wrote.[12] In the end, the BIS took a more judicious approach to the Czechoslovak BIS shares than it had toward the country's gold reserves. After seeking legal advice, the BIS suspended them.

But the affair had highlighted the deeply unsettling connections between the Bank of England, the British government, and the BIS. There was a good deal of cross-party feeling in Britain, reported the *New York Times* , that "the Bank for International Settlements should be liquidated before it furnished any more sinews of war to Germany, and that the odd relationship between the British government and the Bank of England should be re-examined without delay."[13] The *New York Times* then was able to assume that its readers would understand a classical allusion. The word "sinews" was a reference to an epithet of Cicero, the Roman philosopher, who had said, "The sinews of war are infinite money." Cicero's observation was as prescient then as during the late 1930s. But those who wanted the BIS to be liquidated were too late. Thanks to the BIS the "sinews of war" and the flow of near-infinite money were about to be immeasurably strengthened.

THE CZECHOSLOVAK GOLD affair also highlighted how the bank's increasingly sophisticated gold operations were growing in reach and importance. The BIS's gold trades were a primitive forerunner of today's globalized economy where vast sums instantly fly back and forth at the touch of a keyboard. The technology available in the 1930s was far more primitive, but the principle of buying and selling assets sight unseen and without taking physical possession is the same. This development of a free gold market between central banks via the BIS was significant. Had all the Czechoslovak gold been held in an account at the Bank of England in the national bank's own name, rather than at a BIS account, it is doubtful that any would have reached the Reichsbank.

The BIS offered central banks a unique service, one unavailable to private companies or individuals who were not allowed to hold accounts there. The BIS held two kinds of gold deposits: bank deposits and earmarked gold. The first was gold deposited there by central banks. In 1936 this accounted for around 14 percent of deposits. (The actual bars of gold were held at the Swiss National Bank in Bern.) The second category was known as "earmarked" gold—gold that was physically held in another bank but that was credited to the BIS's account (as the Czechoslovak gold in London had been).

The BIS held collective gold accounts at the Bank of England and the New York Federal Reserve. These accounts were subdivided into subaccounts for central banks, which owned the gold, although the gold was physically stored in London or New York. Neither the Bank of England nor the New York Fed was supposed to know which central bank owned the sub-accounts held in the name of the BIS, although as Norman's correspondence over the Czechoslovak gold affair shows, they did. So if the Bank of France (sub-account X) wanted to transfer funds to the Bank of Hungary (sub-account Y), the BIS simply instructed the Bank of England to make the necessary deposit from sub-account X to sub-account Y. Earmarked gold, as Toniolo notes, "allowed for cheap and confidential transactions between central banks, as the transfer of property merely entailed a bookkeeping change by the BIS."[14] This was a growth industry for the BIS—in 1935–1936 earmarked gold movements totaled more than 1,121 million Swiss gold francs. By 1938–1939 that sum had increased to more than 1,512 million.

BIS managers and directors were immensely proud of the bank's innovative, new mechanisms for gold and foreign currency trades. But the principle behind earmarked accounts was not nearly as new as they believed. Few, if any, of the BIS directors had ever heard of the island of Yap, in Micronesia. But

centuries ago its inhabitants had invented a similar system, one based on large limestone discs. The discs, known as *fei*, were quarried on a neighboring island and brought back to Yap by boat. The discs, the islanders decided, represented substantial wealth—enough, for example, to pay for a daughter's dowry. But the "currency" was extremely heavy and almost unmovable. So it stayed in its place, and only the ownership changed with the agreement of the buyer and seller. In fact the stone did not even need to be present on the island. The locals' oral tradition tells of one disc that fell off the boat into the sea. Rather like the gold deposits at the BIS accounts in London or New York—or indeed any bank nowadays—the physical existence of the submerged *fei* was taken as a matter of faith. The islanders simply passed the ownership of the submerged disc back and forth—until 1899 when the Germans arrived and colonized the island of Yap.

The islands' new rulers demanded that the inhabitants repair the walkways that linked the different settlements. The locals ignored their orders, and eventually the Germans decided that they must be fined. Painting a large black cross on the most valuable fei and declaring them to be the property of the government exacted the fine. It worked. The islanders quickly fixed the paths, the German officials removed the crosses, and the islanders once again had possession of their capital assets.

To the sophisticated financiers of the twentieth century, such an episode would have seemed charming but irrelevant. But as Milton Friedman later noted, it was very relevant indeed. Neither gold nor stone discs have any inherent value. Their worth is completely arbitrary, the worth that we give them. The painting of the Yap islanders' stone discs had precise parallels in 1932 when the Bank of France decided to sell its dollars. The bank feared that the United States would not adhere to the traditional gold standard at $20.67 for an ounce of gold. It asked the Federal Reserve of New York to use its dollars held there to buy gold. As it was expensive and risky to ship the gold across the Atlantic, the Bank of France asked the New York Fed to simply store the Bank of France's newly acquired gold at its account there. Friedman described what happened next:

> *In response, officials of the Federal Reserve Bank went to their gold vault, put in separate drawers the correct amount of gold ingots and put a label or mark on those drawers indicating that they were the property of the French—for all it matters they could just have done so by marking them "with a cross in black paint" just as the Germans did to the stones.*[15]

This event—or arguably non-event—had serious consequences. The French sale of dollars drove the exchange rate down, while the franc strengthened, even though nothing had actually happened. What was the difference, asked Friedman, between "the Bank of France's belief that it was in a stronger monetary position because of some marks on drawers in a basement more than 3,000 miles away and the Yap islander's conviction that he was rich because of a stone under the water a hundred miles or so away?"[16] Evidently, not very much.

PERHAPS NORMAN AND Schacht sensed, as they traveled together from Berlin to Basel that January 1939, that this would be the last meeting at the BIS they would attend together. By then Schacht realized that he had created a monster. The German war economy and state spending were out of control. If things carried on as they were, Schacht and his fellow Reichsbank board members believed, the country would go bankrupt. On January 7, Hitler received a memo signed by all eight members of the Reichsbank board, including Schacht. Uncontrolled expenditure would soon cause the "national financial structure" to

collapse, the memo warned. “It is our duty to warn against this assault on the currency.”[17]

Two weeks after Hitler received the Reichsbank directors’ memo, Schacht was summoned to the Chancellery in Berlin. Hitler handed him the official notification that he was relieved of his position as president. Most of Schacht’s fellow directors resigned. Walther Funk, who also took his place on the BIS board, replaced Schacht. Funk, a former journalist, was an ardent Nazi and had joined the party in 1931. He was the point man for big business and industrialists, including IG Farben, who used him to channel funds to the Nazis, and was also one of Hitler’s key economic advisers. Funk had replaced Schacht as economics minister in 1937, and as Plenipotentiary for the War Economy in 1938, so his appointment as Reichsbank president surprised nobody. What was a surprise was how Funk’s dissolute personal life had not stalled his steady rise through the highest reaches of the Nazi state. Funk was a scruffy drunkard and homosexually active at a time when gay men were sent to concetration camps.

Schacht retreated home to his villa in the Berlin suburb of Charlottenburg for a while, and then set off in March on a trip to India. In July 1939 he returned to Basel where he had a secret meeting with Montagu Norman. Schacht made a bizarre offer to the British government. Fearing for his life, and less protected by Hitler from his enemies in the SS, who had always envied his power over the economy, Schacht proposed that he go to east Asia to report on the economy for Britain. Norman met with Neville Chamberlain and told the prime minister of his friend’s request. Schacht’s offer was met with some bewilderment, but Frank Ashton-Gwatkin, a foreign office official, was dispatched to Italy. He and Schacht spent three days closeted in a luxury hotel above Ancona. Ashton-Gwatkin recalled, “I listened to Schacht’s odd-sounding scheme, and, allowing for the fact that he was anxious to get as far away from Hitler as possible, I had to confess that I had heard of more promising ventures.” Still, he told Schacht that he would write a report on his proposal and submit it to London.

Schacht then demanded to see what Ashton-Gwatkin had written. The Foreign Office man handed over his notes. Schacht, imperious as ever, informed him, “This won’t do at all.” Schacht rewrote the report and then demanded that the original be destroyed. Ashton-Gwatkin handed over his notes, which Schacht, with great theater, proceeded to set on fire, sheet by sheet and then drop into the toilet. Schacht was less adept as a spy than a banker. The toilet cracked, and water gushed the wet ashes all over the floor. “We spent what seemed to me a long time mopping up the water and fishing for sodden bits of charred paper,” recalled Ashton-Gwatkin. Schacht’s mission never took place.[18]

Just over a month later, on September 1, Germany invaded Poland.

"The business affairs of the bank, which are run on a greatly reduced scale, virtually rest in the hands of Mr. McKittrick, the president of the bank."

— John Gilbert Winant, the US ambassador to Britain, July 1941[1]

Merle Cochran, the American diplomat whom Henry Morgenthau had dubbed the "unofficial ambassador" to the BIS, had some inside information for the treasury secretary. The main business at the "usual Sunday informal and secret meeting" of the bank's governors that May 1939 was the appointment of the next president. Johan Beyen, the hapless Dutch incumbent who had handed over the Czechoslovak gold to the Nazis, was due to retire in 1940. There were three main contenders to succeed him: a Dutchman, a Swede, and an American. "Chances are best for the American, so far," Cochrane reported.[2]

The American was Thomas McKittrick. On the surface McKittrick seemed a curious choice. He was a lawyer by training with no direct experience of central banking. But that mattered little, for war was coming. All sides already agreed that the financial channels must be kept open during the conflict. In that sense, McKittrick was the perfect candidate. He was citizen of both a neutral country—the United States—and of the world's newest hinterland—transnational finance.

McKittrick had worked for Higginson & Company, the British subsidiary of Lee, Higginson & Company—a renowned Boston investment house. The bank no longer exists, thanks in part to McKittrick, but in its heyday it was richer and more prestigious than Goldman Sachs and Lehman Brothers. Born in St. Louis, McKittrick had graduated from Harvard in 1911. He moved to Italy where he worked for the foreign arm of the National City Bank of New York, before joining the US Army in 1918. He was sent to Liverpool, where he was seconded to British military intelligence, to check that there were no spies using the docks to pass in and out of Britain. After the armistice in November, McKittrick was dispatched to France to work with the Allied occupation forces.

He returned to New York in 1919 and started work at Lee, Higginson. McKittrick's foreign experience in Italy and France made him unusual in the more parochial world of American bankers. He was sent to London in 1921 to work for the company's British wing, and was made a partner in charge of foreign operations for both London and New York. Although McKittrick was a lawyer rather than a banker by training, he soon found his way around the City of London and built up an impressive network of contacts with international connections. Much of his time was spent working on German loans and investments, including the Dawes Plan German External Loan of 1924, which had been arranged by John Foster Dulles and Sullivan and Cromwell. McKittrick became a kind of honorary Englishman, regarded in Europe as an envoy from the City, complete with a butler who ironed his copy of *The Times* before he read it. "I was leading the life of an Englishman," he later recalled. "My associates were all British, and toward the end of that time I was frequently spoken to by people who assumed I was British."[3]

McKittrick had come to the BIS in 1931 when he joined the German Credits Arbitration Committee, which adjudicated over any disputes of credits granted to German private banks. The other two members were Marcus Wallenberg, of Sweden's Enskilda Bank and Franz Urbig, the chairman of the Deutsche Bank supervisory board. Wallenberg and his brother, Jacob, were two of the most powerful bankers in Europe. The Wallenberg family enjoyed a network of lucrative connections to bankers in London, Berlin,

and Wall Street. During the Second World War, the Wallenberg brothers would use Enskilda Bank to play both sides, always making sure to harvest enormous profits along the way. Their relative, Raoul, would later save tens of thousands of Hungarian Jews during the Holocaust before disappearing into the Soviet gulag, abandoned by his uncles.

McKittrick had long been a good friend of Allen Dulles, whom he had first met when Dulles was working at the American Legation in Bern and Dulles assisted him with a visa matter. McKittrick well understood that Sullivan and Cromwell offered an entrée in the covert world where politics and diplomacy met transnational finance. In September 1930 McKittrick wrote to a colleague, "We are seriously considering throwing some legal work to Sullivan and Cromwell in order to get benefit of Dulles services in many directions."[4] McKittrick also arranged short-term loans to the German government. McKittrick's German loans were watched appreciatively at the BIS and Sullivan and Cromwell. In October, Gates McGarrah, the BIS president, wrote to John Foster Dulles expressing how glad he was that the "Lee Higginson [German] credit got itself through."[5]

So were McKittrick and his partners at Lee, Higginson. At least something was going right, for the firm had become embroiled in the affairs of one of the greatest swindlers in history, Ivar Kreuger, a Swedish industrialist. Kreuger had built up a fortune—on the simple safety match—that would now be worth billions.

Wall Street had welcomed Kreuger with open arms and checkbooks. Thanks to McKittrick and his colleagues, Kreuger's reputation had preceded him. The London Higginson partners told their American colleagues that Kreuger had already made them a fortune. But it was a fortune built on fraud. Kreuger had constructed a massive Ponzi scheme that demanded a never-ending stream of new investors to pay their predecessors. In 1931 one of the brokers at Lee, Higginson wrote to Kreuger that some of his bank creditors would like more information about the company and how it worked. The broker asked Krueger to explain what he meant by "loans secured by real-estate mortgages," which was an eerie precursor of the bundled mortgages that triggered the subprime meltdown in 2007.

What Kreuger meant was that he could no longer pay his creditors. He frantically tried to arrange a bailout with Sosthenes Behn of ITT. Behn wrote a check for $11 million on the condition that Price Waterhouse, the accounting firm, could check Kreuger's finances. It did, and it quickly found a hole of $6 million. Kreuger's empire began to collapse. ITT wanted its money back. Kreuger returned to Europe in March 1932 to meet his bankers, but he made it only as far as his apartment on Avenue Victor Emmanuel III in Paris. There, according to most accounts, he lay down on his bed and shot himself in the heart. Lee, Higginson, the venerable Boston bankers who had backed Kreuger for a decade, went bust. The partners were ruined. "I suddenly knew we had all been idiots," an anonymous source told investigators. But McKittrick kept his job at the bank's London branch, as well as his position as vice chairman of the BIS's German Credits Arbitration Committee. It seems there were no recriminations or questions in Basel about McKittrick's judgment—or lack of. McKittrick himself later claimed that he had been selected as president of the BIS without his knowledge or participation. In March 1939, he recalled, "People began whispering—primarily on the continent—'we hear that you're going to BIS as president.' And that continued. The normal grapevine operation." The following month Charles Dalziel, McKittrick's fellow partner at Higginson & Co., told him that "he had heard on an unquestionable basis that I was going to be offered the presidency in the BIS and he wanted me to know that I would make a great mistake if I didn't accept it."[6] Sir Otto Niemeyer, the chairman of the BIS board, made the formal offer in May. McKittrick readily accepted. At first the State Department refused to allow McKittrick to travel to Europe, but after what McKittrick later described as the "principal European countries," doubtless including Britain, applied sufficient pressure, he was allowed to leave. McKittrick moved to Basel and started work in

January 1940 on an annual salary of SF175,000 (US$40,000). He immediately traveled to Berlin, Rome, London, and Paris to meet the German, Italian, British, and French BIS directors and central bankers.

But before McKittrick moved from London to Basel he had another task: to help Hitler's former propaganda chief get released from a British prison camp. In October 1939 Ernst Hanfstaengel's lawyers asked McKittrick to provide a character reference for their client. Hanfstaengel, a Harvard graduate, had lived in New York and was well connected in American high society. He returned to Germany to become one of Hitler's earliest backers. Hanfstaengel lent the Nazi party $1,000 dollars during its early years—an enormous sum during the Weimar hyperinflation—which paid for the publication of the *Völkischer Beobachter*, the party newspaper. Appointed foreign press chief in 1931, Hanfstaengel's job was to present a moderate, sophisticated face to journalists. However his eccentric mannerisms, dry sense of humor, and close connection to Hitler made him enemies, and he fled in 1937. Hanfstaengel's detention as an enemy alien was especially badly timed, explained his lawyers, as he had just signed a contract with an American magazine to write a series of articles about his relations with Hitler—at one dollar a word. McKittrick replied that he would do all he could. McKittrick was ready to declare that the former Nazi spin doctor would not act against British interests if he were set free—although it is unclear how McKittrick could know this.[7] Hanfstaengel was duly released and returned to the United States, where he compiled psychological profiles of Nazi leaders for American intelligence.

McKittrick was not a Nazi, but he was certainly a friend of the new Germany and, like many in his social and business circles at that time, had an ambivalent attitude toward Jews. In November 1938, two weeks after Kristallnacht, he used his contacts to help Rabbi Israel Mattuck, of the Liberal Jewish Synagogue in London. McKittrick introduced Rabbi Mattuck to the US Consul General in London to try and help arrange the immigration of German Jews. Mattuck wrote a grateful note thanking McKittrick "most heartily." The meeting had been very useful. "As a result, I hope that I may, by means of a fund that we have here, help at any rate a few German Jews to find a way of escape."[8] Later on, during the war, in August 1942, Paul Dreyfus, a Basel banker, asked McKittrick to write a letter of introduction to Leland Harrison, the American ambassador to Switzerland. McKittrick obliged but made his feelings about Dreyfus clear in a separate letter to Harrison. "He is, as you will surmise, a Jew, but a good sort who is doing everything he can to help his unfortunate countrymen."[9]

THE OUTBREAK OF war brought existential choices for the BIS's management. There were three options: liquidate the bank, downsize and become dormant until the end of hostilities, or remain as active as possible within the bounds of the declared policy of "neutrality." The directors were unanimous—and already thinking ahead of the needs of transnational capital: the BIS must be kept going to assist with postwar financial reconstruction. McKittrick gave an undertaking to the Swiss authorities that all staff would not "undertake political activities of any sort whatsoever on behalf of any governments or national organizations." Any such departures, he noted in a memo to staff, would be "particularly regrettable at present when special privileges are being sought on behalf of the bank and its staff."[10] A safe passage home would be arranged for anyone who wanted to leave.

The BIS declaration of neutrality meant the following: the bank would not grant credit to central banks of belligerent countries; it would, when operating on neutral markets, ensure that belligerents did not profit from such operations; it would not carry out any transactions, either direct or indirect, between countries at war with each other; it would not sell assets in one country to make a payment to another if they are at war, and it would not hold assets of one belligerent country secured against another. Badly burned by the Czechoslovak gold affair, the BIS said it would not make decisions implying recognition of what it delicately called "territorial changes not universally accepted." When the central bank of the

German Protectorate of Bohemia and Moravia (the illegitimate Nazi regime ruling Czechoslovakia) requested the transfer of its remaining gold held at the BIS to the Reichsbank, it was blocked. When the Belgian government in exile proclaimed that the National Bank's official seat was in London, the Nazi occupation regime responded that the bank's headquarters were in Brussels. The BIS said it was neutral and would not recognize either. The Belgian vote on the board of directors remained unused. The BIS took the same position with regard to Yugoslavia, when faced with competing claims from Belgrade and London.

The bank's declarations of neutrality soon proved worthless. McKittrick and the rest of the bank's management turned the BIS into a de facto arm of the Reichsbank. This was not a result of inertia, passivity, or bureaucratic sloth. It followed from a series of deliberate policy decisions. The BIS carried out foreign exchange deals with the Reichsbank. It accepted looted Nazi gold until the final days of the war, when even neutral countries such as Sweden had begun to refuse it. It recognized the forcible incorporation of occupied countries, including France, Belgium, Greece, and the Netherlands, into the Third Reich. By doing so, it also legitimized the role of the Nazi-controlled national banks in the occupied countries in appropriating Jewish-owned assets. The BIS allowed the Nazi occupation regimes to take ownership of BIS shares, so that the Axis block held 67.4 percent of the bank's voting stock. Board meetings were suspended, but Annual General Meetings continued. Shareholder banks voted by proxy. The case of Poland is telling. In April 1940, Leon Baranski, the Polish representative to the BIS, asked for the government in exile in London to take control of the Polish shares. McKittrick refused. He told Baranski that he did not want to have to issue a ruling, but if he was forced to, the "result may necessarily be an adverse decision" for Poland. McKittrick was determined to avoid raising "a question of this sort," for "once political discussion gets underway, even without publicity, one never knows where it will end."[11]

While Nazi territorial annexations were accepted, Soviet ones were not. In June 1940 the Red Army invaded Latvia, Lithuania, and Estonia. The Soviets ordered the three central bank governors to instruct the BIS to transfer their gold reserves to the Soviet Union's state bank. The parallel with the Czechoslovak gold was clear—but the outcome was very different. The BIS's management, as legalistic as ever, argued that the bank had to accept the instructions. But this time the president refused. "I had to fight my whole management—particularly my legal adviser, saying that we had to accept these instructions and turn the gold over to the Russians. But I just couldn't do it," McKittrick recalled.[12]

Instead, McKittrick commissioned an outside legal opinion from Professor Dieter Schindler of Zürich University. Schindler argued that neither the governors nor the banks of the Baltic States were free agents, but had probably acted under the instructions of the Soviets. He quoted Article 10 of the BIS charter, which prohibited coercive measures against depositors. Thus, Schindler argued, it was the duty of the BIS management to "resist, as far as lies in their power" any attempts by governments to interfere with the BIS's assets. McKittrick was vindicated. He sent a copy of Schindler's memo, which was accepted by the bank management, to Merle Cochran. The BIS president asked him to keep Schindler's legal opinion confidential. "My one serious concern is that it should not get into the press. After the damaging campaign of publicity regarding the Czech gold, it is of the greatest importance to the BIS to remain in the background at this time."[13]

UNTIL THE OUTBREAK of war, the BIS was a congenial place to work. The staff were well paid, intelligent, and cosmopolitan in their outlook. The BIS, like the League of Nations, was an international oasis. Managers regularly traveled to meet their counterparts in London, Paris, Berlin, and other capitals.

The governors' meetings were the high point. Some of the most powerful people in the world traveled to Basel, sprinkling the staid BIS with a little stardust. The staff enjoyed the glamour, the sense of being on the inside track, and the social whirl of dinners, receptions, and teas.

That idyll ended with the fall of France in May 1940. Axis-controlled territory now surrounded Basel on two sides where the borders reach almost to the city limits. Bank officials worked to a backdrop of gunfire. The Swiss authorities feared a German invasion and made plans to evacuate the city. Meanwhile, McKittrick's patrons in London were keeping a very close watch on their protégé. The BIS president was in regular contact with Sir Frank Nelson, the British consul in Bern. Nelson, who was an experienced international businessman, later became chief of the Special Operations Executive, the British wartime sabotage organization. One day, around May 20, as tension soared, Nelson called McKittrick at home at 7 a.m. The British diplomat told him, "Things look very bad indeed. They couldn't look worse." Nelson explained that he must be able to reach McKittrick at any time. He told him, "Don't go out without telling somebody where you are going, and don't leave the next place without telling me where you're going."

At 7 p.m. that evening, McKittrick had returned home when Nelson called again. He instructed the BIS president to evacuate all French and British staff from Basel immediately. The Nazi invasion was imminent, expected to commence at any moment. McKittrick returned to the bank's headquarters and summoned his senior staff, including Roger Auboin, Rafaele Pilotti, and Paul Hechler. They contacted as many French and British employees as they could. Hechler then told McKittrick, "You're the only man who alone can dispose of the assets of this bank. I think you're the most important man for us to get out of Basel." McKittrick agreed and quickly abandoned his colleagues. He called his chauffeur, and went home and grabbed some clothes. The chauffeur, McKittrick recalled, "didn't pack them but stuffed them into the car." They headed for Bern and were stopped on route fourteen times by Swiss soldiers or police.[14]

The German invasion of Switzerland never happened. Swiss francs, Swiss banks, and the BIS were far more use to the Third Reich than another stretch of mountainous territory, where a stubborn, hardy population would have likely waged guerilla warfare against the Nazis. The BIS relocated to Château d'Oex, in the southwest of the country. McKittrick and Per Jacobssen moved into the Chateau de Rougemont, kindly loaned by its American owner. The rest of the staff had to make do in the village. There were few decent houses, schooling was basic, and the village was tiny. By the end of the autumn, as the war ground on, relations between the different nationalities were near-poisonous. Morale was collapsing, recalled McKittrick. "There was only one movie house in town, and if a Frenchman and his wife went to the movies, and a German and his wife went to the movies, and they walked into each other, it was an embarrassment for all concerned."[15]

Everyone was relieved when the BIS returned to Basel in October 1940. There, despite the conflict, the BIS continued to enjoy immense financial as well as legal privileges. It could buy and sell unlimited amounts of Swiss francs. This was the most important currency in wartime Europe, accepted everywhere. The BIS, thanks to its charter, did not have to report foreign exchange transactions. Its exchange rate against the Swiss franc was not subject to the same restrictions as Swiss commercial banks. Until 1942 the BIS could buy and sell gold at better rates than the Swiss National Bank. This bizarre setup, where Allied and Axis bankers worked together so profitably, drew increasingly hostile attention in London and Washington, DC.

The State Department asked the American embassy in London to investigate the state of the relationship between the British government and the BIS, noting that "many problems" have come up. John Gilbert Winant, the ambassador, met with Sir Otto Niemeyer, the former chairman of the BIS board. Niemeyer was as adamant as ever about the BIS's immunity. He pointed to article 10 of the BIS's charter that guaranteed that in the event of war, the property and assets of the bank shall be immune from seizure.

Niemeyer had even made arrangements with the British government that BIS communications to London could pass directly through the censor. "It is Niemeyer's belief," wrote Winant, "that the British should continue their association, as well as lend the bank their tacit approval, if only for the reason that a useful role in postwar settlements might later have an effect."[16] While the BIS was operating in such a restricted manner, "it was felt that it would be of no use at this time to raise difficult legal questions with respect to the relationship of the various countries overrun by the Germans." Niemeyer argued that McKittrick should stay in Switzerland as he was "the guardian of the bank against any danger that might occur."[17]

McKittrick was far more than a guardian of the BIS. He repeatedly passed economic and financial intelligence to the Reichsbank leadership. McKittrick was especially close to Emil Puhl, the vice president of the Reichsbank and BIS board member, whom McKittrick described as his "friend." Puhl, a gold and currency specialist, was a regular visitor to both the BIS at Basel and the Swiss National Bank in Bern. He had close links with the financial wing of the SS that managed its extensive business interests. Puhl, rather than Walther Funk, his nominal superior, was the real boss of the Reichsbank. In autumn 1941 McKittrick gave Puhl a tutorial on the Lend Lease program, under which the United States supplied the Allies with arms, ammunition and other war material. The act, passed in March of that year, effectively marked the end of the United States' policy of neutrality. McKittrick later recalled the conversation. Puhl asked the BIS president,

> *"What does this Lend Lease thing mean? We don't understand it. Is there anything you'd be willing to tell me about it?" And I [McKittrick] said, "Yes. I'll give you this. It's my own idea but there's no reason I shouldn't tell it to you. I think that if America is going to be in the war something will happen to get us in. Just the way it did in the first war. And what is happening is that we're getting our industrial organization into shape for our entry into the war." I've never seen a man's face drop more than his did. I though he was going to faint or something. He said, "My God. If you're right, we've lost the war."*[18]

McKittrick's prediction proved correct. But America's entrance into the war in December 1941 caused him further problems. The BIS president was no longer a neutral, but a citizen of a belligerent nation—in daily contact with his German, French, and Italian colleagues. But the advent of hostilities between the United States and Nazi Germany did not change his cordial and productive relationship with the Reichsbank. Puhl wrote of McKittrick in September 1942, "Neither his personality nor his manner of conducting business have been any cause for any criticism whatsoever."[19] Puhl even described the BIS as the "only real foreign branch" of the Reichsbank.[20] Some of the BIS dividend payments to its shareholders in Nazi-occupied countries went through the Reichsbank, thus giving Berlin access to the foreign exchange transactions and allowing it to charge a fee for its services. During the war the Reichsbank continued to pay interest on BIS investments in Germany, even though that interest contributed to the bank's dividends, which were paid to its shareholders, including the Bank of England. Thus, through the BIS, Nazi Germany was contributing to Britain's wartime economy.

It was a price worth paying, Puhl believed. For despite Hitler's bluster and Schacht's planning, Nazi Germany had not achieved autarky. It needed to buy vast amounts of raw materials to manufacture armaments and to feed, heat, and clothe its population. Swedish steel, Romanian oil, Portuguese tungsten, even South American beef, all had to be purchased and paid for in hard currency. Nazi Germany needed a financial channel to the neutral countries it ran through Basel. Which is the main reason why Nazi Germany did not invade Switzerland or Sweden. These neutral countries were far more use to the Third

Reich as monetary hubs on the transnational financial network than as extra swathes of German-controlled territory.[21]

When questions were raised at the German Foreign Ministry as to why the Reichsbank remained a member of a bank with an American president, Puhl was the BIS's most influential advocate. The BIS was one of Germany's most important external trading partners, he argued. It carried out gold and foreign exchange transactions and gave the Reichsbank a mechanism for buying vital war materials. It was a listening post, providing useful intelligence on enemy financial transactions. The Germans working there, such as Paul Hechler, the assistant general manager, were loyal and efficient. If Germany pulled out and the BIS closed down, it would be an enormous loss to the Nazi war effort. And the BIS needed the Reichsbank—and Puhl—just as much. Per Jacobssen, the BIS's economic adviser, had lunch with Puhl on December 7, 1942, at Puhl's office in the Reichsbank. The two men always enjoyed each other's company. They had a pleasant meal, just a short walk from the bank's vaults that held the wealth of a looted continent and of its exterminated Jews. Puhl, Jacobssen believed, was the BIS's most important ally in Nazi Germany. Without his support the bank would collapse. Jacobssen later wrote in his diary, "I know full well to what extent the future of the BIS depends on Puhl's possibilities of holding the fort in Berlin."[22]

THE WAR WAS not good for the BIS's balance sheet. By 1943, its business volume fell to less than 5 percent of the average for prewar years. But the BIS had 294 million Swiss gold francs ($96 million) invested in Germany in the form of state bank funds, bills, and bonds. The bank was kept going by the interest payments it received from the Reichsbank, which eventually accounted for 82 percent of its income. At first Germany paid its dues in currency. But after March 1940 it changed to gold, much of it looted. During the war Germany added $603.5 million worth of gold to its reserves, more than 80 percent of which was plundered from the central banks of occupied countries. $88 million-worth was seized from citizens of Germany and Nazi-occupied territories. Around $3 million worth was taken from concentration camp victims, including the macabre category of "dental gold." This was also credited to an account at the Reichsbank, overseen by Emil Puhl, the confidant of Thomas McKittrick and lunch partner of Per Jacobssen.[23]

Thanks to research by Piet Clements, we know that during the war years a total of 21.5 metric tons of gold passed in and out of the Reichsbank gold account at BIS, of which 13.5 metric tons was acquired during the war. Some of the new gold—much of which was looted—was used to pay the interest on the BIS's loans and investments to Germany. Six metric tons were used to pay the Reichsbank's debts through the BIS payments system for international railway and postal traffic, which the bank also handled.

The fate of the Belgian gold reserves is the most extraordinary. At the end of 1939 the National Bank of Belgium sent more than 200 metric tons of its reserves to France for safekeeping. As the Nazis advanced, France transported the Belgian gold and some of its own to the port of Dakar in West Africa. Fearing an Allied raid, the French authorities then moved the gold inland. After the fall of Paris, Germany ordered the collaborationist French government based in Vichy to send the gold to Marseilles to be taken into the "custody" of the Reichsbank. The gold was then transported by boat, truck, train, and camel train through the Sahara Desert to Algiers. From there it was flown to Marseilles and eventually deposited in the vaults of the Reichsbank.

In the summer of 1943 Yves Bréart de Boisanger, the governor of the Bank of France, now under Vichy control, traveled to Basel to warn McKittrick about the fate of the Belgian gold, some of which would doubtless end up in Basel. McKittrick dismissed de Boisanger's concerns. All the gold received at the BIS had been stamped with the proper markings, he said, and was German, not Belgium. Whether or

not he believed this, McKittrick understood that if the bank were to stay in business there was probably no other option than to accept the Reichsbank's gold shipments. But Auboin, the French manager, sided with his compatriot. The BIS should no longer accept German payments in gold, but demand Swiss Francs instead.

Auboin was right. The Belgian gold had been melted down at the Prussian Mint and stamped with false identifying numbers and dates between 1934 and 1939. About 1.6 metric tons was used by the Reichsbank to meet its BIS interest payments, as well as 2 metric tons of looted Dutch gold.

However, not all the gold melted down at the Prussian Mint originated in the vaults of national banks. The Nazis set up a network of informers and torturers, called the Devisenschutzkommando (DSK), to track down private gold holdings in occupied territories. The stated purpose of the special unit that was handpicked by SS soldiers was to control currency traffic across the Third Reich. Its actual purpose was "the acquisition of gold by any means, including deceit and brutality," according to British intelligence records. In Paris alone the DSK employed eighty informers, from the "lowest levels of society to the highest circles."[24] Each received a 10 percent commission, as well as false identity cards and counterfeit American and British currency. Victims were lured with supposed sales of property or land. They were then arrested, beaten, and tortured to reveal how they would pay for such a purchase. The favorite interrogation method of Hugo Doose, who ran the DSK for the Channel Islands, was to break a beer glass over his victim's head. Ludwig Jaretski, an Austrian living in Paris, "employed burning matches on stripped victims."[25] Some of the BIS gold had an even more grisly origin, which came from the watches, spectacles, jewelry, and gold teeth of concentration camp victims. This was why, after the war, Emil Puhl, vice president of the Reichsbank and BIS director, would be found guilty of war crimes.

Under McKittrick's leadership, the BIS also carried out a significant number of gold transactions for other Axis powers. It sold gold for the Bank of France (Vichy) to Portugal for escudos, which France needed to pay for Portuguese imports. It organized three gold shipments from Bern to Bulgaria. It sold almost nine metric tons of gold to Romania, by undercutting the Swiss National Bank. All of these were direct breaches of the policy of neutrality. The BIS also carried out thirteen gold swaps with Turkey—a total of 8.6 metric tons—exchanging gold that Turkey had held at the Swiss National Bank for BIS gold that was held in New York, Paris, and London. Turkey was technically neutral but had strong trade relations with Germany and was the Third Reich's main supplier of chromium. Nor was the BIS was alone in its acceptance of looted Nazi gold, and the failure of its managers to check the gold's provenance. Swiss commercial banks and the Swiss National Bank (SNB) also readily accepted looted Nazi gold. The bankers' policy of "business as usual" with the Nazis was led from the top. Ernst Weber, the chairman of the BIS board from 1942 to 1947, was also the president of the Swiss National Bank. Weber, like McKittrick and Jacobssen, enjoyed cordial relations with Puhl. Even as the Allies fought their way through Nazi-occupied Europe to the Swiss border, Weber and Puhl were still arranging gold shipments. The two bankers had dinner together on December 10, 1944, to discuss their latest arrangement: Switzerland would buy German gold, and in exchange Germany would sell Switzerland coal. The negotiations took place in what Otto Köcher, the head of the German legation in Bern, called the "usual atmosphere of trust."[26]

The cozy relations between the BIS, the SNB and the Third Reich stayed buried until the late 1990s, when the scandal broke that Swiss commercial banks were still holding the assets of Holocaust victims. The BIS and the SNB were soon dragged in. A report commissioned by the Swiss government, published in 1998, said that Swiss National Bank officials followed an "ethic of the least effort" to check the origins of the gold sent to Switzerland, some of which had been looted from Holocaust victims. During the war the SNB bought $280 million of gold from the Nazis. By 1943 the SNB knew about the extermination of

European Jewry, but bank officials did not take measures to distinguish looted gold from other Reichsbank holdings.[27]

DESPITE MCKITTRICK'S SAFE and privileged existence, he was often lonely. His wife and four daughters were far way in the United States. Travel remained difficult and slow. There were few visitors in Bern, apart from Emil Puhl, and the postal service was erratic. McKittrick kept an account at a bookshop on Charing Cross Road and took refuge in non-bankerly works including, *Will Europe Follow Atlantis*, which examined the coming cataclysm of European civilization; a work of Sufi devotion called *At the Gate of Discipleship;* and even *The Occult Causes of the Present War*. McKittrick went walking in the woods and mountains with Erin Jacobssen, the daughter of the bank's economic adviser. A keen botanist, McKittrick taught Jacobssen about the region's rich flora. Other correspondence doubtless cheered the BIS president. Hermann Schmitz, the CEO of IG Farben and BIS board member, for example, sent his sincerest New Year wishes on January 3, 1941. Schmitz wrote, "For their friendly wishes for Christmas and the New Year, and for their good wishes for my 60th birthday, I am sending my sincere thanks. In response, I am sending you my heartfelt wishes for a prosperous year for the Bank for International Settlements."[28] It would certainly be another prosperous year for IG Farben, whose profits were soaring and whose plans were well advanced for the construction of IG Auschwitz, the firm's own corporate concentration camp.

Most of the BIS staff stayed, but Charles Kindelberger, an American with a young wife, returned home. His departure left a vacancy. Leon Fraser, now president of the First National Bank of New York, had a suggestion for his old friend McKittrick. In November 1940, Fraser met with a young man named Henry Tasca in Washington, DC. Tasca was working at the National Defense Commission, specializing in foreign trade and Latin America. "He has a pleasing personality, a manifestly keen mind, and is ambitious and hard-working."[29] Tasca could leave for Switzerland on thirty days' notice. "He makes a much more favorable impression than did Kindelberger, both in appearance and seriousness of purpose."[30] And Tasca, fortunately, had the right answer for the most sensitive question, reported Fraser. Merle Cochran had asked it, "and the reply was that Tasca was not Jewish."[31]

As the war ground on, the Czechoslovak gold affair still haunted the BIS. Once again, there were angry questions in the House of Commons about Britain's continued membership, the bank's role, and its connections to Nazi Germany. The government stayed firm in its support. Sir Kingsley Wood, the finance minister, declared in October 1942 that with McKittrick at the helm, there was nothing to worry about. "The conduct and control of the bank have been and are today in the sole hands of the President of the Bank, an American citizen. . . . This gentleman has our complete confidence."[32]

In Washington the Treasury Department was increasingly hostile, especially after the United States entered the war in December 1941. McKittrick's first term of office ended in December 1942. Many argued that it should not be renewed. Montagu Norman was certainly worried. In June 1942, Norman wrote to McKittrick to assure him of his continuing support. "We certainly hope that means can be found for you to continue your presidency of the Bank, indeed it is not too much to say that we regard it as *essential*."[33] Perhaps McKittrick could simply "carry on without any formal steps at all." Bearing in this mind, it would be helpful for McKittrick to visit the United States. "We would at any rate do our best to make that possible."[34]

Norman and his allies had a plan: to appoint Ernst Weber, the president of the Swiss National Bank and a BIS board member, as chairman, as long as he agreed to re-appoint McKittrick as president. Weber would be a neutral figurehead for the BIS and provide cover for its activities. As Ivar Rooth, the governor

of the Swedish Rijksbank, wrote to Norman, it was "important" that the Bank should be safeguarded by "putting in as authoritative position as possible a personage of neutral nationality."[35] Weber's discretion was guaranteed. In 1940 McKittrick had mentioned the Czechoslovak gold to Weber. The BIS president explained that the conversation went like this: "I asked him not to tell me where the gold would go, and he did not do so."[36] McKittrick was in close contact with Weber, whom he met in Zürich or Bern two or three times a month.

In Berlin, Joachim von Ribbentrop, the former German foreign minister, did not understand McKittrick's value to the Third Reich either. McKittrick should resign, he thought, and be replaced by a neutral, or Germany should sever its links with the BIS. Emil Puhl and Paul Hechler swiftly went into action. Both were great admirers of McKittrick, whom they described as "professional and loyal."[37] They told von Ribbentrop that if McKittrick went, Ernst Weber, once appointed chairman of the board, would take control. Even if McKittrick was deposed as president, the United States would still have a representative in the bank's management. Such a person would undoubtedly disrupt the "until now smooth functioning of the BIS and its use by us for conducting gold and foreign exchange transactions."[38]

McKittrick himself lobbied Marcel Pilet-Golaz, the Swiss foreign minister. The two men met in October 1942. There were several items to discuss. The unpleasant articles about the BIS in the British press unsettled McKittrick. The BIS president was hypersensitive to criticism or any hint that the British government might withdraw its support for the bank. As the bank depended on its neutrality for its continued existence during wartime, a British withdrawal would spell the end. The Swiss legation in London had taken the matter up with the Foreign Office and the Treasury. The articles did not reflect British governmental opinion, Pilet-Golaz said, reassuringly. Pilet-Golaz also confirmed the Swiss government's support for the BIS. The Swiss attitude to the numerous international organizations it hosted "varies very much."[39] He complained the League of Nations was the worst. The conduct of its staff left much to be desired, and it had created "numerous political difficulties."[40] The International Labor Organization (ILO) was somewhat better regarded, while the BIS had never "given cause for severe criticism."[41] It would certainly be a "cause for regret" if the bank would leave Switzerland.[42]

McKittrick then raised the delicate matter of the Weber plan. The chairman of the board, he explained, was very different to being president of the bank. The board dealt mainly with the bank's internal governance. The big questions of transnational capital flows, loans, and currency support were dealt with at the governors' meetings, which were anyway suspended for the war. Pilet-Golaz was agreeable, noted McKittrick. "He thinks it desirable that Switzerland should assist in the maintenance of international organizations and as an intermediary between belligerent countries when this can be done without undue publicity and when it does not interfere with the general policy of neutrality."[43]

It worked. Weber was appointed chairman of the BIS board. And on January 1, 1943 the Swiss banker re-appointed McKittrick for a further three years. By then, the BIS president—just as Norman had suggested—was in the United States.

"He believes that the Germans—at least those connected with the Reichsbank —desire his return [to Basel] and that some way will be found to make it possible."

— American intelligence report on Thomas McKittrick and the BIS, December 14, 1942[1]

The BIS had pioneered swift movements of international capital but could do little to speed its president across the Atlantic with enough cash in his pocket. In late 1942 Thomas McKittrick planned to travel to France, Portugal, Spain, and Britain, and then head to the United States. But even with his privileged status, he was still subject to currency control laws that allowed him to take a maximum of 1,000 French francs into France. "Can French franc banknotes be sent by registered mail to Spain from Switzerland?" he wondered in a note to himself. Such postal smuggling might be a better option, as he could use the French francs to buy pesetas on the black market. "Spanish currency can be obtained on better terms than by exchanging dollars or Swiss francs in Spain at the official rate," McKittrick mused to himself. Food might also be problematic, especially perhaps for someone used to the BIS dining room. "Take sandwiches to supplement food available in France. On arrival in France, ask for bread coupons. Use these to purchase bread on leaving France, as bread in Spain is very scarce and bad."[2]

McKittrick left Basel in early November and arrived in Lisbon some days later. There, while checking into his hotel, he had a pleasant surprise. He recalled, "The first thing I knew, somebody grabbed me from behind and said, 'Is that you Tom McKittrick?' I said, 'Yes' without seeing who it was. He said, 'Well, my gosh, I've got to see you. You're the first man I wanted to see in Switzerland.'" [3] It was Allen Dulles, who was on his way to Bern to set up the Swiss station of the Office for Strategic Services, the embryonic American foreign intelligence service. The two men spent some enjoyable time together before McKittrick flew to London. There he spent two weeks ensconced with Montagu Norman and Sir Otto Niemeyer. McKittrick then traveled to Ireland, took a flying boat back to Lisbon, and eventually reached New York via Portuguese Guinea, Liberia, Brazil, Trinidad, and Puerto Rico.

There was much to think about on the long and arduous journey. The BIS now had a suitably neutral chairman in the shape of Ernst Weber, the president of the Swiss National Bank, and McKittrick had secured himself another three years as president. McKittrick had lobbied hard for a second term, using his extensive network of diplomatic contacts to make sure he was acceptable to both the Allied and Axis powers. The world was at war, but the one thing both sides could agree on, it seemed, was that the BIS should stay in business, with Thomas McKittrick in the president's chair. The American banker carefully cultivated his friends at the foreign legations in Bern. He was so successful that the foreign diplomats even sent his letters in their embassies' diplomatic pouches, McKittrick later recalled. "I made it my business to keep on good terms with their ambassadors or ministers in Bern, and they were all of them kind enough to send letters that were of certain importance and secrecy in the diplomatic pouches—so they were all informed of this and they all agreed to do it."[4]

The American Legation in Bern also encoded communications from the BIS to McKittrick while he was in the United States. In February 1943 Roger Auboin, the BIS's general manager, asked the US

Legation to send a coded cable to McKittrick inquiring about the arrangements for his return journey to Basel, via Lisbon:

> *Please communicate as soon as possible approximate date arrival Lisbon to enable us to settle material details of your journey regarding which we shall cable you in due course care American Legation Lisbon.*[5]

It seemed that Leland Harrison, the American ambassador to Switzerland, even allowed McKittrick to write his cables for him—in exchange for a substantial sum of money. On November 15, 1943, McKittrick wrote to Harrison about "the draft cable of which we spoke on Thursday." The cable had been "recast," noted McKittrick, who admitted he had "gone rather far in putting words" into Harrison's mouth. "My purpose has not been to tell you what to say but to avoid leaving blanks in the picture, and if I have used the wrong color anywhere you will please make the necessary correction." McKittrick then promised Harrison a "reward" for his services, of three million Swiss francs (around US$700,000).[6]

The Treasury Department did not share the State Department's enthusiasm for McKittrick and the BIS. Henry Morgenthau, the Treasury secretary, and his colleague, Harry Dexter White, loathed the BIS, seeing it, correctly, as a channel for the perpetuation of Nazi economic interests in the United States. They ensured that the bank was facing ever more obstacles to doing business in the United States. Under wartime legislation Swiss banks, including the BIS, could operate only under special license in the United States. At first, McKittrick's friends at the New York Federal Reserve had obtained a general license for the BIS, so most routine transactions could be executed without delay. But that was revoked in June 1941, which caused substantial difficulties. The bank's dividends to its American shareholders, and other planned transactions, were blocked. The Treasury Department believed that Swiss banks were being used to transfer ownership of Italian and German firms to Swiss or American front companies. Their investigators were unraveling the links between New York, Berlin, and Bern. For example, Felix Iselin, a Swiss banker, was the chairman of IG Chemie, the Swiss subsidiary of IG Farben, the industrial conglomerate that drove the Nazi war machine and whose chairman, Hermann Schmitz, sat on the BIS board. Iselin also sat on the board of the Swiss Bank Corporation and the Credit Suisse bank.[7] IG Chemie was a holding company for General Aniline and Film, IG Farben's American subsidiary.

Morgenthau was a doughty foe, drawn from a very different world to McKittrick's WASP friends on Wall Street. Born into a prominent Jewish dynasty in New York, Morgenthau was an intellectual and a farmer who grew Christmas trees. His father, Henry Morgenthau Sr., had served as American ambassador to the Ottoman Empire during the Armenian genocide and had loudly condemned the extermination. A close friend of Franklin and Eleanor Roosevelt, Henry Morgenthau had a strong sense of social justice and was a key architect of Roosevelt's New Deal. White, like Morgenthau, was also Jewish, but his parents were poor Lithuanian immigrants. Born in Boston, White worked for a while for his father's hardware business and served in the US Army during the First World War. White was a prize-winning Harvard economist and had a solid understanding of the new global financial architecture emerging under the aegis of the BIS. He left academia to work at the Treasury, where Morgenthau placed him in charge of international affairs. Morgenthau and White would prove to be McKittrick's most powerful enemies in the United States. McKittrick later recalled that White "hated me, because I was doing things that he couldn't get done because I could get in all sorts of places in Europe that he couldn't get his people in."[8] This was largely because many of the things that McKittrick was doing, such as gold and foreign exchange deals with the Reichsbank after Pearl Harbor, were treasonable.

Once McKittrick had safely arrived in Manhattan, he set up an office at the Federal Reserve, with the help of his old friend Leon Fraser, the former BIS president who was now president of the First National Bank of New York. McKittrick needed a lawyer to persuade the Treasury to unblock the BIS's funds. His choice was never in doubt: John Foster Dulles. Meanwhile, McKittrick made the rounds of government departments, trying to show how the BIS could help with the American war effort by offering financial services and helping in the postwar reconstruction of Europe. The BIS president was much in demand as a fresh, firsthand source on wartime Europe. "I had a lot of questioning to go through in Washington, because everybody wanted to know everything about the war in Europe, everything about political affairs in Europe."[9] McKittrick also met Henry Morgenthau. The encounter did not go well. McKittrick laid out his arguments for paying dividends to American BIS shareholders and the bank's position on other contentious matters. Morgenthau walked out after twenty minutes, recommending that he consult Treasury experts.

But the worst was to come. In April 1943, while McKittrick was still in the United States, Congressman Horace Jeremiah Voorhis demanded an investigation into the BIS. Voorhis wanted to know why the bank's president was an American and whether the bank was being used to help the Axis powers. Voorhis, McKittrick believed, was being fed information by Paul Einzig, the BIS's journalistic nemesis, who ever since the fiasco of the Czechoslovak gold, had lambasted the bank in the British financial press. Einzig was a dogged reporter, whose criticisms of the bank struck a nerve, so much so that McKittrick, always hypersensitive about press coverage, referred to him in one letter to Leon Fraser as a "swine."[10]

McKittrick then found he could not get permission from the US authorities to return to Basel. He was stranded, his requests for help unanswered. "I talked to the State Department and they made believe they didn't know what I was talking about."[11] McKittrick asked Col. Bill Donovan, the OSS chief and Allen Dulles's boss, for help. Donovan also stonewalled the BIS president, repeatedly promising him to sort out his passport. But the passport did not arrive. The OSS did not want McKittrick to go anywhere until he had told them everything he knew about Nazi Germany's economy, the Swiss connection, the role of the BIS, the progress of the war, in-fighting among the Nazi leadership, conditions inside Germany, and anything else of interest. McKittrick was called in for several interviews. He was, it turned out, a fantastic source, if somewhat delusional about the centrality of his own role. Even with all that we now know of the BIS's wartime record, the OSS report of McKittrick's explanations of why an American should run an international bank that was under de facto control of the Nazis is still eye opening.

The Weber plan—to install the president of the Swiss National Bank as BIS chairman—McKittrick explained, had been carried out with the full knowledge of the Reichsbank and the German Foreign Office. Both also knew that the Swiss banker would name McKittrick as the next BIS president and were satisfied with that. Hitler himself, though, was not involved, and the plan to extend McKittrick's term as president avoided mentioning the American banker in detail, in case Hitler "heard of the matter" and became angry. The OSS memo reveals how much high-grade economic intelligence McKittrick had access to: the governor of the Hungarian National Bank explained to him how Hungary had deliberately obstructed a new trade agreement with Germany; Vichy France, had been sending gold into Switzerland by a roundabout route to avoid occupied France; Switzerland was awash with Romanian oil, as Romania preferred to sell there rather than to its ally Germany; Walther Funk, the Reichsbank president, had failed to persuade Germany's allies in the Balkans that their debts would eventually be paid. There is an intriguing glimpse into the morale of the BIS's staff: the bank employed fourteen British staff and eight Italians. The Italians were "morose and depressed." They felt that Italy was already defeated and would not "have a friend in the world."

McKittrick's Reichsbank contacts made him an excellent source for news about life inside the Third

Reich. Hitler, McKittrick revealed, had become indecisive. "Instead of having a definite plan laid out, and pursuing it relentlessly, he switches from one plan to another," the OSS document noted.[12] There were even rumors that he had started drinking. Despite the soaring casualties on the Eastern Front, and the surrender at Stalingrad, most Germans, McKittrick explained, still believed state propaganda. He related how one friend of his in the Reichsbank said he had to get out of Germany every now and again or he would start to believe the propaganda himself. McKittrick was also in contact with Hjalmar Schacht. The BIS president was not a fan of Schacht's and regarded him as a "political crook and entirely untrustworthy." Schacht still saw Hitler every couple of months, and when the Nazi leader asked numerous technical questions Schacht proffered his advice. Sometimes Hitler took it, other times not. As for Basel, McKittrick believed that there were twenty thousand Germans living in the city, who were "well-organized under Nazi leadership." He did not believe he was under observation by the Gestapo.

Some of most intriguing material the OSS obtained from McKittrick detailed his role as a back-channel between anti-Nazi Germans and the United States. This doubtless explains why the State Department eventually allowed him to return to Basel and the BIS to stay open. McKittrick told the OSS that he received "peace feelers" from non- or anti-Nazi Germans twice a month. All of them, however, argued that, even if a deal was made, Germany would remain the dominant European power "with a free hand in the east and a large measure of economic control in western Europe." These envoys included a "Berlin lawyer" and a "retired diplomat" Adam von Trott zu Solz. A former Rhodes Scholar at Oxford University, von Trott was a German nobleman and diplomat. He had lived in the United States and was active in the resistance against Hitler. McKittrick's personal papers include the record of a meeting with von Trott in June 1941. Von Trott asked McKittrick to arrange for five hundred dollars to be transferred by the Institute of Pacific Relations (a liberal think tank based in New York) to Switzerland, so von Trott could keep in touch with the IPR's European members. Communications for von Trott should be sent through Werner Karl von Haeften, the German consul in Basel, McKittrick noted.[13] Von Trott was a leading figure in the July 1944 plot against Hitler. Had it succeeded, he would have become foreign minister and led negotiations with the Allies. After it failed, von Trott was hanged.

McKittrick, like his colleagues in London and Berlin, strongly emphasized the BIS's future use in planning the postwar order. "While it does not concern itself with political affairs, it does offer facilities for the discussion of postwar financial and economic questions," wrote the author of the OSS memo, "and he thinks that a year or two can be saved in getting Europe back to work by informal international conversations under its auspices."[14]

McKittrick's return to New York was the talk of Wall Street. On December 17, 1942, Leon Fraser hosted a dinner for him at the University Club. Thirty-seven of the United States' most powerful financiers, industrialists, and businessmen gathered in his honor. The Treasury was stonewalling him, his passport was stuck on a bureaucrat's desk, and the OSS was grilling him, but here at least friends and admirers surrounded him. They included the presidents of the New York Federal Reserve, the National City Bank, the Bankers' Trust, the New York Life Insurance Company, the New York Clearing House Association, and General Electric, as well as a former undersecretary of the Treasury and a former US ambassador to Germany. Standard Oil, General Motors, J. P. Morgan, Brown Brothers Harriman, several major insurance companies, and Kuhn Loeb also sent senior executives. It was probably the greatest single gathering of America's war profiteers.[15] Many of these companies and banks had, like McKittrick, made fortunes from their connections with Germany, connections that carried on producing massive profits long after Hitler took power in 1933 and certainly after the outbreak of war in 1939. Some have been accused of continuing links with the Nazis after December 1941, through subsidiaries in Germany—accusations they deny. The three most powerful sectors were oil, cars, and banks.

Jay Crane, Treasurer, Standard Oil

Walter Teagle, Crane's boss, was a founding board member of General Aniline and Film, IG Farben's American subsidiary. When in 1929 Standard Oil entered into a "division of fields" arrangement with IG Farben—a cartel—IG Farben retained supremacy in the chemicals field, including in the United States, in exchange for giving Standard Oil its oil patents for use anywhere—except Germany, according to a Senate investigative committee.[16] Further agreements followed over the next decade to share technical information and patents. In 1938 Standard sent the full specifications of its processes for synthesizing Buna—artificial rubber—to IG Farben. In exchange, the German chemical combine promised its latest research—once it had permission from the government. Not surprisingly, this was not forthcoming. Thus IG Auschwitz, the firm's massive chemical and Buna factory, run by slave labor and concentration camp inmates, was based partly on American scientific knowledge.

When war broke out in 1939, IG Farben assigned its Buna patents to Standard Oil—to prevent them being seized as enemy property. This was not illegal. But Standard's obstructive policies over development of the Buna industry were. By the time the United States entered the war in December 1941, the country was facing a desperate shortage of artificial rubber. Standard had deliberately delayed the development of the domestic artificial rubber industry by repeatedly telling other American companies that it would share its expertise, even though it had no intention of doing so, to prevent them developing alternatives, according to the US Department of Justice, which brought a lawsuit against the company.[17] In March 1942, six Standard Oil subsidiaries and three company officials were fined five thousand dollars each by a federal judge for violating anti-trust laws. IG Farben was named as a co-conspirator. Thurman Arnold, the assistant attorney general in charge of the Antitrust division, accused Standard of "treason" and entering an "illegal conspiracy" to prevent the development and distribution of artificial rubber. In its defense, Standard claimed that its agreement with IG Farben had resulted in the release of new information about synthetic rubber production, fuel, and explosives.

British Security Coordination, the British intelligence service operating in the United States, was closely monitoring the connections between Standard Oil, GAF and IG Farben, whose CEO, Hermann Schmitz, sat on the board of the BIS. GAF and Chemnyco, another American subsidiary of IG Farben, were the headquarters of Nazi industrial espionage in the United States. British intelligence believed that before the outbreak of war, IG Farben's spy service, "Buro IG," had dispatched deep cover agents to settle in the United States, to make business contacts, and to glean American scientific know-how. Some had married American women and become citizens. Chemnyco was also investigated by the US Department of Justice, which reported that it was a spying operation: "The simplicity, efficiency, and totality of German methods of gathering economic intelligence data are exemplified by Chemnyco, Inc., the American economic intelligence arm of IG Farbenindustrie. Chemnyco is an excellent example of the uses to which a country with a war economy may put an ordinary commercial enterprise."[18]

Donald MacLaren, a BSC operative based in New York, had been working for months on an operation against GAF. MacLaren's plan combined dirty tricks with very public exposure of the firm's links to Nazi Germany. MacLaren, an ebullient Scot and bon viveur, was a forensic accountant by training and an expert in economic warfare. He had untangled the web of connections linking Standard Oil and Sterling Products, an American pharmaceuticals firm, with GAF and IG Farben. GAF, he wrote, was a "supply depot" for the Latin American subsidiaries of IG Farben and sought to "camouflage its German ownership."[19] MacLaren knew that there were two factions in GAF's board of directors. He infiltrated both groups under a false name and gained their confidence. He then persuaded each of his contacts to reveal their faction's plan to outmaneuver the other grouping—information that he promptly passed on to the other side, which produced "an outright quarrel between the two." The result was most satisfactory,

he wrote, with "one faction racing the other to Washington to report the wicked activities of their colleagues to the Department of Justice, thereby exposing their German instructions to the United States government."[20]

MacLaren and his colleagues in British Security Coordination also set up a company called Booktab. The firm published a seventy-page pamphlet entitled *Sequel to the Apocalypse: The Uncensored Story—How Your Dimes and Quarters Pay for Hitler's War* . With a trenchant foreword by Rex Stout, the popular mystery novelist, the pamphlet described, in forensic detail, "the hidden corporate relationships between American organizations and German monopolies." The pamphlet, published in early 1942, demanded the "the full penalty" for German industrialists and bankers, including Hermann Schmitz and Hjalmar Schacht. Two hundred thousand copies were printed. Despite the best efforts of the companies exposed to sabotage the project by buying up as many copies as possible, tens of thousands were sold. The facts about American business links with the Nazis were now out.

Sequel to the Apocalypse caused a nationwide furor. It was certainly a public relations disaster for Standard Oil. The Treasury Department took control of GAF in February 1942 and soon after handed the stock to the newly established Alien Property Custodian. One hundred members of staff known to be sympathetic to the Germans were sacked, from directors to engineers. GAF's research arm was turned over to war production. By 1944 the Custodian had also seized a total of twenty-five hundred patents from Standard Oil and its affiliates. Standard Oil eventually released all its patents for artificial rubber for free.[21]

Meanwhile, in Nazi-occupied Poland, the slave laborers at IG Auschwitz were enduring a living hell of backbreaking work, extreme brutality, and starvation rations. Among them was a teenage boy named Rudy Kennedy. Rudy and his family were deported to Auschwitz in 1943 from the ghetto in Breslau, now Wroclaw, in Poland, when he was fourteen. When the train arrived at the selection ramp, Rudy took his father's advice and lied about his age, claiming to be eighteen:

> *My father and I went to the right, my sister and my mother to the left. The guards kicked and beat us, and we went into a room with showers and basins at one end. My father was naked with hundreds of older men. Everyone was very agitated. They shaved our hair and told us to go into the shower. I was very disturbed by the shoes. All the shoes were piled up and jumbled together in a big heap. I wondered how they were going to sort them out, if we would ever wear them again. We went into the shower. Water came out. By then my mother and my sister were dead. The temperature was about minus ten and we were chased naked and barefoot down a frozen path to a blockhouse. We were given a red blanket and a piece of bread and salami. In the morning we were given clothes, everything at random, nothing fitted. They called out our names and we had numbers tattooed on our arms. The tattoo needle was very thick, like a knitting needle and the blood of the previous prisoner was still running down it.*[22]

Rudy and his father were sent to the IG Farben factory, where he worked at installing electric motors. The extremely harsh conditions were designed to kill off the laborers in a couple of months. Rudy survived because of his specialist knowledge of electrical systems, which meant he had access to food. He became a kind of mascot. One day a supervisor dropped his sandwich on the floor and told Rudy to pick it up. He would not eat it, he told the starving boy, because it was dirty. But Rudy could have it. This counted as an act of kindness. The IG Farben managers were fully aware of what was happening in their

factory, Rudy later recalled. "We saw the civilians from IG Farben all over the place. We worked very near a site where they were building a chemicals factory. We could see people dragging sacks of cement, then they would collapse and die. The IG Farben civilians had to go past that on the way to their canteen. They absolutely knew what was going on. There is no question."[23]

When IG Farben's managers judged their slave laborers to be *gebraucht*, or used up, they were dispatched to Auschwitz I or II, to be dispatched by Zyklon B. Degesch, the German pest control company, which manufactured the poison gas capsules was a subsidiary of IG Farben. Rudy Kennedy survived. His father, Ewald, endured for about two months before being killed by an injection of prussic acid, which fit with IG Farben's planners' calculations about how long a slave laborer could live on his own body fat reserves.[24]

Walter Teagle resigned from the board of Standard Oil in November 1942. Bruised and disappointed by the pillorying he had received in the media, in 1944 he set up the Teagle Foundation with a mission to "advance the well-being and general good of mankind throughout the world." The foundation's reach did not extend to Nazi-occupied Poland but it still exists today.[25]

Donaldson Brown, Vice Chairman, General Motors

War had brought enormous profits to the American car industry. Opel, General Motors' German division, produced the "Blitz" truck on which the Wehrmacht invaded Poland. Ford's German subsidiary produced almost half of all the two- and three-ton trucks in Nazi Germany. There is a strong argument that without General Motors' and Ford's German subsidiaries the Nazis would not have been able to wage war.[26] Hitler was certainly an enthusiastic supporter of the American motor industry's methods of mass production. He even kept a portrait of Henry Ford by his desk.

In July 1938, Henry Ford was awarded the Grand Cross of the German Eagle, the highest honor Nazi Germany could bestow on a foreigner. The following month James Mooney, who ran General Motors' overseas operations, was also awarded a high Nazi honor. Mooney was a regular visitor to Berlin, where he met numerous Nazi officials, including Hjalmar Schacht, to negotiate deals to produce vehicles for the military. In 1939 Mooney even held talks with Hermann Goering on converting the General Motors plant at Russelheim to production of the Junker Wunderbomber.[27]

George Messersmith, the U.S. Consul-General in Berlin, who later served as ambassador to Austria, was watching Mooney's enthusiasm for the Nazis with alarm. Messersmith, despite his German origins, was an ardent anti-Fascist. His reports through the decade detail Mooney's unwavering determination to build up General Motors' links with the Nazis. Mooney, like Sosthenes Behn (the president of ITT whose German partner was the BIS director Kurt von Schröder) believed that the Nazi regime was here to stay in Germany and was "well established," wrote Messersmith in November 1934.[28] Thanks to Schacht's policies and the armaments drive, the German economy was booming. "It is curious that he and Colonel Behn and some other factories in Germany give this opinion. The factories owned by the ITT in Germany are running full time and in double shifts and increasing their capacity for the simple reason that they are working almost entirely on government orders and for military equipment."[29]

Numerous American business leaders traveled to Berlin to ingratiate themselves with the Nazis. Thomas Watson, the president of IBM, arrived in 1937, to be decorated with the Merit Cross of the German Eagle. That was one grade down from Henry Ford's honor. But Watson could comfort himself with the fact that Schacht himself had hosted the ceremony and given a speech in Watson's honor. [30] The following year, after the Nazi annexation of Austria, the SS used one of IBM's prototype computers, known as a Hollerith machine, to keep a record of Jewish properties and their subsequent Aryanization.

The Vienna Nazi party newspaper boasted that thanks to the Hollerith machine, "within six weeks we shall have laid hands on all Jewish fortunes over 5,000 marks; within three years every single Jewish concern will have been Aryanized."[31] The historian Edwin Black argues that IBM's technology, used for cataloging and identifying the Jews of Europe, was crucial for the organization of the Holocaust.[32]

Mooney's medal was certainly a good investment by Hitler. In late 1938, Mooney was still pressing for a trade agreement with Nazi Germany, noted Messersmith, claiming that it would "help the conservative elements in Germany and therefore improve the prospects for a more reasonable regime in Germany," as though a wealthier Third Reich would somehow become more benign. Messersmith dismissed Mooney's claim. His real aim was to "in some way or other help along the important General Motors interests in Germany."[33]

Even in April 1941 Mooney refused to get rid of Axis supporters in the company's overseas subsidiaries, Messersmith wrote to Breckinridge Long at the State Department. "There are some cases like the General Motors, which are not giving us any cooperation in our program to get rid of anti-American agents of American firms abroad. This is due to the fact that there are certain people in the General Motors, such as Jim Mooney, and some of the men whom he brought into the organization over the years, who are really betting on a German victory and who hope to be the big boys in our country if there is a Nazi victory."[34]

Siegfried Stern, Vice President, Chase National Bank

Chase National Bank was the world's largest private bank in terms of assets and deposits. Its New York headquarters was a key hub in the Nazi's global financial network and held accounts for the Reichsbank and Germany's Gold Discount Bank. Chase was so close to the Reichsbank that after the war, Thomas Dodd, a prosecutor at Nuremberg, claimed the bank had once offered Emil Puhl, the vice president of the Reichsbank and BIS board member, a job in New York.[35] The Treasury closely monitored Chase's transactions for its Nazi clients. On October 3, 1940, Merle Cochran sent a note to Henry Morgenthau detailing transfers from Chase's German accounts. In the previous two days alone, $850,000 had been debited from the Reichsbank account, of which $250,000 was sent to the Wallenbergs' Enskilda Bank in Stockholm. A further $1.13 million was transferred from the account of the Gold Discount Bank to Topken and Farley, a firm of lawyers at 17 Battery Place, New York.[36]

Chase National was of special interest to the Nazis because of its overseas branches in London, Paris, Mexico City, and Shanghai. A wartime investigation of the bank's Nazi links, by Paul Gewirtz, a US Treasury official noted, "The Chase Bank, like the other American banks in France, operated on a relatively small scale. The attitudes of the Germans, however, when they came into France, indicates that they looked beyond the activities in France and were more interested in the international character of an organization like Chase with its established branches through the world and its history in international banking which including a friendly intercourse with the Germans."[37] In other words, Nazi Germany valued Chase National, like the BIS, for its transnational reach.

After the German invasion of France in May 1940 the Paris headquarters of Chase National had enthusiastically collaborated with the country's new overlords—with the knowledge of the bank's headquarters in New York, reported Gewirtz.

> *Investigations conducted at the Paris Branch and at the Home Office in New York of Chase Bank disclosed that the bank operated in Paris throughout German occupation and engaged in sundry activities indicate an over-riding desire to continue operating even*

though this required a close collaboration with the German authorities. There is evidence that the Home Office in New York was fully informed of these activities, at least until late in 1942, but took no steps to discourage them, at the same time withholding pertinent information from United States Governmental authorities.[38]

Carlos Niedermann, the manager of Chase's Paris office, was an ardent Nazi sympathizer. He closed Jewish-owned accounts and transferred the assets to Nazi-owned ones. In May 1942, Hans Caesar, a director of the Reichsbank, was put in charge of American banks in France. Niedermann met with Caesar. Caesar held the bank in "very special esteem" because of its New York headquarters. Niedermann recorded, "It is a fact that the Chase Bank enjoys special prestige in the banking circles in question owing to the international activities of our head office."[39]

Thomas Lamont, J. P. Morgan

Thomas Lamont was a senior partner at J. P. Morgan, one of the BIS's founding banks, a veteran of the reparations negotiations and, naturally, a friend of John Foster Dulles. Lamont had represented the US Treasury at the Paris Peace Conference in 1919 and later sat on the Young Plan committee. Like Chase National, J. P. Morgan encouraged its French subsidiary, known as Morgan & Cie, to continue trading with the Nazis, according to declassified US intelligence reports. As the Germans advanced on Paris, the French authorities ordered Morgan & Cie to liquidate their accounts and destroy their stocks of banknotes. Morgan & Cie ignored the order. Instead, like Chase National, the bank opened a new office in Vichy, France, at Châtel-Guyon to service its Nazi clients.

A Treasury investigation reported that "the primary loyalty of the Morgan partners was not to the US or France, but to the firm. Regardless of national considerations, they invariably acted in what they deemed to be the best interests of Morgan et Cie."[40] Morgan & Cie even gained permission to handle payments from German accounts to the European subsidiaries of American firms that were building military equipment for the Third Reich—such as General Motors. This ran so smoothly that Morgan & Cie's American lawyers cabled the firm's French managers to thank them: "The office at Châtel-Guyon has proved to be of great practical utility; without it we could not have carried on any business with the outside world."[41]

SWEDEN, ONE OF the Nazis' most important trading partners, was also represented at McKittrick's dinner, by Lars Rooth, the son of Ivar Rooth, the director of the Rijksbank. Ivar Rooth was one of the world's longest-serving central bankers and a founding member of the new transnational financial elite. He was important enough to be elected unanimously to the BIS board in 1931, even though Sweden was only a shareholder and not a founding member of the BIS. Rooth stayed until 1933 and returned in 1937, praised in the BIS annual report for that year as a banker well known for his "constructive work of collaboration." Working with the Wallenberg brothers at Enskilda Bank, Rooth helped steer Sweden through a neutrality whose profitability was rivaled only by Switzerland's. Swedish firms supplied the Nazis with millions of tons of iron ore to be turned into tanks, guns, and ammunition, with vital ball bearings, foodstuffs, and timber. Rooth, it seemed, was indeed a highly skilled collaborator, although not only in the meaning referred to in the BIS report.

Thomas McKittrick was the third American president of the BIS, after Gates McGarrah and Leon Fraser. The American connection had shaped the BIS since its foundation in 1930. The bank had been ostensibly set up to administer the Young Plan for German reparations, named for the American diplomat

who had brokered the deal. The BIS was the trustee for the loans Germany took out from Wall Street to meet those obligations. The bank's American presidents stood at the center of the network of connections between Wall Street and American industry and Nazi Germany. Standard Oil had formed a cartel with IG Farben, whose CEO, Hermann Schmitz, sat on the board of the BIS. The French subsidiary of J. P. Morgan, a founding member of the BIS, traded profitably with the Nazis after the invasion of France. ITT had gone into partnership with Kurt von Schröder, the powerful Nazi banker who was a director of the BIS. For the new class of transnational financiers, war was merely an interruption in commerce, albeit a highly profitable one. Both McKittrick and his guests were already planning how to maximize their profits in the postwar era. Meanwhile, the money channels had to be kept open, and they ran through Basel. McKittrick embodied the American-Nazi financial network, which is why dozens of the United States' richest and most powerful businessmen and industrialists gathered in New York that freezing December evening to honor Hitler's American banker.

MCKITTRICK REMAINED MAROONED in New York, unable to return to Basel, until Montagu Norman came to the rescue. Meanwhile the BIS president was still a man in demand. Thomas Watson, the president of IBM who had been honored by Hitler, could not attend McKittrick's dinner at the University Club. Instead, Watson, who was also the president of the International Chamber of Commerce, arranged a luncheon in McKittrick's honor. Aware that not all of the American public shared the financiers' enthusiasm for the BIS, McKittrick limited himself to three private formal engagements while in New York. On January 12, 1943, he wrote to Ernst Weber, the president of the Swiss National Bank and chairman of the BIS board, that "it seemed to me best, however, for the BIS not to take part in public or semi-public gatherings."[42]

One day, McKittrick paid a call on a diplomat at the British embassy in Washington, DC. He had reassuring news for the BIS president. The Bank of England and the Treasury were "very interested in the BIS," the British diplomat said. "I've got to take this up with London. I'll be surprised if I can't get you back."[43] Calls were made, cables were sent, and the wheels of transitional finance started turning. Rafaelle Pilotti, the BIS's Italian secretary general, told McKittrick to travel to Lisbon and report to the Italian Legation, which would help him get to Rome, and from there he could travel on to Basel. McKittrick eventually received permission to leave the United States and arrived safely in Lisbon. After a stop in Madrid, he flew to Rome.

The United States was at war with Italy, and McKittrick was a citizen of an enemy nation, but none of that mattered. The BIS president still received a regal reception, he recalled. "I was met at the airport as if I was the king of something. Nobody looked at my passport; they just waved their hands at it." McKittrick was then taken to a comfortable hotel where Pilotti met him. Understandably, the Italian authorities did not want an American banker wandering freely around Rome. Pilotti arrived, to act as McKittrick's minder. The two men sent out for a sumptuous dinner. "That was the best meal that I ever had in the war, and Italy was really short of food, but good gracious they gave me a wonderful meal," recalled McKittrick. Soon after, at 11 p.m., McKittrick was put on a train to Switzerland.[44]

McKittrick finally arrived back in Basel in April 1943. His trip to the United States had produced mixed results. Despite his lobbying and John Foster Dulles's legal advice, the BIS's request for exemption was denied. The bank's funds in the United States remained frozen. But if that battle was lost, a far larger one loomed: for the bank's very survival. This time Henry Morgenthau, rather than McKittrick, would find himself outgunned.

> *"The bearer of this letter, Mr. Thomas McKittrick, President of the Bank of International Settlements, is a close friend of a prominent member of the State Department stationed in Switzerland, Mr. Allen Dulles."*
>
> — OSS *laisser-passer* for Thomas McKittrick, June 15, 1945, requesting the provision of US Army billet and mess facilities[1]

There were many in Washington, DC, especially in the Treasury department, who asked why the State Department had renewed McKittrick's passport and allowed him to return to Basel, when it was clear that the BIS was aiding the Nazi war effort. The answer lay in Bern, at Herrengasse, 23. Here McKittrick's old friend and protector, Allen Dulles, ran the Swiss branch of the Office of Strategic Services, America's foreign intelligence service—a complex network of bankers and businessmen, scholars and spies, and refugees and émigrés. Some of Dulles's assets and agents traded information out of principle, others for money. McKittrick, also known as OSS codename 644, traded information out of loyalty—not to the Allied cause or the national interest of the United States, but to transnational finance, a creed shared by America's spymaster.

Back channels between the Allies and the Axis powers existed throughout the war in neutral capitals such as Stockholm, Berne, and Lisbon. The BIS was one of them. Its multinational staff and neutral, privileged status made the bank an ideal place for gathering and disseminating intelligence. Switzerland was its natural home. As the cynical wartime saying noted, "For six days a week Switzerland works for Nazi Germany, and on the seventh it prays for an Allied victory." After his return to Basel in 1943, McKittrick regularly met with Allen Dulles and American ambassador Leland Harrison. The three men, McKittrick recalled, talked more freely "in those meetings than at any other time." Dulles and Harrison wanted to know everything McKittrick knew, especially about Nazi money channels—which was a lot, McKittrick later recalled,

> *And I did know, for instance, the way the Germans were obtaining the money with which they maintained their organisation for sabotage, subversion, as well as political and military intelligence, especially in South America. The Allies were very anxious to stop this, but no way was found to do so without risking a loss of good will among the neutral nations which would be too serious to provoke.*[2]

The Portuguese connection was key, McKittrick explained to Dulles and Harrison. The Germans needed a steady supply of Portuguese escudos to pay for vital war materials such as tungsten. The Portuguese escudo was then a hard currency, accepted by the Allies, the Axis powers, and of course, South American countries. Some German companies were still connected to their American partners or parent firms through subsidiaries in South America. The key players were the Bank of Portugal, the Reichsbank, the Swiss National Bank, and the BIS. The Bank of Portugal bought gold bullion from the Reichsbank, which was delivered to the Swiss National Bank and credited to the Bank of Portugal's account. The Bank of Portugal then credited the requisite amount of escudos to German accounts in Lisbon, allowing German purchases to take place there.

Germany was also shipping gold to the BIS, McKittrick explained,

> *You see we had a lot of German investments, which were made in '31 in accordance with the statutes of the bank. We had to help Germany with loans to pay for reparations payments in the first years . . . they had to pay us about a million Swiss francs a month and that is what we lived on. And in order to give us that money they would ship gold to us. Now, we had no vaults. We had no place to handle gold. We had none of the necessary devices to assay gold or weigh gold. They [the SNB] have a scale as big as that chimney breast there, and you can weigh the weight of your signature on a piece of paper. So we had the Bank of Switzerland do all our gold handling and gold storing for us in Switzerland.*[3]

The American government knew this. A source referred to as "A" passed intelligence about BIS gold movements to American officials in Bern. It was sent to the State Department in a cable dated June 23, 1943:

> *German gold shipments (gold bars) arriving here, which were referred to recently, seem to be for the account of the Bank for International Settlements. The value involved is small, approximately Swiss francs 750,000 at a time. The gold, upon the arrival at the National Bank of Switzerland, Bern, is passed to the credit of the Basel bank.*[4]

The BIS also held gold for the Reichsbank so sometimes, when the interest was due on the bank's investments, the BIS simply helped itself to the Nazi gold it held to make up the payments, McKittrick explained. At other times, the Germans borrowed BIS gold for their dealings with Swiss banks. This cozy arrangement caused no concern at the BIS, said McKittrick, as "we knew that they'd replace it." McKittrick's close relationship with Emil Puhl, the vice president of the Reichsbank, was especially valued by Dulles and the OSS. Puhl, whom McKittrick described as a "friend," passed on important information about German morale, the country's economy and political intrigue. OSS telegram 3589-90, sent on May 25, 1944—at a time when thousands of Hungarian Jews were still being deported every day to Auschwitz, where most were immediately murdered—records Puhl's fears—not that the war was lost, but that the Reichsbank might lose its privileged position during the reconstruction.

> *Not long ago our 644 [McKittrick] had two lengthy conversations with Puhl of the Reichsbank. The latter was extremely depressed, not so much by the idea of Nazi defeat, but by the situation, which Germany will have to contend with later. The Reichsbank has been engaged in work on plans for the reconstruction, and evidently they are unable to see where an effective beginning can be made.*[5]

Roger Auboin, the BIS manager, was known as OSS codename 651. Auboin naturally had excellent connections in France. OSS telegram 3401, sent on May 11, 1944, warns that the Nazis planned to plunder what remained of French national assets:

> *I have been informed by 651 that he is the recipient of secret information from Paris pointing out the danger of an attempt to seize both the French Treasury and Bank of France's gold and foreign exchange.*[6]

McKittrick also had excellent connections in neutral Sweden. The Stockholm OSS station closely

observed Jacob Wallenberg and his brother Marcus, of Enskilda Bank. Jacob, the author of the Swedish-German trading agreement, was the most powerful banker and businessman in Sweden. He had strong links with both the Nazi leadership and the German resistance. His brother Marcus was McKittrick's mentor at the BIS since the two men worked together on the German Credits Committee during the 1930s, when Wallenberg had taught McKittrick about the intricacies of international finance.

When Marcus fell ill in June 1943, McKittrick wrote an appreciation of the Swedish banker, which was hand delivered by Ivar Rooth, the governor of the Rijksbank. "During the three years I have been in Basel," wrote McKittrick, "your method of approaching international problems, of which I gained some understanding during our work together in Berlin, has helped me more than I can tell you in dealing with the intricate and delicate questions which have presented themselves to the Bank for International Settlements by reason of changes wrought by the war." Marcus Wallenberg was his most important teacher, McKittrick concluded. "The thought of following in your footsteps will provide spur to my will and a goal for my ambition."[7]

The most important lesson the Wallenbergs could teach McKittrick was how to play both sides at once: ensuring that Sweden remained one of Nazi Germany's key trading partners while feeding intelligence to the Allies—and thus guaranteeing that regardless of whoever won the war, the Wallenberg banking and business empire would survive and thrive. Jacob Wallenberg managed the bank's channel to Berlin while Marcus looked after connections with the Allies. As the managing director of the Enskilda Bank, Jacob Wallenberg was the "principal financial figure in Scandinavia" and was "vigorous, shrewd, and cautious," Abram Hewitt, an OSS agent based in Stockholm, reported.[8] Outside the Swedish foreign office, Jacob Wallenberg was the country's "principal representative" dealing with Nazi Germany. "Wallenberg frequently goes to Germany and most Germans of importance visiting Stockholm are in touch with him."[9]

Sometime in 1943, Wallenberg had asked Hewitt if he would like to meet representatives of cells forming in Germany who planned to overthrow Hitler. Nothing came of this as the cells were subsequently "liquidated." In 1944 Wallenberg claimed to know the names of German generals who were now opposed to Hitler—because of German defeats—and were ready to overthrow him. However, he would share the names only when "in his opinion conditions would justify it." Wallenberg "probably has better sources of information about Germany and the continent in general than any man in Sweden," Hewitt continued. However Wallenberg was a "very difficult" man to approach, except by someone whom he had known for a long time. Jacob Wallenberg was still a bachelor at the age of fifty-four, and one possible approach of getting to know him was the time-honored one of the honey trap, preferably on a yacht. "It is important for anyone dealing with Jacob Wallenberg to know that he is very interested in sailing and in attractive women." Marcus Wallenberg, his young brother, was quickly dismissed, as a "man of less integrity and less weight."

Meanwhile, in Washington, DC, the Treasury was also closely monitoring the Wallenberg brothers and Enskilda Bank. A Treasury report in December 1944 made numerous accusations of economic collaboration with the Nazis: "Jacob Wallenberg recently indicated that he was willing to sell to the Germans a Swedish plant in Hamburg for gold, provided the price was high enough to compensate for possible future complications from the Allies."[10] Enskilda Bank acted for the German interest in the American branch of the Bosch company and had also worked with the Swiss Bank Corporation to conceal German interests in Schering, a chemical company in New Jersey—which had since been vested by the Alien Property Custodian, the report noted.[11]

J. Holger Graffman, Wallenberg's point man for foreign currency deals, was regarded as a high-value asset by the OSS. Graffman, an engineer by training, had worked as Latin American representative of Ivar

Kreuger, the Swedish fraudster bankrolled by Lee, Higginson, the former employers of Thomas McKittrick. After Wallenberg had taken control of the remains of Kreuger's empire, Graffman returned to Sweden and joined Enskilda Bank, working on currency transfers, foreign credit, and blocked accounts. "In my opinion this man is the most useful single contact there is for us in Sweden. He is very pro-American and is married to a Dutch woman whose feelings toward the Germans are what you would expect," noted Hewitt.

But Graffman was also friends with Felix Kersten, an Estonian-born masseur who now lived in Stockholm. Kersten's most important client was Heinrich Himmler and he frequently returned to Berlin to treat him. Graffman introduced Hewitt and Kersten over coffee and cakes at his house. Kersten began treating Hewitt for his back problems. But Kersten was much more than a masseur: soon afterward he brokered a meeting between Hewitt and Walter Schellenberg, the Nazi intelligence chief, in Stockholm. Schellenberg and Hewitt met in Kersten's office in November 1943. Schellenberg hoped to arrange a separate peace with the Western Allies to prevent a Soviet takeover of Eastern Europe. The plans came to nothing.[12]

The Wallenberg business empire was the most important transnational finance channel between Sweden and Nazi Germany. Not just money but vast amounts of intelligence flowed back and forth between Stockholm and Berlin. Much of the State Department and the OSS—especially Allen Dulles—shared Jacob Wallenberg's desire to keep links with German industry so that business could resume as swiftly as possible after the end of the war. An OSS psychological warfare operation known as the "Harvard Plan" specifically utilized Thomas McKittrick for this purpose. The Stockholm OSS office published a wartime newsletter for German businessmen filled with snippets of intelligence and news. The purpose of "Information for German Business," was to suggest that cooperation now would pay handsome dividends after the Allied victory. OSS officials believed that the newsletter was seriously affecting the morale of German businessmen, many of whom were now planning for their future in a post-Nazi Germany.

On February 1, 1945, David Williamson, a senior official in the OSS Morale Operations department, wrote to codename 110—Allen Dulles. Williamson suggested to Dulles that he set up a similar psychological warfare operation in Switzerland, or find another way to use the Harvard Plan material to erode German morale. Williamson enclosed some draft material for Dulles's perusal. Notably, all the information in the OSS Stockholm newsletter had been passed by the State Department before it was to be distributed. The newsletter included this paragraph:

> *The direct negotiations, which have been taken up by the business interests on both sides thanks to the mediation of Mr. McKittrick, the American who lives in Basel, have already led to a number of detailed agreements. Thus, we learn that representatives of the German potash industry have contacted and entered into binding agreements with the new and expanded potash industries overseas . . . it is expected that the postwar demand permanently will be materially higher than pre-war consumption. The new agreement will guarantee the German export interests during this second period an export income at least equal to their pre-war revenues regardless of the expected break in the German cartel control.*[13]

Once again, the German chemical industries were key. In 1925 Lee, Higginson, McKittrick's employers, had been part of a syndicate, including Enskilda Bank, that had issued an £8 million bond on behalf of the German Potash Syndicate. Nineteen years later, McKittrick was still ensuring that supplies of the mineral, vital for agriculture, would continue after the war's end. A second paragraph, also

datelined Basel, outlines how, even as Allied airmen were bombing Germany, McKittrick had already concluded an agreement to "preserve the industrial substance of the Reich." Anyone who questioned the wisdom of such backdoor accords was merely a "leftist radical":

> *Mr. Thomas H. McKittrick, the American president of the BIS, has announced his decision to continue his efforts for a close cooperation between the Allied and German business world, irrespective of the opposition of certain leftist radical groups; in these efforts he counts on the full assistance of the American State Department. "After the war such agreements will be invaluable," said McKittrick. We learn that certain German interests have received assurances that their negative attitude toward the National-Socialist regime will be fully be considered by the Allied political and economic leadership after the war. Negotiations are under way to bring hostilities to a speedy conclusion and to preserve the industrial substance of the Reich.*[14]

Thus, while American and Allied troops were fighting their way across Nazi-occupied Europe, Thomas McKittrick, an American citizen, was using his position at the BIS—with the knowledge of the State Department—to try and bring Allied and Nazi businessmen together, to plan for a post-war Germany that preserved as much as possible of the country's industry. McKittrick was even brokering agreements to guarantee German companies' postwar profits and to help German industrialists avoid the financial consequences of the break-up of prewar cartels.

THE OSS MEMO on the Harvard Project also noted how profitable Cicero's "sinews of war" had been for the American oil industry, most of all for Standard Oil. Oil industry dividends in 1944 reached a new high of almost $300 billion, the memo noted, quoting the *Wall Street Journal*—nearly a fifth more than in 1943. Standard Oil alone would pay out $68.3 million.

With such enormous sums moving around the increasingly globalized economy, it was becoming more clear that the world would need a new international financial system to finance postwar reconstruction and stabilize trade. In July 1944 more than seven hundred delegates from the forty-four Allied nations gathered at the Mount Washington Hotel in Bretton Woods, New Hampshire, for the United Nations Monetary and Financial Conference. Henry Morgenthau and Harry Dexter White led the American delegation. The conference agreed on the creation of the International Monetary Fund (IMF) and an International Bank for Reconstruction and Development (BRD), which became part of the World Bank. The IMF would monitor exchange rates and lend reserve currencies to indebted countries. The new bank would provide loans to underdeveloped countries. Bretton Woods also gave its name to a new international currency exchange system, where currencies were linked to the US dollar. In exchange the United States agreed to fix the price of gold at $35 an ounce. There would be no more currency warfare or manipulation.

But if there was consensus on the basics, there was none on the future of the BIS. With the IMF at the center of the new international financial system why was the BIS still needed? Henry Morgenthau and Harry White wanted the bank to be abolished. On July 10, 1944, they seemed about to get their wish. Wilhelm Keilhau, of the Norwegian delegation, introduced a motion to liquidate the BIS:

> *Be it resolved that the United Nations Monetary and Financial Conference recommends the liquidation of the Bank for International Settlements at Basel. It is suggested that the*

liquidation shall begin at the earliest possible date and that the governments of the United Nations now at war with Germany appoint a Commission of Investigation in order to examine the management and the transactions of the Bank during the present war.

No delegation spoke publicly in defense of the BIS. But behind the scenes its defenders—sections of the State Department, Wall Street, the Bank of England, the British Treasury, and Foreign Office—went into action. Johan Beyen, the hapless Dutch former president of the bank who had handed over the Czechoslovak gold, blamed the US Treasury Department, in particular Harry White for the resolution. White, Beyen claimed, had got the Norwegians to do his "dirty work." White certainly supported the motion, which he believed would force McKittrick to resign, an event he described as "a salutary thing for the world."[15] White's opposition to the BIS—and clear understanding of its wartime role for the Nazis—had long caused alarm at the Bank of England. In December 1943, E. W. Playfair, a senior official at the bank, had written to Otto Niemeyer, the former chairman of the BIS board, drawing his attention to an article in the *New York Times* about White and the BIS. White had "disparaged" the bank and said it had "no significance" in relation to plans for the postwar reconstruction of Europe. Germany, said White, was being nice to the BIS because it hoped to use it to "get back into financial power."[16] White was even more scathing about McKittrick, describing him as "an American president doing business with the Germans while our American boys are fighting Germans." All of which was true and so even more infuriating for the financial mandarins, who preferred to keep their arrangements with the other side out of the public eye.

The Foreign Office advised the British delegation that any resolution dealing with the BIS or its liquidation would be "improper," that most British of sins. Britain, from the start, had been "opposed to doing anything with respect to the BIS," noted Orvis Schmidt, a US Treasury Official.[17] So was Wall Street. Leon Fraser, said Morgenthau, was "one of the spearheads of opposition to what we are doing here and has surrounded himself with a group who are fighting what we are doing here. . . . Now I don't say that Mr. Fraser isn't a very fine American citizen, but he has certain loyalties which run there, just the way Mr. McKittrick has, Mr. Beyen has. . . ." The BIS was a kind of club for central bankers, said Morgenthau and people like Schacht and Funk still hoped that the "same kind of thing would continue after the war."[18] Morgenthau was an implacable opponent not just of the BIS but of any kind of reconstruction that would allow Germany to dominate Europe. His plan for the country called for German heavy industry to be dismantled or destroyed, for Germany's industrial areas to be internationalized or ceded to neighboring countries, for complete demilitarization, and for the country to be reduced to a pastoral or agricultural economy.

Harry White saw the BIS clearest. The bank's emphasis on its supposed neutrality was an alibi for its future role in reconstructing Europe, he argued:

They hope to be a moderating influence in the treatment of Germany during the peace conference. That is why Germany has treated it with the greatest of care. She has permitted her to pay dividends; she has let the people in BIS come and go across enemy territory; she has been extremely careful and well-disposed to the BIS, because she nursed that baby along in the hope that that would be a useful agency that would protect her interests beyond those that any other institution around the peace table would.[19]

On July 18, Ansel Luxford, a member of the US delegation, proposed a new resolution, that no country

could join the IMF unless it had "taken the necessary steps to foster the liquidation of the BIS." John Maynard Keynes, the influential economist who was part of the British delegation, was furious. Keynes, who was also close to John Foster Dulles, suffered from angina and became so agitated by the affair that there were rumors he had suffered a heart attack. He demanded that the resolution be withdrawn or he would quit the conference. There could be no linkage between dissolving the BIS and joining the IMF, Keynes wrote to Morgenthau, or Britain would not participate in either the IMF or the new bank for an "indefinite period."[20] Morgenthau backed down.

Eventually, a new Norwegian-Dutch resolution calling for the liquidation of the bank at the "earliest possible moment" was finally agreed. It was a perfect compromise: critics were satisfied that the principle was now established that the BIS must be closed down, while the bank's supporters noted that the resolution set out no date or conditions for this eventuality. Beyen, the former BIS president, distanced himself from the bank, rapidly remodeling himself as a pillar of the postwar democratic order. The BIS was incompatible with the IMF, and its statutes and banking operations would be obsolete after an Allied victory, he now argued. Little wonder that Beyen was described by Orvis Schmidt as a "very shifty fellow" who had "demonstrated his ability to forget what he said five minutes earlier."[21]

The Bretton Woods conference was watched with intense interest in Berlin. Puhl and the Nazi bankers understood that whatever was agreed upon by the fractious delegates, the BIS, or something like it, would survive. There were too many vested interests, on both sides of the conflict, to allow the world's most important channel of transnational finance to be closed down—especially when it had consistently proved its worth under the most arduous of conditions. An article in the Berlin newspaper *Das Reich*, published in September 1944, argued that the global economy was now so complex that an international clearinghouse would be needed once the war was over. The new IMF and IBRD would not be able to perform these functions. Even if the Allies were unwilling to hear "the un-speakable name of the BIS" they would need something like it.[22] *Das Reich* was correct.

IN BASEL, MCKITTRICK was enraged by the attacks on the bank. He wrote to the Bank of England and demanded a full investigation into the BIS's wartime record, which he apparently believed would exonerate him. The prospect of that set off alarms from Whitehall, the British government quarter, to Threadneedle Street, where Lord Catto, the new governor of the Bank of England had taken over from Montagu Norman. McKittrick, noted a Foreign Office memo, had gone native in neutral Switzerland and was "thoroughly out of touch with the way people are thinking nowadays."[23]

The end of the war did not seem to bring McKittrick any closer to reality. In March 1945 Orvis Schmidt, the US Treasury official who had attended the Bretton Woods conference, met with McKittrick in Switzerland. Schmidt, like his boss Henry Morgenthau, was not a fan of either McKittrick or the BIS, and McKittrick knew it. "It was clear that Mr. McKittrick was fully aware of the manner in which he and the BIS are regarded by the Treasury Department," Schmidt wrote.[24] McKittrick tried his best to persuade Schmidt otherwise—if only the Treasury Department understood "the real role that he and the BIS had played" all that would change, the BIS president ardently believed. This seemed unlikely, considering what followed.

Schmidt continued, "The BIS, McKittrick said, had been 'strictly neutral' during the war. The bank was a 'sort of club' for the world's central bankers, a 'little group of like-minded-men who understood and trusted one another.'" This trust was unimpaired by issues such as national, political, or governmental interests. Rather it was a kind of celestial understanding. It would continue "regardless of the condition of the world or of the constantly changing political relations between their respective countries."

Unimpressed by McKittrick's eulogy, Schmidt asked McKittrick why the Germans had allowed him to run the BIS in this manner—what was in it for them? In response, McKittrick claimed that, "In order to understand the conduct of the Germans toward the BIS, one must first understand the strength of the confidence and trust that the central bankers had in each other and the strength of their determination to play the game squarely." McKittrick then said that the German members of this elite could positively influence the German government's conduct. These financiers, said McKittrick, were not Nazis but were needed by the Nazis because of their technical skills. "The existence of this little group is the keystone in the explanation of Germany's conduct with respect to the BIS," he explained.[25]

Schmidt asked McKittrick if he could name any members of this group. Only one name was forthcoming: Emil Puhl—the vice president of the Reichsbank, BIS director and guardian of looted gold, for which he would soon be put on trial at Nuremberg. McKittrick admitted that the BIS had accepted payment in gold from the Germans during the war. It had all been kept separately so that it could be checked easily to see if any was looted. McKittrick justified this on the grounds that "he thought it would be better to take the gold and hold it in this fashion rather than refuse it and let the Germans use it for other purposes." [26] The conversation then took a surreal turn. Puhl, McKittrick continued, knew where the looted Belgian gold was: in the vaults of the Reichsbank, where Puhl was holding it "for return to the Belgians after the war," rather as a fence might justify his possession of stolen goods to police investigating a robbery. McKittrick also admitted that the BIS had supplied the Third Reich with foreign exchange. But by doing so, he suggested, the BIS had actually weakened the Nazi economy, as Germany had paid more into the BIS in foreign exchange than it had received. Schmidt was incredulous. "I was surprised that a voluntary recital intended as a defense of the BIS could be such an indictment of that institution," he wrote to Henry Morgenthau.

An American intelligence report on the bank's wartime activities, prepared in December 1945, was even more damning. Much of the report was based on interrogation reports of Emil Puhl, who was singing like the proverbial canary in an effort to save himself from a lengthy prison sentence. Puhl revealed how the Reichsbank had used the BIS to pull out its money from neutral countries before it was blocked and then traded the rescued funds with the BIS. He said that German officials had wanted McKittrick to be reelected as his opinions were "safely known" and that the BIS was also of great value to the Reichsbank as an "open window to financial information about the outside world." Much of this information, it seems, was provided personally by McKittrick in his conversations with Emil Puhl. Perhaps the most shocking revelation is that McKittrick, after his return from the United States in May 1943, reported to Puhl directly on "the general picture of the current opinions and financial problems in the United States." McKittrick, the report notes, also provided Puhl with advance information about the Allied Tripartite Mission to Switzerland in February 1945, when the Allies pushed Swiss officials to freeze Nazi assets and stop trading with Germany.[27]

McKittrick was not the only BIS manager providing Puhl with intelligence and acting as a go-between for both sides. When Allen Dulles arrived in Bern, one of the first people he met was Per Jacobssen, the BIS's economic adviser. The spymaster and the economist were introduced at a charity party hosted by the wives of the American and British ambassadors. Bern, like Lisbon, Madrid, and Stockholm, was crowded with legions of spies, informers, and secret agents, trading in information, gossip, and intrigue. Dulles and Jacobssen had much to discuss.

As a Swedish national and high-ranking BIS official, Jacobssen was of extreme interest to both the Allied and Axis intelligence services. Jacobssen could freely travel to and from Allied and Axis territory. Jacobssen, like his compatriots the Wallenberg brothers, played both sides. When Jacobssen returned from the United States in the spring of 1942, he discussed American attitudes toward Germany with Emil

Puhl, the vice president of the Reichsbank.[28]

Jacobssen also relayed valuable information about the British General Staff to Puhl. In the summer of 1942, Jacobssen asked Paul Hechler, the head of the BIS's banking department, who was also a Nazi party member, to pass some news on to Puhl when Puhl next visited Basel: Jacobssen's British brother-in-law, General Sir Archibald Nye, had been appointed vice chief of the General Staff. This was valuable intelligence. Both sides carefully watched staff movements among their enemies' military leadership. The arrival or departure of senior officers could herald new strategies or fresh thinking and herald the rise or decline of a particular commander. Aware that he was breaking a confidence, Jacobssen recorded in his diary that Nye's promotion should be kept from the press: "Puhl said he was glad to be told. We might make a gentleman's agreement between Hechler, himself and me not to mention it further. . . . I pointed out that when it was said in London that what I wrote was too friendly to Germany, these journalists obviously did not know who my relatives were."[29] Thankfully for Jacobssen, "these journalists" also did not know that he was passing valuable military information to the Reichsbank.

Jacobssen, accompanied by Hechler, met Puhl in Zürich on May 1, 1943. Puhl and the Reichsbank wanted information about the different plans circulating in Washington for postwar currencies and trade. Forward-thinking Nazi officials were already planning ahead for the postwar era. They needed to know what the Allies were thinking. As ever, Jacobssen was ready to help. The meeting must be discreet, Hechler emphasized to Jacobssen. "Puhl would of course be suspect if people in Germany heard that he had been in Switzerland to discuss these plans, but Puhl hoped, of course, that still one day it would be possible to come to an arrangement with the enemy," Jacobssen recorded in his diary.[30] "Arrangements with the enemy" were why the BIS existed. Puhl's wish was granted. The following month Jacobssen made a speech in Berlin to German commercial bankers, entitled "The Anglo-American Currency Plans," where he shared his thoughts on Allied postwar economic planning, based on what he had learned in the United States.

Thanks to the BIS's economic adviser, Allied postwar economic plans were now public knowledge in Nazi Germany. Yet it seems unlikely that Jacobssen gave this speech without the permission of the United States authorities. As the OSS documents on the Harvard Plan reveal, the US government ensured that the channels to Nazi industrialists and businessmen remained open, even as American and British soldiers walked into a hail of machinegun bullets on the beaches of Normany. Jacobssen's speech, delivered in German, was translated by the American Legation in Bern and wired to Washington.[31] Jacobssen also passed information on to his brother-in-law Archibald Nye that was useful to the Allies. In 1940, after visiting Berlin, Jacobssen wrote to "Arch," advising Britain and France not to aid Finland in its war with the Soviet Union, as they might soon be on the same side as Russia, fighting the Germans. The letter, said Nye, had been of great value, and he had passed it on to the Foreign Office and intelligence services.[32] Jacobssen, like McKittrick, considered himself above national loyalties, but his heart at least seemed to be with the Allies. He listened to the nine o'clock news from London every night. When the national anthem was played at the end, he rose and stood at attention.

Meanwhile, German anti-Nazi émigrés believed that Georg von Schnitzler, a board member of IG Farben, used the BIS to communicate with the Allies. Von Schnitzler was certainly well placed to send messages to London and Washington. As the sales and commercial chief of the chemical conglomerate, he was one of the Third Reich's most powerful businessmen. Von Schnitzler's boss, Hermann Schmitz, sat on the BIS board. Before von Schnitzler joined IG Farben, he had worked for J. H. Stein, the Cologne bank where Kurt von Schröder was a director, and which ran Special Account "S," Himmler's private slush fund. By 1943, like most German industrialists, von Schnitzler understood that the war was lost. Germany would soon fall under international control, hopefully under the Western Allies. The priority

was to preserve IG Farben's factories, sites, and offices so that the chemical conglomerate could quickly resume its dominance after the hostilities were ended.

Von Schnitzler used the BIS to send a message to the Allies that the bombing of German industry had to stop, according to Heinz Pol, who was a former associate editor of the *Vossische Zeitung*, Germany's paper of record until it was dissolved in 1934. Pol had excellent sources among German émigrés and in neutral countries. He wrote,

> *According to information emanating from Lisbon, Schnitzler is said to have drawn up a memorandum, which he has sent to the board of directors of the Bank for International Settlements at Basel, Switzerland. It is not known whether the memorandum arrived in Basel in time for the general meeting, which took place at the beginning of June (the American Mr. McKittrick presiding as usual), but several points raised in the memorandum are known. Schnitzler, the Lisbon sources say, stresses the fact that the term "unconditional surrender" implies that the Germans will still have something to surrender. But if the war of destruction, especially the bombing of the industrial centers in Germany, goes on, then there will be nothing left in the end but ruins and ashes.*[33]

Schnitzler's terms were clear, wrote Pol: "Collaboration on condition that German industry survives." If the bombs stopped falling, the German industrialists would cooperate with the forthcoming occupation. As none of the IG Farben main sites had been much damaged by bombing so far, von Schnitzler's offer "might not sound too unreasonable to other industrialists on the side of the United Nations."[34]

THE BIS WAS used by Japan as a channel to try and negotiate a peace treaty. Japan was a founding member of the bank and kept its links with Basel during the war. In July 1945 two Japanese bankers, Kojiro Kitamura, a board member of the BIS, and Kan Yoshimura, the head of the BIS's Exchange Section, asked Per Jacobssen if he would act as an intermediary to arrange a peace accord. The Allies demanded unconditional surrender, but the crucial point for Tokyo, the bankers said, was that Japan would retain the royal family, and ideally, the country's constitution.[35] Jacobssen, naturally, passed the information to his close friend, Allen Dulles, who took the Japanese proposal to Henry Stimson, the secretary for war. They discussed it in Potsdam on July 20, 1945, but events soon overtook the slow pace of the backdoor diplomacy. On August 6 Hiroshima was destroyed by an atomic bomb, followed by a second one in Nagasaki on August 9. Six days later Japan surrendered.

Jacobssen at least had the excuse that he was a citizen of neutral Sweden to justify his contacts with the Nazi bankers. McKittrick, whose homeland was at war with the Third Reich, did not. Cocooned in Basel, the BIS president seemed to have lost touch with reality, let alone morality. McKittrick had spent the war years in a parallel universe, one in which neutrality meant that the Reichsbank—the financial motor of war, plunder, and genocide—was judged equal to those banks whose assets it had stolen. A place where Puhl, the Reichsbank's vice president and receiver of stolen goods, was actually helping the victims by keeping their goods in a safe place, and where Puhl—and doubtless Hjalmar Schacht as well—were not the builders and managers of the Nazi economy. Instead they were merely technocratic bankers, who only wanted to "play the game squarely."

It is hard to judge which is worse: that McKittrick really believed these arguments, or they were a cynical lawyer's ploy to ward off difficult consequences. McKittrick was certainly nervous about

possible consequences of his entanglements with Nazi bankers, especially with Paul Hechler, the head of the banking department, who continued to sign his correspondence "Heil Hitler" throughout the war. Fate came to McKittrick's rescue when Hechler died in 1945. His death "raises a serious administration problem while solving a political one," wrote McKittrick to Roger Auboin.[36] But with Allen Dulles covering his back, McKittrick had nothing to worry about. McKittrick traveled to Germany at least twice in 1945 and in September stayed at Allen Dulles's house in Dahlem, in Berlin. Although McKittrick was still president of the BIS, his laisser-passer was organized by the OSS and numerous senior American officials received him.

Not everybody shared Dulles's enthusiasm for the BIS's president. There was a nasty surprise waiting for McKittrick on his return to Basel. The October 11 edition of the *New York Herald Tribune* carried a scathing attack on the BIS, and the article was reprinted in the *Tribune de Lausanne*, a Swiss newspaper. The article reported that the American occupation authorities in Germany were investigating whether the BIS had supported Germany's gold operations and helped finance Nazi rule in other countries. McKittrick's activities during the war were criticized. The bank may be called to give evidence on its gold transactions with Germany during WWII, it added. Hypersensitive as ever to press criticism, and doubtless mindful of his need to find a new job in the United States, McKittrick asked Allen Dulles to take action. The source of the leaks, he suspected, was an American official named Fox, whom McKittrick had met in Frankfurt. Fox was a colleague of Harry White. "White and his associates have taken consistently an extremely unfriendly attitude toward the BIS and the attacks on the bank at the Bretton Woods conference originated with White," complained McKittrick.[37]

Despite the bad publicity and attacks on McKittrick, the bankers at Basel got on with what they knew best: keeping the money moving. Quietly, carefully, barely noticed by the outside world, the BIS returned to business as usual. In December 1946 the bank held its first postwar directors' meeting. Maurice Frere, the governor of the National Bank of Belgium and BIS board member, traveled to Washington, DC, to lobby US policymakers to free the BIS's blocked assets and to try to defuse the media attacks. He found a sympathetic hearing. The turning point came in May 1948 when the BIS agreed to return 3.74 metric tons of looted gold to Belgium and the Netherlands. In exchange, the Allied Tripartite Commission, which dealt with Nazi plunder, agreed to drop all future claims against the bank. The US Treasury freed all BIS assets. Frere was elected president of the BIS, the bank's first since Thomas McKittrick's term had come to an end in June 1946. The Bretton Woods resolution calling for the BIS to be liquidated quietly faded away.

MEANWHILE, THOMAS MCKITTRICK had a lucrative new job. Soon after he stepped down as BIS president in 1946, he was appointed a vice president of Chase National in New York, in charge of foreign loans. McKittrick was even lauded by those whose stolen goods he had purveyed. He was invited to Brussels and decorated with the royal Order of the Crown of Belgium. The honor, noted a press release, was "in recognition of his friendly attitude to Belgium and his services as President of the Bank for International Settlements during World War II."

PART TWO: **BUNDESREICH**

> *Our whole concept of the unification of Europe was that it would first contribute to economic unification. Then we hoped to secure an economic-military unity and finally a political unity.*[1]
>
> — Averell Harriman, US Special Envoy for the Marshall Plan for the postwar reconstruction of Europe

Thomas McKittrick opened his hotel door to find fifteen slips of paper on the floor. It was the spring of 1947, and McKittrick, vice president at Chase National Bank, was passing through London. The messages from the switchboard indicated that someone in Washington, DC, was urgently trying to get in touch. McKittrick asked the operator to phone the number, and the call went through soon afterward. A voice said, "Is that you, Tom? This is Averell Harriman. You're coming to work for me for six months. I talked to Winthrop this morning, and he said you could."[2]

"Winthrop" was Winthrop Aldrich, the chairman of the board of Chase National Bank. Aldrich, who had run the bank since 1934, was one of the best-connected financiers in the United States. His father, Nelson Aldrich, had given his name to the plan, which had eventually resulted in the creation of the Federal Reserve system. Winthrop Aldrich was now an outspoken advocate of economic aid to Western Europe. Aldrich and McKittrick were old friends. In December 1945, at the height of the political attacks against McKittrick and the BIS over their acceptance of Nazi gold, McKittrick had written to Aldrich, complaining about "the people in Washington who seem to dislike us so heartily." McKittrick explained, "The situation will need to be handled skillfully." And indeed, it was, at least from the point of view of the BIS, which survived, and its former president, who was now working for Aldrich.[3] Harriman, the man at the other end of the line, was also a prominent banker and a diplomat who had served as US ambassador to London and Moscow. Harriman was now one of the most powerful men in the world, in charge of the Marshall Plan, the $12 billion American aid program to reconstruct postwar Europe. Harriman asked McKittrick if he could be in Paris to start work on June 2. Yes, gladly, replied McKittrick.

TWO MILLENNIA AGO, the Roman philosopher Cicero observed, "The sinews of war are infinite money." An updated version of his epithet would note that "the sinews of war are the transnational flow of infinite money," which will find its way around any obstacle. When the Allied leaders met at Potsdam in August 1945, they agreed that the German economy would be decentralized and the power of the cartels broken up. But the Nazi industrialists had no fear of such threats—Thomas McKittrick, as the OSS Harvard Plan documents show, had already reassured them that even if decartelization took place, the Allies would still guarantee their profits.

By the time Harriman summoned McKittrick to Paris, it had long been decided in Washington that the German business elites would not be punished. The Morgenthau Plan, which called for Germany to be stripped of its industrial might and turned into a pastoral state, had been so watered down by General Lucius Clay, the American commander of occupation forces, that it was meaningless. (Clay had set up shop in Frankfurt at the former headquarters of IG Farben, whose buildings had mysteriously escaped Allied bombing.) Washington's JSC Directive 1779, passed in the summer of 1947, institutionalized this

change in policy. German industry would be rebuilt; its steel mills and forges would once again be the powerhouse of Europe.

What would be the role of the BIS in the German renaissance? After 1945, the bank had no reason to exist. The BIS had been founded to manage German reparations payments, and none had been paid since the early 1930s. The BIS claimed it was needed as a meeting place where central bankers could gather to coordinate monetary policy. But as commercial airlines expanded their networks across the world, the BIS's lush hospitality could easily be replicated in a hotel or conference room in London, Paris, Wall Street, or anywhere else the bankers wished to gather. The BIS said it was needed to help coordinate the postwar global economy. The new institutions of the IMF and the World Bank had been founded for precisely this reason. Unlike the BIS, the IMF and World Bank were not Nazi collaborators.

The Basel bankers had also lost their golden touch. For the first time, in 1946, the BIS registered a loss. The founders could not help. Montagu Norman, now in his midseventies, had retired from the Bank of England. Raised to the peerage as Baron Norman of St. Clere, his legacy endured, and he remained influential, but he could no longer move markets with a sentence or two. Nor could Hjalmar Schacht provide assistance to the bank he had once proudly called his own. Schacht had been arrested after the July 1944 plot against Hitler and sent to Dachau concentration camp. He survived and was liberated by the US Army. He was then arrested and put on trial at Nuremberg and charged with organizing Germany for war, which is precisely what he had done. Unbowed by the weight of the proceedings, Shacht and his lawyers were putting up a spirited defense, aided by his sporadic instances of public opposition to the Nazis during the 1930s.

Yet, ultimately, no matter how tainted its reputation, Norman and Schacht's creation would prove as durable as they had hoped. Throughout the war, the repeated arguments of BIS officials that the bank must keep working so that it could play a central role in the reconstruction of postwar Europe had found a ready audience among both the Allied and Axis leadership. Bureaucratic inertia also helped the BIS. The general sentiment in both Washington, DC, and London was that the bank could be useful and was too complicated to dismantle. The BIS was "built to last," argued British Treasury officials. It was both a Swiss corporation and an international organization protected by its own treaty. Britain had just won a war, and there were other priorities for scarce resources. Lord Catto, the new governor of the Bank of England, also came to the BIS's defense: The IMF was completely new, and who knew how effective it would be? The BIS, in contrast had existed for fifteen years and was staffed by experts. Postwar Europe, like prewar Europe, still needed a place for pan-European meetings of central bankers. Basel remained the ideal venue.

BUT BEFORE A cent of Marshall aid could be sent to Europe, the plan had to be approved by the US Congress. Harriman set up a bipartisan committee of political, labor, and business leaders to steer the plan through the US government and persuade American public opinion that it was in their best interest to send tax dollars to the war-ravaged continent. The committee's members included Owen Young, the architect of the last German reparations program, whose own eponymous plan had set up the BIS, and, of course, Allen Dulles, who saw the Marshall Plan as a means of dealing the death blow to the spread of Communism in western Europe. Barely a few months after the war ended, Allen Dulles was already demanding imports of food and raw material to rebuild German industry. He condemned the arrest and detention of one hundred thousand Nazis. "We find ourselves in the concentration camp business on a large scale," he told the Foreign Policy Association in January 1946, as though the German detainees who were fed, clothed, and received medical treatment from the Allies were about to dispatched to the gas chambers.[4]

In July 1947, soon after General Marshall announced his plan, the Conference for European Economic Cooperation (CEEC) met in Paris to work out how it would be implemented. The State Department made it clear to its European allies that American aid would come at a price: financial and economic cooperation between the recipient countries with a view toward eventual European union. The first step was to replace bilateral trade deals and exchange controls with multilateral policies. The following year, the CEEC was institutionalized as the Organization for European Economic Cooperation (OEEC), which still exists today as the Organization for Economic Cooperation and Development (OECD).

The OEEC's mandate was, essentially, to ensure that the State Department's plan for Europe, and, especially Germany, was implemented. It was charged with promoting economic and political cooperation between its members; developing intra-European trade by removing barriers and tariffs and studying the feasibility of customs unions, free trade, and multilateral payments.[5] The Marshall Plan was administered by another new agency, the European Cooperation Administration (ECA), which is where Thomas McKittrick worked. McKittrick arrived in Paris for the first ECA meeting on June 2, 1947. Conditions did not meet the standards of the BIS, he recalled. "The American embassy let us have a room and secretary. But the room didn't have any carpet on the floor and [only] the barest of bare furniture and we sat there."[6] There were twelve people present, and Harriman instructed each as to his responsibilities. McKittrick's was "Trade and payments." The dozen officials had no office, no organization, and no support staff. But they did have $5 billion in the bank, which they had to distribute quickly—and McKittrick no longer had to worry about Henry Morgenthau and Harry Dexter White.

Morgenthau had stepped down as Treasury secretary in 1945 and was now largely retired from public life. He devoted himself to Jewish causes and helping the new state of Israel. White left government and joined the IMF as its first US executive director. He was an idealist as well as a realist. He saw the IMF as a means to promote economic growth through trade and financial stability. White, like the BIS, believed in global financial cooperation as the path to prosperity—but crucially, a cooperation coordinated among governments rather than unelected central bankers and technocrats.

After 1945 White was subjected to sustained attacks on his patriotism, attacks that James M. Boughton, the IMF's official historian, has described as ranging from "the questionable to the bizarre."[7] White's failed attempt to bring the Soviet Union into the IMF in 1944 (when the country was an ally of the United States) and his meetings with Soviet officials were recast as support for Communism. So was his support for the Morgenthau Plan to de-industrialize Germany. White's request to the nationalist government in China to account for how it had spent hundreds of millions of dollars in American aid was respun as sympathy for Mao Tse-Tung's Communist forces. In August 1948, White was called to testify before the House of Representatives Committee on Un-American Activities to be questioned about his relations with the Soviets. Historians continue to investigate these. There is evidence that White passed sensitive information to Moscow. Decrypted Soviet diplomatic cables from the 1940s detail White's discussions of American foreign policy with a Soviet official. But an authoritative biography of White by Bruce Craig argues that White was regarded by Moscow as a "trusted individual" rather than an active agent.[8] Certainly White's influence on policy making and access to high-level governmental decision making made him a person of great interest to the Soviets. Whether White was an agent or an asset, he was passing sensitive information to a hostile foreign power. Craig argues that White was a Rooseveltian internationalist, who believed in the need for cooperation with the Soviets, rather than a Communist.[9] Either way, such views were no longer acceptable in Washington in the late 1940s.

White suffered from heart trouble. His appearance before the committee was highly stressful. Three days later, he died.

MEANWHILE, THE BIS was swiftly building itself into the new global financial architecture. That September 1947 bank officials in charge of protocol and hospitality were in overdrive. The BIS was preparing for the two most important VIPs it had received since the end of the war: John McCloy, the president of the new World Bank, and Eugene Black, its executive director. There was little danger of discord: McCloy was one of the most influential advocates of normalization with Germany. Black was a former vice president of Chase National—the new employers of Thomas McKittrick. McCloy had deliberately sabotaged the Morgenthau Plan and steered President Roosevelt away from punishing Germany in favor of rebuilding German industry. As the website of the United States embassy in Germany notes, "He was instrumental in undermining the proposed 'Morgenthau Plan' for Germany which would have reduced the country to a land of forests and farms."[10]

The Marshall Plan was certainly a triumph for the prewar Wall Street–Berlin financiers. McCloy, Black, and Harriman all had extensive prewar financial interests in Nazi Germany, as McKittrick had. McCloy had been a partner in Cravath, a powerful New York law firm, which represented General Aniline and Film, IG Farben's American subsidiary.[11] Like his friend Allen Dulles, McCloy had been based in Paris in the prewar years where he ran the law firm's office. McCloy left Cravath in 1940 to serve as assistant secretary for war. This prevented a potentially ugly conflict of interest, for Cravath's clients also included the United States Alkali Export Association (Alkasso), which had intentionally deprived the United States of vital chemicals during the war.[12]

Alkasso was composed of the eleven most important alkali producers in the United States and handled their foreign trade. In 1936 Alkasso entered into a cartel agreement with Solvay & Cie, the Belgian chemicals company represented by John Foster Dulles, and Imperial Chemical Industries, a British combine. The cartel continued during the war, and in 1942 the Department of Justice launched an investigation into Alkasso, just as it had with Standard Oil. Standard Oil had restricted the United States' ability to produce artificial rubber. Alkasso prevented free trade in soda ash, a basic ingredient in vital war materials such as glass, textiles, and numerous chemicals.

In 1944 the Justice Department launched a civil lawsuit against Alkasso and ICI for breaching the Sherman Anti-Trust Act. Also named as co-conspirators were Solvay & Cie and IG Farben. Alkasso was charged with restricting exports and prohibiting imports, eliminating competition, and price-fixing. Cravath and Alkasso lost the case. The sixty-page decision, delivered by federal judge Samuel Kaufman, was blistering. It found that Alkasso had near total control of alkali imports and exports. Alkasso even ran its own network of inspectors at docks to examine materials leaving the United States. It compiled a blacklist of all competitive exporters and instructed its members not to sell to those on it. It forced its customers to give written assurances that they would not sell their products outside the United States. The cartel had continued during the war years, the decision, delivered in 1949, noted.[13]

McCloy was a ruthless, self-made man who was not known for his humanitarianism. On the contrary—the president of the World Bank had been instrumental in the internment of some 120,000 American citizens and residents of Japanese ancestry, causing an enormous amount of human suffering—a bitter legacy that still lingers today. Arguably, he had blood on his hands. McCloy used his office and influence over Henry Stimson, the secretary for war, to repeatedly block attempts by Jewish organizations to have the US Air Force bomb Auschwitz. By 1944 numerous testimonies of escapees and witnesses had reached Western capitals.[14] It was widely known among both governments and Jewish organizations that the camp was an industrial death factory. Allied bombers regularly overflew the complex and occasionally bombed the outlying IG Farben Buna factory at Auschwitz III and other buildings. It would have been comparatively simple to destroy the key railway junctions and gas chambers. In August 1944, soon after 430,000 Hungarian Jews had been deported to Auschwitz, where most were gassed on arrival, A. Leon

Kubowitzki of the World Jewish Congress wrote to McCloy asking that Auschwitz be bombed. McCloy refused. He replied that such an operation would demand diversion of resources being used elsewhere and would be of "doubtful efficacy," an argument also echoed by British officials. McCloy also made the macabre claim that bombing Auschwitz might "provoke even more vindictive action by the Germans," although it is hard to imagine what could be more vindictive than the industrialized extermination of thousands of people per day.[15]

Eugene Black, McCloy's colleague at the World Bank, had joined Chase National in 1933 as vice president. He was promoted to senior vice president in charge of the bank's investment portfolio. This was substantial: at that time, Chase National was the world's largest bank in terms of assets, which is why it was so appreciated by Nazi Germany.

Averell Harriman's financial links with Germany also stretched back decades. Soon after the end of the First World War he had set up his own bank, W. A. Harriman, which carried out extensive business in Germany. Together with Lee, Higginson—the former employers of McKittrick—W. A. Harriman bank lent $20 million to the Berlin City Electric Company, with legal work provided by John Foster Dulles. Harriman was a board member of the International Chamber of Commerce (ICC), as was Thomas McKittrick. The chamber's president, after 1937, was Thomas Watson, the boss of IBM who had traveled to Berlin to be awarded the Merit Cross of the German Eagle by Hjalmar Schacht and whose Hollerith machine was used by the Nazis to speed up the organization of the Holocaust.

Harriman was an early enthusiast for transnational finance. During the mid-1920s he attended an ICC meeting in Paris, the only American of any prominence present. He later recalled,

> *One evening I remember that I met with the leading bankers and industrialists of the principal countries. I remember the British and German, the French—I can't remember who else was there. It was quite a small dinner—it was a private dinner. Yet, they took the International Chamber of Commerce more seriously than we did and there were some important men present. I asked them why they thought that the United States was moving ahead as we were in the mid-twenties, you remember, whereas Europe was stagnant with built-in unemployment. They said it was because we had a continent of free trade.*[16]

Sometime in the early 1920s, Harriman had traveled to Berlin and met Fritz Thyssen, the powerful German industrialist, according to declassified US documents. Thyssen became one of Hitler's most influential backers and persuaded many of his fellow businessmen to support the Nazis, until he fell out with Hitler after Kristallnacht and fled Germany. Thyssen told Harriman that he wanted to set up a bank in New York to look after his interests in the United States. In 1924, W. A. Harriman duly set up a new bank for Thyssen called the Union Banking Corporation (UBC). UBC had seven directors, including E. Roland Harriman, his brother, and Prescott Bush, the grandfather of President George H. W. Bush, and great-grandfather of George W. Bush. But UBC was not a bank in the normal sense of the word. It was a front for Bank Voor Handel en Scheepvaart, based in Rotterdam in the Netherlands. Bank Voor Handel en Scheepvaart was wholly owned or controlled by the Thyssen family, US investigators believed.

In 1931 W. A. Harriman merged with Brown Brothers & Co., to form Brown Brothers Harriman (BBH) with offices at 59 Wall Street, a few doors from Sullivan and Cromwell, which was at number 48. The UBC was highly successful. US investigators believed that between 1931 and 1933 UBC bought more than $8 million worth of gold, of which $5 million was sent abroad, probably to Germany.[17] This is why, on November 6, 1942, the US Alien Property Custodian issued vesting order 248 and seized all four

thousand shares of UBC and its assets.[18] Harriman, who was traveling the world as President Roosevelt's special envoy to meet with Churchill and Stalin, continued his diplomatic career unhindered. The month after UBC was vested, Joseph Ripley, one of Harriman's oldest and closest business associates, represented Brown Brothers Harriman at McKittrick's dinner at the New York University Club.

WITH CREDENTIALS SUCH as these, McCloy's and Black's visit to the BIS could only be a success. The BIS, its officials pointed out, had much to offer. It was the world's oldest global financial institution. It had unrivaled experience in gold and currency swaps and superb technical expertise. Its annual reports were universally regarded as the single most useful source of financial and economic information. The BIS agreed to host the World Bank's European mission and to provide it with technical support. Soon after, when the World Bank issued its first non-dollar bond, the BIS negotiated the bond's sale to Swiss banks and bought a substantial share for its own account.

It seemed only natural that when the CEEC, the committee in charge of Marshall Plan payments, formed a subcommittee to manage multilateral payments between France, Italy, Luxembourg, the Netherlands, and Belgium, the BIS would be at the center of the new system. Frederick Connolly, a veteran BIS official who had formerly worked at the Bank of England with Montagu Norman, drafted an agreement on multilateral payments, which was signed in Paris in November 1947. The BIS was appointed agent in charge of executing the transfers. The bank hosted a conference for the five signatories and observers from Switzerland, Britain, and the US Treasury and State Departments. A resolution was passed encouraging central banks to use the BIS to settle their payments, rather than doing so directly between creditor and debtor. It also requested that the BIS be informed of any direct transactions.

At first glance, the Paris accord on multilateral payments seems an obscure footnote to postwar economic history. Monetarily, it was almost irrelevant. By the end of 1947, only $1.7 million of $762.1 million outstanding balances between the five signatories had been settled. But this little-known accord was, in fact, highly significant. An important precedent had been set: transactions between central banks would now go through Basel, rather than between national treasuries. Only the BIS had the staff and the expertise, dating back to its experience managing reparations payments in the 1930s, to manage an effective system for intra-European payments. The BIS had effectively reasserted itself as an international clearinghouse for Europe's central banks.

Emboldened by the new payments system, the technocrats and Euro-federalists were now on the rise. Belgium called for a customs union between the Benelux countries and France and Italy. Italy went one better and proposed a customs union between all countries receiving aid under the Marshall Plan, as a step toward European Union.

The postwar blip in the BIS finances was short and temporary. By 1951, the BIS was once again paying dividends to its shareholders. BIS observers attended IMF and World Bank meetings. The bank enjoyed a cordial relationship with the New York Federal Reserve, thanks in part to the legacy of Leon Fraser, the former BIS president who had also served as a director of the New York Fed. (Despite his successful career, Fraser suffered from severe depression. In April 1945 he shot himself in the head with a revolver and died on the way to the hospital.)

THE BRETTON WOODS motion calling for the dissolution of the BIS, and the campaign against the bank led by Henry Morgenthau and Harry White had been the most serious threat yet to the BIS's existence. Although the full details of the bank's role as a channel between the Allies and the Axis were not yet public in the immediate postwar years, the BIS was thoroughly tainted by its acceptance of Nazi

gold and its cozy relationship with the Reichsbank. But the bank proved more nimble and agile than its foes. Its managers deftly immediately built the BIS into the new global financial architecture. The BIS did not seek to compete with the IMF and offer loans to indebted countries (although it would later arrange international credits to troubled economies). Nor did it try and compete with the World Bank and fund development projects. Rather, the BIS stuck to what it knew best: offering discreet services, financial coordination, and a confidential venue to central bankers, all of which were in great demand in postwar Europe.

The bank's excellent connections with American policymakers such as Allen Dulles and John McCloy brought an early understanding of Washington's commitment to a new, united Europe. The drive was now unstoppable, with wide political support across European capitals. Such a project, the BIS managers understood, would offer immense new opportunities for the bank over the coming decades. The new Europe would need swift, international payment mechanisms, more harmonized exchange rates, and perhaps eventually a new single currency. There was nobody better placed to offer these services than the technocrats of the BIS.

When detained in Dustbin, among a number of references to the financially great he pointed out that the President of the BIS, Mr. McKittrick of the United States, would be able to speak favourably of him.

— British intelligence report on Hermann Schmitz, CEO of IG Farben, while held prisoner at Kransberg Castle, aka "Dustbin," December 1945[1]

While Hermann Schmitz was dropping Thomas McKittrick's name in the hope that the BIS president might somehow spring him from prison, Rudolf Brinckmann was also plotting how to keep his wartime profits. The German banker, who would soon be appointed a director of the BIS, was locked in a bitter dispute with the Warburgs over the ownership of Brinckmann, Wirtz and Company, in Hamburg, the successor to M. M. Warburg bank, which had been Aryanized by the Nazis.

Brinckmann had joined M. M. Warburg in 1920 and worked as the office manager. He spoke six languages and was seen as loyal, dependable, and trustworthy. The Warburgs joked that Brinckmann was their "in-house Aryan," even though he was actually Mediterranean looking, because of his Greek-Turkish background. M. M. Warburg was then one of the world's most influential banks, the centerpiece of a financial dynasty whose name was a byword for stability and prudence. The family trusted Brinckmann absolutely, so when the Nazis took power in 1933, he was granted full power of attorney and took the place of the members of the Warburg family on other company boards. Five years later, when the bank was Aryanized, Brinckmann, together with Paul Wirtz, was made a director, on the understanding that he would look after the Warburgs' interests.

Brinckmann's wartime record was ambiguous. He had hired Nazi party loyalists and purged the last remaining Jewish employees. Staff began to wear Nazi party insignia. Brinckmann wrote letters to former clients, pointing out that now that the bank had been Aryanized there was no reason not to come back, the letter usually ending with "Heil Hitler."[2] He traveled to Essen to win back the account of the Krupp family of industrialists, who were one of Hitler's most important backers. Brinckmann renamed the bank after himself, and he also negotiated the release of fourteen members of the Warburg family and employees from Nazi-occupied Amsterdam, who eventually reached the United States.

After the war numerous German bankers, including Brinckmann, were placed under house arrest. But the Warburgs, grateful that their bank still existed, albeit in another form and under another name, helped Brinckmann as much as they could. They provided a supply of food. His house arrest was lifted. They got him a place on a de-Nazification tribunal—an immensely influential position. Brinckmann initially offered to return the bank to the family, but as the full horror of the Holocaust became public, the Warburgs declined, ambivalent about their return to Germany.

Brinckmann was soon glad that his offer was refused, because the bank was profitable. Soon after, some of the Warburgs, including Eric, decided to settle in Germany and asked for their bank to be returned. Brinckmann refused. Like many German owners of formerly Jewish concerns, he rewrote history. The 1938 transfer into his name was not an Aryanization, he claimed. Rather, he had saved the remnants of a collapsed bank. The Warburgs should be grateful to him, rather than vice versa. He offered the family a ten percent ownership stake. That was unacceptable, said the family. If it had not been for M. M. Warburg, Brinckmann, Wirtz and Company would not exist. It was built on the ruins of the Warburg

empire and even operated out of the same building. The two sides finally agreed that the family would take 25 percent, with a five-year option on 50 percent.

Brinckmann joined the BIS board of directors in 1950, after the Warburgs put his name forward. But if the Warburgs hoped that trips to Switzerland, the BIS's famed hospitality, and the inside information gleaned at the bank's lunches and dinners would mollify Brinckmann, they were quickly disappointed. The BIS, it seemed, had gone to Brinckmann's head, and he remained as stubborn as ever. Eric Warburg, a prominent member of the Jewish banking dynasty, dubbed the new BIS board member "John Foster Brinckmann," after John Foster Dulles, the ruthless lawyer turned Cold War warrior who was soon to be appointed secretary of state. Sigmund Warburg wrote to Eric in 1950, "During the last few years I've found Brinckmann extraordinarily arrogant and egotistical, but during my last discussion in Hamburg I found that his arrogance and his egotism had gradually reached a point where they are scarcely bearable any longer."[3] There seemed no end in sight to the dispute.

DESPITE THE MARSHALL Plan, postwar Germany was devastated, its population barely scraping a living. A fifth of all housing stocks had been destroyed, food production was about half of its prewar levels, and industrial output in 1947 was one-third of its 1938 level.[4] Basic goods were rationed, and wages and prices were controlled. The black market was thriving, and there was no properly functioning central bank. Officially, the Reichsbank had ceased to exist. The Reichsmark staggered on, still in circulation, although the main unit of currency was American cigarettes.

In 1948, everything changed. The Reichsbank was abolished completely and replaced by the Bank deutscher Länder (BdL). The deutschmark replaced the Reichsmark. The BdL was a national clearinghouse for the banks of the German regional states in the western occupation zone, modeled broadly on the US Federal Reserve. Unlike the Reichsbank, which had been brought under government control, the BdL, which would now represent Germany at the BIS in Basel, had its independence constitutionally guaranteed.

Hjalmar Schacht was not impressed with the deutschmark. It was backed neither by gold nor by foreign currency reserves. It was a fiat currency, imposed by the Western authorities. Schacht told Wilhelm Vocke, the president of the new German national bank, that the deutschmark would collapse in six weeks. But Schacht was wrong. The deutschmark was backed, and by assets even more powerful than gold or foreign exchange: public confidence and postwar planning by the Nazi leadership.

At the same time, Ludwig Erhard, the economic director of the British and American occupation zones, lifted price restrictions and controls. The results were spectacular. Employment soared, inflation plummeted, the economy boomed. The deutschmark was stable and enjoyed the public's full confidence. The western powers and their German subordinates proclaimed the dawn of a new era.

But the new central bank, currency, and Germany's economic recovery were all deeply rooted in the Third Reich. Because German companies, especially armaments firms, had reinvested their massive profits, despite the Allied bombing campaign and reparations, Germany's capital stock—its productive equipment, buildings, infrastructure, and other assets—was actually greater in 1948 than in 1936.[5]

The lines of financial continuity between the Third Reich and postwar Germany reached right to the top. The BdL's first president, Vocke, was a Reichsbank veteran and ally of Hjalmar Schacht. Wilhelm Vocke had sat on the Reichsbank board from 1919 to 1939 and was Germany's alternate member on the BIS board from 1930 to 1938. He would now return to Basel for the governors' meetings. Vocke remained loyal to his former boss and testified at Schacht's trial at Nuremberg. He made the unlikely claim that Schacht had believed Germany's weapons buildup was intended to support a policy of armed neutrality and to reduce unemployment.[6] Vocke, however, had not joined the Nazi party, unlike many of

his colleagues at the BdL. Every state institution in postwar Germany—the police, judiciary, civil servants, teachers, doctors, and the intelligence services—relied on former Nazis to function. But the continuity among the bankers was striking. Between 1948 and 1980, 39 percent of officials on the executive and governing boards of either the BdL, the central banks of the regional states, or the Bündesbank (the BdL's successor) were former Nazis.[7]

Some, such as Fritz Paersch, had been important figures in Hitler's economic empire. Paersch was the mastermind of the Nazi plunder and despoliation of Poland. As president of the central bank in German-occupied Poland, he reorganized the currency. Without his work, the Nazi occupation would not have been able to function economically. Hans Frank, the governor general of Poland who oversaw the murder, enslavement, and deportation of millions of Poles and Polish Jews was a great admirer of Paersch. Frank was found guilty of war crimes at Nuremberg and executed. And Paersch should have been put on trial as well, but instead he lived freely and applied for a senior position at the BdL. He was rejected because of his wartime past but was compensated with a position as vice president of the Hesse state central bank, where he worked until 1957. Paersch then found a new sinecure: as official liquidator of the Reichsbank, whose legal affairs still stuttered on.[8]

Like Schacht during the 1930s, Ludwig Erhard, the economic director of the western occupation zones, was hailed as a miracle maker. The truth was more prosaic. Erhard, a future chancellor of West Germany, was an ambiguous figure. He had refused to join any Nazi party organizations and was connected to the German resistance. But Erhard had accepted funds from the Reichsgruppe Industrie, the organization of German industrialists, including IG Farben, that supported Hitler. He was awarded the war service cross for his work on economics. By 1943 Erhard's work had come to the attention of the German bankers and industrialists who realized that the war was lost. They formed two groups to prepare for the future and ensure their continuing economic power in the postwar world: the Committee for Foreign Economic Affairs, composed of financiers and industrialists, and the Small Working Group, composed solely of industrialists, including Hermann Schmitz, the CEO of IG Farben and BIS director.[9] Erhard was the connection between the two groups.

The members of the Committee for Foreign Economic Affairs included Hermann Abs of Deutsche Bank, the most powerful commercial banker in the Third Reich. The dapper, elegant Abs was an old friend of the BIS. He had been sent there by Schacht during the 1930s to try and stall demands for repayments of the loans that financed Germany after 1918.[10] In Basel, Abs frequently met with a British banker called Charles Gunston, who was a protégé of Montagu Norman. Gunston managed the Bank of England's German desk, which made him immensely important during the 1930s. Gunston was so keen on the new Germany that he spent his 1934 summer holidays at a work camp for enthusiastic Nazi party members.[11] He also admired Abs and later described him as "Very urbane. Always a velvet glove around an iron fist." Abs did not join the Nazi party, but he was so essential for the functioning of the Third Reich's economy that he did not need to. As the head of Deutsche Bank's foreign department during the war, Abs was the lynchpin of the continent-wide plunder, directing the absorption of Aryanized banks and companies across the Third Reich. During the twelve years of the Third Reich, the bank's wealth quadrupled. Abs sat on the board of dozens of companies, including, naturally, IG Farben.[12]

In 1943 the Nazi industrialists asked Erhard to write a paper on how German industry could be converted back to peacetime production. Erhard argued for a free and competitive market with a gradual elimination of state controls. German industry would be redirected, as quickly as possible, to producing consumer goods.[13] Erhard was taking a substantial risk by putting his name to such thoughts: any postwar planning that assumed that Germany might lose the war was enough to send the author to a concentration camp.

But Erhard had protection at the highest levels of the Nazi state: Otto Ohlendorf, the chief of the SS internal security service. The SS was a business as well as a killing machine, the state engine of looting, plunder, and despoliation, from the gold extracted from the teeth of concentration camp victims to the banks, steelworks, factories, and chemical plants of Nazi-occupied countries. Ohlendorf had extensive firsthand experience of the SS's methods. Between 1941 and 1942, Ohlendorf had commanded Einsatzgruppe D, the extermination squad operating in southern Ukraine, which had murdered ninety thousand men, women, and children. Ohlendorf, an intelligent and educated man, showed great concern for the psychological welfare of his squad's gunmen. He ordered that they should all fire at the same time at their victims, so as to avoid any feelings of personal responsibility.

Ohlendorf also held a senior position at the Ministry of Economics, supposedly focusing on Nazi Germany's foreign trade. By 1943, after the Russian victory at Stalingrad, Ohlendorf also understood that the Third Reich would eventually lose the war. His real job was to plan how the SS would keep its financial empire so that Germany would reassert its economic dominance over Europe after the inevitable defeat. The postwar priority was rapid monetary stabilization, to preserve economic stability and avoid Weimar-style hyperinflation. Germany would need a new currency, which would have to be imposed by the occupying powers, as well as a mixed economy of state and private sectors. There was an obvious overlap with Erhard's ideas. Ohlendorf came to hear of Erhard's work, and Erhard was persuaded to send him a copy of his memo.

As the Allies advanced on Germany, the Nazis stepped up their plans for the postwar era. On August 10, 1944, an elite group of industrialists gathered at the Maison Rouge Hotel in Strasbourg, including representatives of Krupp, Messerschmitt, Volkswagen, and officials from several ministries. Also in attendance was a French spy, whose report reached the headquarters of the Allied invasion force, from where it was forwarded to the State Department and the Treasury. The account of the meeting is known as the Red House Report.

Germany had lost the war, the Nazi industrialists agreed, but the struggle would continue along new lines. The Fourth Reich would be a financial, rather than a military imperium. The industrialists were to plan for a "postwar commercial campaign." They should make "contacts and alliances" with foreign firms but ensure this was done without "attracting any suspicion." Large sums would have to be borrowed from foreign countries. Just as in the prewar era, the US connection and links to chemical firms, such as the American Chemical Foundation, were essential to expanding German interests. The Zeiss lens company, the Leica camera firm, and the Hamburg-American line had been "especially effective in protecting German interests abroad." The firms' New York addresses were passed around the meeting.

A smaller group attended a second, select meeting. There the industrialists were instructed to "prepare themselves to finance the Nazi party, which would be forced to go underground." The prohibition against exporting capital had been lifted, and the government would help the industrialists to send as much money to neutral countries as possible, through two Swiss banks. The Nazi party recognized that after the defeat, its best-known leaders would be "condemned as war criminals," the intelligence report concluded. However, the party and the industrialists were cooperating in placing the most important figures in positions at German factories as research or technical experts.[14]

US Treasury officials were closely watching this massive export of German capital, much of which was going to South America. Funds were pouring out of Germany and other Nazi-controlled territories, Harry Dexter White told a meeting of Treasury officials in July 1944 during the Bretton Woods conference. Nazi leaders were preparing to flee the country or have their property confiscated. "They bought estates and industries and corporations, and there is evidence that the German corporations have been buying into South American corporations in the expectation of being able to re-establish themselves

there after the war."[15] The cloaking operation was extremely complex, said White. "They are working through first, second and third fronts, so it is pretty hard to trace it without having all the data available." The Treasury officials also discussed the BIS at the same meeting, noting that out of twenty-one board members and senior officials, sixteen were "representatives of countries that are either now our enemies, or are occupied," including Walther Funk and Hermann Schmitz.[16]

Emil Puhl discussed the Nazi leadership's postwar strategy with McKittrick at the BIS in March 1945, during the last few weeks of the war. The information he passed to McKittrick echoes that included in the Red House Report and Harry Dexter White's discussion at Bretton Woods. Military defeat was merely a temporary setback. The Nazis were fanatics and would never give up their ideals, Puhl explained. Instead they would go underground. McKittrick immediately informed Dulles of the conversation. Dulles sent the information on to London, Paris, and Washington on March 21, 1945. His telegram noted that Puhl had "just arrived" in Basel:

> *He said that the jig was up but that Nazis had made careful plans to go underground, that every essential figure had his designated place, that Nazism would not end with military defeat as Hitler and his fanatical followers would no more change their philosophy than would Socrates or Mohammed, that these men were just as convinced of their cause as ever and carried a great body of people with them. He emphasized that Nazism was like a religion, not merely a political regime.*[17]

After the Allied victory, Donald MacLaren, the British intelligence agent who had brought down GAF, IG Farben's US subsidiary, was sent to Berlin to investigate the chemicals conglomerate. MacLaren wrote an extensive dossier on IG Farben, its history and key personnel, and its central role in preparing and waging war. MacLaren laid out in detail how IG Farben's trading partners in New York and London, such as Standard Oil, had willingly entered into cartel arrangements with the chemical conglomerate, thus ceding control to Germany and helping it to re-arm.

SO WHAT THEN should be the fate of the Nazi industrialists such as Hermann Schmitz? For MacLaren, the answer was clear. Schmitz had murdered, enslaved, and plundered from behind his desk, rather than on the battlefield. He was a war criminal as much as the leaders of the SS and should face the same punishment. But not all Allied officials agreed. When MacLaren asked his superiors if the industrialists were to be included with the Nazi military leadership as war criminals, he was told, "The term 'industrialists' raises a point on which no definite line has been laid down."[18] Schmitz, as MacLaren noted, certainly believed himself to be protected by his connection to the BIS and to Thomas McKittrick.

At one stage it seemed justice might be done. In 1947, twenty-four IG Farben executives, including Schmitz, were put on trial at Nuremberg. Twelve were found guilty. The sentences were derisory. Schmitz was sentenced to four years. Georg von Schnitzler, the commercial chief, who had apparently used the BIS to contact the Allies, received five years. Otto Ambros, a senior manager of IG Auschwitz, received eight years. Ambrus testified that the prisoners at IG Auschwitz were fortunate to "have been spared all that which happened" in the main concentration camp. The IG managers had also saved them a commute. The slave laborers could live on-site and no longer had to march fourteen kilometers a day to and from the main camp. "There was no stinting when Monowitz was built. It was heated and hygienic," Ambrus explained, although Rudy Kennedy, who worked as a slave laborer for IG Farben when he was a teenage boy, remembered conditions rather differently. The slave laborers were served soup at lunchtime,

soup with a "higher calorific content" than most Germans enjoyed in the immediate postwar years. "I believe that IG Farben and its officials deserve not a reproach, but due recognition," Ambrus later wrote, and they would soon get it.[19]

IG Farben was broken up into four successor companies: BASF, Bayer, Hoechst, and Cassella. The dismantling was no punishment. The shareholders asked the occupation authorities to transfer the conglomerate's assets to the successor firms, and they agreed. BASF, Bayer and Hoechst immediately reconstituted themselves, with the same staff working in the same offices and factories. A new holding company was created to deal with the legal fallout and consequences of the breakup. The legacy firms said they had no obligations for IG Farben's sins, as they had not legally existed during the war. It was a shameless and completely successful legal maneuver.

In 1949 John McCloy left the World Bank and started work as US High Commissioner for West Germany. McCloy, the former partner in the Cravath law firm that had represented GAF, the American wing of IG Farben, did not forget his former business partners. Hermann Schmitz was released from prison in 1950, and by February 1951 all of the IG Farben executives were free. McCloy also freed Alfried Krupp. The Krupp industrial empire had worked about eighty thousand slave laborers to death in a network of fifty-seven labor camps guarded by the SS. Krupp was sentenced to twelve years imprisonment, but he served less than three.

Otto Ohlendorf, the former commander of Einsatzgruppe D and protector of Ludwig Erhard, was an exception. He was hanged. But McCloy ordered that Nazi camp doctors who had conducted experiments on inmates, Nazi judges who had dispensed Gestapo justice, and SS officers who had organized mass killings be freed or have their sentences drastically reduced.[20] Seventy-four of the 104 defendants convicted at Nuremberg had their sentences substantially reduced, and ten death sentences were commuted.[21] Heinz Hermann Schubert, Ohlendorf's adjutant, who had personally supervised a mass execution of seven hundred people at Simferopol, had his death sentence commuted and was sentenced to ten years in prison.

The IG Farben managers were swiftly welcomed back into the German business community. Hermann Schmitz joined the supervisory board of the Deutsche Bank. Otto Ambros, provider of soup to slave laborers, joined numerous company boards and set up as an economic consultant. His clients included Konrad Adenauer, the federal chancellor. Kurt von Schröder, the banker and BIS director who had brokered Hitler's rise to power, was found disguised as an SS corporal in a POW camp in France. He was tried by a German court for crimes against humanity and was sentenced to three months in prison. Walther Funk, the dissolute Reichsbank president and BIS director, was found guilty of war crimes and sentenced to life imprisonment. The trial established how Funk had worked with Himmler, the SS chief, to ensure that gold and valuables from camp victims were credited to a special account at the Reichsbank in the name of "Max Heiliger" for the SS. Funk was released from Spandau prison for health reasons in 1957 and died three years later. Emil Puhl, Funk's deputy, BIS director, and friend of Thomas McKittrick, was also convicted of war crimes. Sentenced to five years, he was released in 1949.

Ironically, it seems the Warburgs were also instrumental in the reconstruction of German industry, thanks to the family's friendship with McCloy. Freddie Warburg had persuaded McCloy to take the position of president of the World Bank. The two men had known each other since the 1920s when McCloy had done legal work for Kuhn, Loeb, a branch of the Warburg empire. When Eric Warburg and McCloy dined together in August 1949, Warburg pleaded with McCloy to stop the dismantling and destruction of German industrial plants. Soon after, Warburg gave McCloy a list of ten steel, gas, and synthetic rubber concerns, including the Thyssen steel works and the Krupp gas works, to be saved. All were spared.[22] McCloy occasionally took a moral stand—he repeatedly told Germany to return Jewish

property. When he was informed that Germans who served on de-Nazification boards were being shunned as traitors, he ordered state governments to guarantee such people civil service jobs.

As for Schacht, charged with organizing Germany for war, he still had powerful friends in London and Washington. Green Hackworth, the legal adviser to the State Department, was working behind the scenes to help the former Reichsbank president. During the war, Hackworth had repeatedly sabotaged attempts to publicize Nazi war crimes and bring their perpetrators to justice, arguing that such moves would endanger American POWs.[23] Breckinridge Long, the assistant secretary of state, who had once praised Mussolini, supported Hackworth. Long and his aides had prevented Jewish refugees from obtaining visas, suppressed news of the Holocaust, and derailed attempts to document Nazi war crimes. In 1944 Henry Morgenthau's staff wrote a detailed paper that documented the State Department's wartime record. Its title was "Report to the Secretary on the Acquiescence of this Government in the Murder of Jews."[24]

Once again the Dulles connection came to the fore. In late 1945 Schacht requested that Hans Bernd Gisevius be summoned as a defense witness to testify on his behalf. Gisevius, the wartime German consul in Zürich, was also an officer in the Abwehr, German military intelligence, a member of the anti-Hitler resistance, and one of Allen Dulles's most important agents, known as OSS source 512. Declassified US intelligence documents show that Gisevius was expected to testify that Schacht had attempted to overthrow Hitler in 1938 and to talk about Schacht's difficult relationship with the Nazi party, so that Schacht could present himself as a member of the resistance.

The documents reveal how much effort the State Department made to get Gisevius, who was living near Geneva in Switzerland, to Nuremberg to aid Schacht. A telegram from US diplomats in Berlin to the State Department, on December 10, 1945, requests that the "necessary arrangements be made to bring him to Nuremberg on ten days' notice and that Tribunal be kept fully advised through this office."[25] Three days later, Leland Harrison, the US ambassador to Switzerland, cabled Washington that Gisevius was willing to appear as a defense witness for Schacht and could depart for Nuremberg any time in January on forty-eight hours' notice. Harrison asked the State Department to alert him when Gisevius should arrive in Nuremberg.[26] The US government, was, in effect, acting as an aide to Schacht's defense lawyer, arranging for Gisevius's transport and logistics, and coordinating his appearance with the Nuremberg Tribunal.

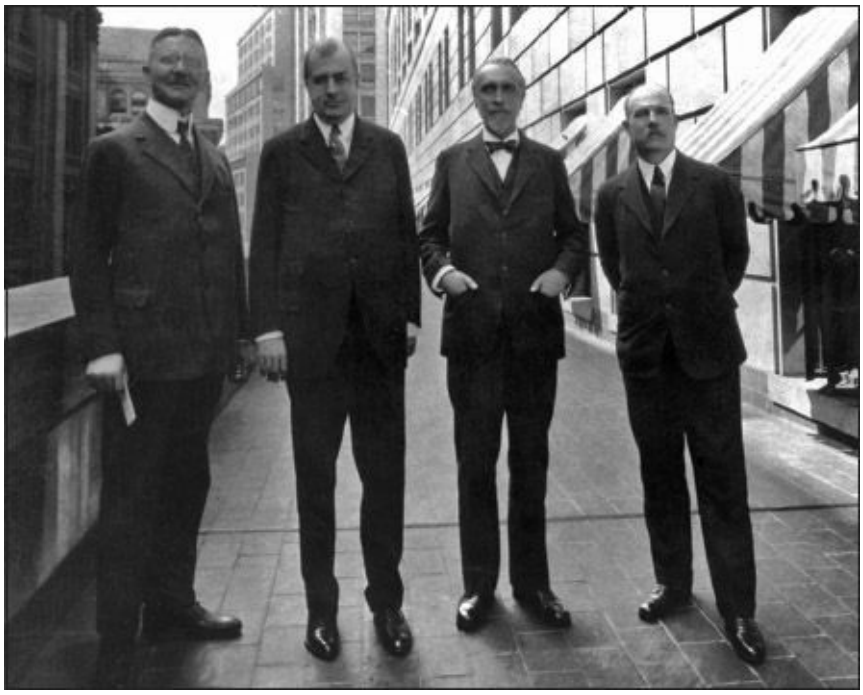
The US team at Nuremberg was split over Schacht. Robert Jackson, the chief US prosecutor, wanted to prosecute him. But his deputy, William Donovan, the former OSS chief, was opposed. Donovan argued that Schacht had been sympathetic to the Allies in the early years of the war. And there was the postwar German economy to consider, always a crucial factor in US policy calculations. A harsh cross-examination of Schacht would alienate the important German businessmen and financiers who favored good relations with the United States.[27] There was consternation in Washington when Schacht's lawyer told the press that Sam Woods, the US Consul General in Zürich, had offered the Reichsbank president a deal in 1939—that if he resigned from Hitler's government, he would be returned to power after the war. Considering all we now know about the secret back channels between the United States and Nazi businessmen, this seems highly plausible. Woods had long been a conduit between the US government and the Axis powers. After Admiral Horthy, Hungary's wartime leader who had permitted 430,000 of his own citizens to be deported to Auschwitz, was released from custody in 1946, Woods invited him to his wedding.[28]

The State Department's efforts on Schacht's behalf worked. He was initially found guilty but was then acquitted, to the fury of the Soviet judge. There were also suspicions that Montagu Norman had somehow managed to influence the proceedings through Sir Geoffrey Lawrence, the British judge. The British obsession with class seemed to play a part. Francis Biddle, the American judge, recorded in his diary that Lawrence had claimed Schacht was a "man of character" while other defendants were "ruffians."[29]

Norman was immensely relieved when Schacht was not hanged at Nuremberg, recalled his stepson, the writer Peregrine Worsthorne. "He did not think Schacht was guilty for the crimes of the war, but obviously being on speaking terms with any prominent Nazi made you a pariah after the war. He had made his mind up about Schacht before the war and the horrors." (In later years Priscilla Norman angrily denied that her husband had tried to influence the outcome of Schacht's trial.)[30]

Intriguingly, Worsthorne believes that Norman and Schacht managed to stay in communication during the war—if they did, the BIS would have been the natural channel. "Norman kept up this strange relationship that he had with Schacht, even during the war. Both during the First and Second World Wars the capitalist world was not at war. The bankers kept the system in cold storage. I am sure that there would have been absolutely no record of their contacts and that Norman kept in touch with him without the government knowing."[31]

After several more years of legal travails with the German authorities, Schacht was finally cleared of all charges. He started a lucrative second career as an investment adviser to countries in the developing world and set up his own bank, Schacht & Co. Schacht even visited Israel, albeit inadvertently when his airplane stopped briefly at Lydda airport in 1951. Schacht and his second wife, Manci, wanted to stay on board but were taken to the airport cafeteria to have breakfast. The Schachts handed their passports to the Israeli police and were photographed by reporters. His wife was too nervous to eat, so Schacht ate her breakfast as well. A waiter asked in German how "Herr President" had enjoyed his breakfast, using Schacht's Reichsbank honorific. The waiter told Schacht that he was from Frankfurt and missed his hometown. He asked for Schacht's autograph, which Schacht provided. The Schachts left Israel with no problems, although a furor erupted in the Knesset, the Israeli parliament, when the news broke that Hitler's banker had passed through the Jewish state without being arrested.[32]



Four of the world's most powerful central bankers gather in New York in 1927: Hjalmar Schacht (Reichsbank), Benjamin Strong (New York Federal Reserve), Montagu Norman (Bank of England), and Charles Rist (Bank of France). (Courtesy BIS)

The first informal meeting of the Board of Directors of the Bank for International Settlements, in April 1930. The gatherings were so secretive that the room remained closed to outsiders, even after the central bankers had departed. (Courtesy BIS)

The first headquarters of the BIS was a former hotel near the Basel central railway station. It was intended as a temporary site, but the bank remained there until 1977. (Courtesy BIS)

The Board of Directors meeting in May 1935. Those in attendance included Montagu Norman, Hjalmar Schacht, and Kurt Freiherr von Schröder, a powerful Nazi private banker. (Courtesy BIS)

Hjalmar Schacht (center) with Adolf Hitler. Schacht, the architect of the German war economy, once described himself as Hitler's "most loyal co-worker." (Süddeutsche Zeitung/Northfoto)

Donald MacLaren, a British intelligence agent, ran a sabotage operation against the American subsidiary of IG Farben, the giant Nazi industrial conglomerate. Hermann Schmitz, the CEO of IG Farben, sat on the board of the BIS. (Courtesy MacLaren family)

Allen Dulles, the American intelligence chief in Switzerland during the Second World War (right). Dulles was friends with Thomas McKittrick, the president of the BIS, who supplied him with information as codename 644. (Süddeutsche Zeitung/Northfoto)

Karl Blessing (left), the president of the Bundesbank and BIS board member from 1958–1969. Blessing, like many German bankers, was a loyal Nazi during the Third Reich. He oversaw an empire of concentration camps and slave laborers. (Süddeutsche Zeitung/Northfoto)

Thomas McKittrick, the American banker who served as BIS president from 1940–1946. The BIS acted as the foreign branch of the Reichsbank, accepted Nazi looted gold and was a back channel for secret contacts between the Allies and the Axis powers. (Courtesy BIS)

Roger Auboin, the general manager of the BIS from 1938–1958. The French banker embodied the continuity of transnational financial interests before, during, and after the Second World War. (Courtesy BIS)

Alexandre Lamfalussy, the Hungarian-born economist known as the "Father of the euro." Lamfalussy served as BIS general manager from 1985–1993 before leaving to set up the European Monetary Institute, which became the European Central Bank. (Courtesy BIS)

Per Jacobssen, the bank's influential economic adviser from 1931–1956. Jacobssen used his status as a neutral Swede to pass economic information from Washington, DC, to Berlin during the war. (Courtesy BIS)

Andrew Crockett, a well-regarded British economist, succeeded Lamfalussy as BIS general manager. Crockett oversaw the transformation of the BIS from a primarily European institution to a global one, thus ensuring its survival. (Courtesy BIS)

The 1980 Annual General Meeting. After fifty years of existence, the bank had made itself an essential pillar of the global economy. (Courtesy BIS)

The Governing Council of the European Central Bank in January 2013. The ECB, like its parent bank the BIS, is protected by an international treaty, and remains opaque and unaccountable. (Courtesy ECB)

"I say no permanent solution of the German problem seems possible without an effective European union.[1]"

— John McCloy, US High Commissioner for Germany, speaking in London in 1950

With the United States supplying the money through the Marshall Plan and the BIS providing the financial and technical expertise, the drive toward a united Europe was unstoppable. In October 1949, Paul Hoffman, the head of the ECA, which administered the plan, gave a definitive speech in Paris. He called for the expanding western European economies to integrate economically, set up a continent-wide free market, and to coordinate their "national, fiscal, and monetary policies."[2] This meant that governments should harmonize their spending and taxation as well as national interest rates: in other words, to move toward a United States of Europe.

Per Jacobssen, the BIS's influential economic adviser, agreed. Jacobssen believed the new European economies should be based on the free market. The era of autarky, state controls, and price restrictions was over. The ideal mix was an economy with about 80 percent in the private sector. The priority should be financial reconstruction and rebuilding trade and payments systems. Political and economic freedom would ensure prosperity, and welfare provision had to be made compatible with the market economy.[3]

Jacobssen also favored a federal solution for postwar Europe. During the war he had often met with Allen Dulles and British diplomats to persuade them of the merits of supra-nationalism, albeit with a maximum of power left at state level. In 1946 he went public with his idea. Jacobssen gave a talk at Gettysburg College in Pennsylvania with the grandiose title of "The Re-Education of Europe." The German problem could be solved only as part of the European problem. Postwar Europe would flourish through diversity, but a new loyalty was needed, one which superseded mere national fidelity.[4] Just as in the 1930s, the technocrats believed they knew best, although their ambitions were far more grandiose: the imposition of a new transnational financial, economic, and political structure, whether the people of Europe wanted it or not.

Marshall aid came at a price: remodeling European societies on the American model of consumerism and consumption. Hoffman's propaganda arm produced pamphlets, posters, leaflets, radio programs, and even traveling puppet shows that extolled the American lifestyle. The American dream—a house in the suburbs, a car, and numerous household appliances—was projected as a near-guaranteed benefit of American-style freedom.[5] The key to this was increased productivity on American-style production lines in a transnational free market.

For that to happen, and for the money to flow freely, new mechanisms of international payment had to be constructed, with the BIS at the center. This had started in 1947, when France, Italy, Belgium, the Netherlands, and Luxembourg had signed the Paris accord on multilateral payments, which was managed by the BIS. That was followed a year later by the Agreement for Intra-European Payments and Compensation, signed by sixteen European governments, the representatives of the French and British-American occupation zones of Germany, and the short-lived Free Territory of Trieste, which soon became part of Italy. The United States wanted the process to be speeded up. Washington pushed the European central banks to construct a comprehensive, multilateral payments system, recalled Alexandre

Lamfalussy, the BIS general manager between 1985 and 1993, demanding, "For the love of God stop being bilateral and start being multilateral."[6] Europe obeyed, swayed in part by a dedicated grant of $350 million of Marshall Plan funds to set up the European Payments Union. Established in 1950, at a single stroke the EPU removed the thicket of regulations governing European trade. EPU member states all agreed to accept each other's currencies for export payments. Bilateral balances were offset against a central fund, so all debts and credits were owed or received from the EPU. Eighteen countries signed up: all of Western Europe (excluding Scandinavia), Greece, Iceland, Switzerland, Britain, and Turkey. The BIS was appointed agent to the EPU. It managed its banking, kept its accounts, and controlled its funds.[7] The EPU "was the European Union of payments," said Lamfalussy. (The EPU applied to non-residents. Currency controls remained in place for residents.)

During the early 1950s Richard Hall worked at the Bank of England, helping to compose the briefing documents for the governor on his regular visits to the BIS. In 1955 Hall was seconded to the BIS to work on the EPU's monthly settlements and reports. There was no discussion about the BIS's wartime record, he recalled. "One of the BIS's finest achievements, for which it deserves no credit, was surviving the war. That was thanks to Maurice Frere, the Belgian banker who had lobbied hard for the BIS in Washington. He said that the BIS should not be got rid of because it might come in handy some time. Nobody in Basel was bothering their consciences about what the bank did during the war. It was the most sensible thing to do at the time. It was not a question of covering things up, it was really not high on anyone's list of priorities. They were trying to get on with the business of reconstruction and restoring the conditions so that trade and payments could now take place."[8]

The BIS itself remained ambiguous about the EPU. It regarded the multilateral payment mechanisms as slow and unwieldy.[9] The bank preferred free trade and currency convertibility. But, politically, the EPU was invaluable for the BIS. Thanks in large part to the EPU, the bank's future was assured. The BIS and the European integration project were locked into each other. The BIS was the only institution capable of handling the complicated technical processes demanded by economic integration. At each step on the road to a united Europe, the BIS would be there.

In 1951, France, West Germany, Italy, and the Benelux states signed the Treaty of Paris, establishing the European Coal and Steel Community (ECSC). The ECSC created a common market for coal and steel. This dry-sounding construct was, in fact, a profoundly significant development. The coal and steel market was now regulated by the ECSC's governing authority, which meant that the ECSC was a supranational institution, with regulatory powers over its members. For Jean Monnet, the architect and president of the ECSC, the new institution had transcended the old idea of the nation-state. The establishment of the ECSC set a pattern that would be followed for decades, one which still continues today. The removal of national sovereignty was always presented as an economic or technical measure, rather than the profoundly political process that it actually was.

Monnet was an early adopter of the idea of rule by technocrats. The French economist and diplomat was a veteran of the era that had brought forth the BIS: the post-1918 settlement. Born in 1888 to a family of Cognac merchants, Monnet worked for a while for the family firm, spending time in the City of London. During the war he coordinated British and French shipping to maximize their efficiency. In 1919 Monnet attended the Paris Peace Conference as an assistant to the French commerce minister. The carnage of the First World War had turned Monnet, like many of his generation, into a convinced internationalist. Monnet helped found the League of Nations and was appointed deputy secretary-general. But the League's slow and cumbersome decision making and the need to help his family business, which was in difficulties, pushed Monnet back to commerce.

Nowadays, Monnet is spoken of in reverential terms as the "Father of the Europe Union." Monnet's

ideas, which for many in Europe are now regarded as near-holy, have shaped our world and look set to do so for generations. His memory endures in buildings, scholarships, awards, and fellowships, including the Jean Monnet Center for International and Regional Economic Law and Justice at the New York University School of Law. Monnet's ideas have generated a whole new academic discipline: European integration studies. More than 785 universities in 72 countries offer the Jean Monnet Program, taught by 1,650 professors to 25,000 students a year.[10] But who were the formative influences on Monnet's thinking? The answer lies not in Paris, Brussels, or war-ravaged Europe, but in Wall Street, where Monnet worked during the 1920s and '30s.

Monnet's hidden history brings us back to some familiar and powerful names. Curiously—or perhaps not, considering the small world of the global financiers in the early twentieth century—Monnet was connected to John Foster Dulles and Sullivan and Cromwell; to John McCloy, then a partner in the Cravath law firm, which represented General Aniline and Film, IG Farben's American subsidiary, and even to Ivar Kreuger, the Swedish match king and con man.

Monnet met John Foster Dulles at the 1919 Paris Peace Conference, and the two men became close friends. They shared a similarly elitist view of the world, a disdain for democratic accountability, and an enthusiasm for making money. Dulles's extensive network of high-level contacts would prove extremely useful to Monnet over the next decades. During the 1920s, Monnet managed Blair & Company, an American finance house. Blair & Co. was represented by the Cravath law firm where John McCloy was a partner, and Monnet and McCloy became close friends. Blair & Co., like many investment houses of the time, was thoroughly corrupt and routinely carried out insider trading operations. Under Monnet's leadership, it kept a preferred list of fifty-eight clients who were brought in on profitable deals.[11] Monnet also worked with Dulles and several American banks, including Chase, on the stabilization of the Polish economy, which gave him an early understanding of the power of transitional finance to make or break a country's economy. When Blair & Co. was incorporated into the Bank of America, Monnet moved to San Francisco to run the new subsidiary. The firm's shares plummeted in the crash of 1929, and Monnet returned to Europe.[12]

After Kreuger, the Swedish match king and con man, went bust, John Foster Dulles sent Monnet to Stockholm to protect the interests of Kreuger's American creditors. In 1933, bored with Sweden, Monnet moved to China to help the government set up the Chinese Development Corporation, to develop communications and infrastructure. Monnet then returned to the United States and moved into a large apartment at Fifth Avenue and 92nd Street.[13] John Foster Dulles then suggested that Monnet—whom he described as "one of the most brilliant men I know" and "an intimate friend"[14]—go into business with another close friend of his, a banker called George Murnane.

In fact Monnet and Murnane had known each other since the First World War, when Murnane had worked for the American Red Cross in France. Murnane was a partner in Lee, Higginson—the Boston investment firm that had financed Kreuger and for whose London branch Thomas McKittrick worked. "I have long felt that they would make an ideal combination," Dulles wrote of Monnet and Murnane. The two men agreed to set up a new international finance house, using Dulles's legal services. At this time Sullivan and Cromwell was making so much money, especially from its business in Germany, that Dulles suggested the law firm invest in his friends' new company, Monnet, Murnane & Company. Sullivan and Cromwell put up $25,000, and Dulles invested another $25,000 of his own money.[15] Monnet focused on business in France and China, and Murnane looked after Solvay & Cie, the Belgium chemical firm that was a partner of IG Farben. Dulles was the lawyer for Solvay & Cie's American subsidiary.

When the Second World War broke out, Monnet put his contacts and belief in international cooperation to good use. He was sent to London to oversee British and French arms production. From

there he went to the United States, where he coordinated arms and aircraft purchases and encouraged American manufacturers to boost their output. Monnet met his "intimate friend" John Foster Dulles whenever he could. The two men shared a common vision for postwar Europe, one now being articulated by decision makers from Basel to Berlin and Washington, DC. There could be no return to the prewar system of nation-states, Dulles wrote in 1941:

> *We should seek the political reorganization of continental Europe as a federated commonwealth. There must be a large measure of local self-government along ethnic lines. This can be assured through federal principles, which in this respect are very flexible. But the reestablishment of some twenty-five wholly independent sovereign states in Europe would be political folly.*[16]

National sovereignty led inevitably to war, Dulles argued in 1942. "The fact of the matter is that economic unity in Europe has primarily been held back by a small group of self-seeking politicians in every nation. . . . Because a lot of politicians want to hold on to the trappings of sovereignty, are we to allow a condition to persist which makes recurrent war inevitable and which now, apparently, also inevitably involves our being drawn into such wars?"[17] Dulles's arguments for a federal Europe were rooted not in hazy idealism about a Europe living in peace and security for its own sake, but hard-headed realism: the preservation of American military and geopolitical interests, building a bulwark against the Soviets, and the preservation of the links between the prewar transnational financial elites in Wall Street and Germany. A united Europe was simply the best means to achieve these ends.

MONNET RETURNED TO Paris after the war's end and began to plan the supranational project that he had drawn up with John Foster Dulles. The ECSC was the first step on the road to today's European Union. The European federal project, like its financial agent the BIS, operated by stealth. The stated reason for the creation of the ECSC was to harmonize coal and steel production and sales in postwar Europe and usher a new spirit of economic cooperation and harmony between Germany and its neighbors that would prevent future wars. The real reason was to ensure the continuing dominance of the German steel and cartels and the power of men such as Alfried Krupp, whose industrial empire had worked eighty thousand slave laborers to death, and who was about to be released from prison by Monnet's close friend John McCloy.

The coal and steel barons intimidated even Ludwig Erhard, the architect of the German economic miracle, recalled Dutch politician Jelle Zijlstra, who had briefly served as prime minister from 1966 to 1967, before being appointed president and chairman of the board of the BIS, where he remained until 1981. Eight years after his retirement, as Europe prepared for the introduction of a single currency, Zijlstra gave a lengthy interview, where he spoke freely about the secret history of the European unity project.[18] The ECSC was a "political exercise" and fundamentally, was "an impossibility," Zijlstra said. The Germans "without any doubt" regarded it as a *dachorganisation* (umbrella organization) for their steel and coal cartels.

Zijlstra served as Dutch minister for economics for most of the 1950s. After a few months in office he went to visit one of Holland's largest coal and steel traders. His host warned him that the German coal and steel barons were so powerful that they were virtually a state within a state. Do not, he advised Zijlstra, upset them. Two months later, Zijlstra received an invitation to the Ruhr, Germany's industrial heartland, to meet the barons himself. He was wined and dined and received the same warning. Zijlstra,

then still in his mid-thirties, was not cowed. He thanked the coal and steel barons for their time and returned to Holland.

Zijlstra saw the ECSC for what it was: a cartel for the German steel and coal producers that fixed prices in their favor, while removing its members states' power to run two crucial strategic industries. He soon clashed with Ludwig Erhard. The German economist's commitment to free trade was less ardent when the country's own interests and those of the coal and steel barons were involved. Zijlstra berated Erhard and told him, "You are not true to your own faith." Erhard did not deny the accusation. He shrugged and told Zijlstra, *"Lieber Kollege, wir sind doch alle Sünder!"* (Dear Colleague, we are all sinners). "In that debate," recalled Zijlstra, "the coal and steel industrialists, the people from the Ruhr, saw the community as a possibility of extending their structures to the European system. And they were not, and they never have been free traders."

Back in 1944, as we have seen, McKittrick, the BIS president, was cutting deals with German industrialists with the support of the OSS and the State Department, as outlined in the Harvard Plan documents. The industrialists' postwar cooperation, McKittrick promised, would preserve their industries and even bring a guarantee of continued profits. The ECSC fit perfectly into that framework.

Zijlstra knew Monnet well. The French technocrat was an unelected bureaucrat, but he still had the power to instruct governments, including the West German government, said Zijlstra. If a problem arose, "Monnet went to see the governments and told them what they had to do. Monnet had an enormous authority over the national governments . . . he certainly visited from time to time the minister of foreign affairs and even prime ministers. He was very powerful."[19] Monnet's power had multiple roots. He was immensely charismatic and persuasive, with a sharp, precise intellect. But more than that, Monnet had John Foster Dulles, Allen Dulles, John McCloy, and the American government behind him.

Much of the United States political and intelligence establishment believed, like Jean Monnet, and indeed Winston Churchill, the wartime British prime minister, that a unified Europe would never go to war again, which meant that the United States would never have to go to war again in Europe. Germany needed to be locked into the unification project, both as a bulwark of stability, and as a counterpoint to rising Soviet power on the other side of the Iron Curtain. With Marshall Plan aid dependent on progress toward a federal Europe, the United States could, and did, wield enormous influence on the political structures of the postwar continent.

In May 1948, eight hundred delegates met at The Hague, under the chairmanship of Sir Winston Churchill, to create the European Movement, with the ultimate aim of a federal union. The movement's secretary-general was Joseph Retinger, a former adviser to the Polish government-in-exile during the war. At the same time, Allen Dulles and William Donovan were using their OSS contacts and expertise to set up the American Committee for a United Europe (ACUE). The ACUE's role was to channel funds to the European federalists and to use the new techniques of psychological warfare, such as the Harvard Plan, which had been honed during the war, to push for a united Europe.

Donovan was appointed chairman of the ACUE and Allen Dulles his deputy. Walter Bedell Smith, the director of the CIA, the successor to the OSS, also sat on the board. Between 1949 and 1960, the ACUE injected more than $3 million into the European Movement, always at least half of its budget and often more. As Professor Richard Aldrich, an intelligence historian, notes, the European Movement's officers and directors included at least four CIA officers. Donovan pushed hard for the creation of the ECSC. He gathered petitions from American and European politicians and released them to the press and directed a stream of federalist propaganda at members of Congress."[20] The message from Washington was consistent: Europe must unite. In April 1950, John McCloy gave a widely quoted speech in London, saying that the German problem could be solved only by a combination of economic and political factors,

echoing the arguments of Per Jacobssen in 1946. "The fact is, we cannot solve the German problem without fitting it into the larger context of a united Europe. . . . These economic factors lead directly to the political. To insure the freer flow of trade and the development of European markets will require effective political machinery." McCloy concluded, "I say no permanent solution of the German problem seems possible without an effective European union."[21]

From Paris to Washington, DC, the postwar committees and movements pushing for European federalism presented themselves as new and innovative, offering a fresh approach for a new era. But they were deeply rooted in the old ways of doing business—of powerful men gathering over lunch or dinner to reshape the world as they saw fit. During the war Allen Dulles had met with Thomas McKittrick and Per Jacobssen to plan the postwar European economic order. Jean Monnet had honed his thoughts on European unity with John Foster Dulles. Per Jacobssen had traveled to Berlin to share American plans for the postwar European economy with Emil Puhl, the BIS director, war criminal, and Reichsbank vice president. None of these discussions were made public, even though the plans hatched there would shape the modern world. The United States' involvement in the European project continued the tradition of secrecy and covert action well into the 1960s. A State Department memo, dated June 11, 1965, to Robert Marjolin, the French president of the European Economic Community, recommends that he pursue monetary union without public discussion. The memo advises him to suppress debate until the "adoption of such proposals would become virtually inescapable."[22]

THE NEW TRANSNATIONAL ECSC naturally needed a transnational bank. In 1954 the ECSC was negotiating with United States for $100 million loan. The monies were to be spent investing in coal and steel projects. The US government had pushed hard for the creation of the ECSC but was reluctant to lend it such a large sum. The ECSC was a new organization. Who knew if it would even exist in a few years? The BIS came to the rescue. The bank would act as the middleman between the ECSC and the United States and manage the loan. If the ECSC no longer existed when the $100 million was due to be repaid, the BIS would collect the money and would then repay the United States. The involvement of the BIS reassured the US Treasury. The loan was agreed. With the BIS's imprimatur the ECSC could now obtain credit on the international market.

The following year the BIS celebrated its twenty-fifth birthday. The bank's swift engineering of itself into the postwar global financial system was proving extremely profitable. Between 1950 and 1959 the bank's assets and liabilities increased 4.7 times, while gold deposits, mainly from central banks, increased by 14 times, and currency deposits increased more than fourfold. The bank was as discreet as ever. Compared to the complications of the war years, the new era of peace was far simpler to navigate. In 1955 the Bank deutscher Länder was prepared to lend $100 million to the Bank of France but feared domestic criticism during an election year. The BIS offered to hold the monies on deposit for the BdL while it was understood, although certainly not mentioned in the contract, that it would make an advance of the same sum to France. That France, a victor of the war, needed to borrow such a substantial sum from Germany, a defeated country, was testimony to the effectiveness of the Marshall Plan.

Newly confident of its future, the BIS had started to issue stern policy prescriptions to the world's governments. Jacobssen was still fulminating against the curse of rising prices. "The inflation mentality," demanded the 1956 annual report, "must be extirpated."[23] The BIS also criticized the cost of the substantial programs of public works launched by postwar European governments to raise standards of living, housing, and public services. "With regard to all these activities, the governments should, in the first place, abstain from inflationary methods of financing," warned Jacobssen in the 1956 annual report. "But usually that is not enough; if the private economy is to develop and maintain a high level of

investment for productive purposes—as would certainly be advantageous for a number of countries—other claims on resources must be kept within reasonable limits and in a great many cases this means that public expenditure should be curtailed."[24] An unelected, unaccountable, and secretive financial institution was issuing policy prescriptions for democratic governments.

This was Jacobssen's last report. He left the BIS in 1956 to run the IMF. Many of his colleagues were amazed at his decision. It was clear that the political dynamic was toward ever more financial and political European integration, all of which would need the BIS. And the project was working. Europe was stable and at peace. Trade and industrial production were breaking records. The BIS's future was assured. The European Payments Union, managed by the BIS, was so successful that by 1959 western European currencies became freely convertible into each other and into the US dollar.

The IMF was new and still defining its role. Sir Otto Niemeyer, the veteran British banker and former chairman of the BIS board, told Jacobssen that the IMF had no future and that he would be wasting his time there. But Jacobssen felt that after twenty-five years at BIS it was time to move on.

JACOBSSEN WAS NOT the only international banker on the move. In 1956 Eric Warburg joined Brinckmann, Wirtz & Company as a partner. Rudolf Brinckmann, the bank's owner and BIS director, ungraciously told Warburg that he should be grateful to be allowed to return to the successor bank to the House of Warburg. The dispute between the Warburgs and their former employee remained as rancorous as ever. Brinckmann still refused to change the bank's name back to Warburg, or even include the family name in the bank's title as it might mean a loss of Arab business.

Emil Puhl, the former vice president of the Reichsbank and BIS board member, also had travel plans. In 1954 Puhl applied for a US visa, despite his conviction for war crimes, which would under normal circumstances immediately disqualify such a request. But it seemed there were special rules for valued international bankers, even for Nazi financiers. Puhl gave the Chase National Bank, the employers of his old friend McKittrick, as his reference. During the trial of Walther Funk, Puhl's former boss, Thomas Dodd, an American war crimes prosecutor, told the court that Chase National had once offered Puhl a job in New York.[25] Perhaps the bank wanted to make this offer again. The US Consul General in Berlin wrote of Puhl's application, "It should be noted that the Consulate General has in the course of its examination found no other grounds that would prevent Mr. Puhl from receiving a non-immigrant visa. Mr. Puhl is one of the outstanding bankers in Germany and wishes to proceed to the United States on the invitation of several well-known American bankers to participate in discussions of some importance."[26] It is not publicly known if Puhl traveled to the United States, and if he did, with whom he met.

Donald MacLaren, the British spy who brought down IG Farben's American operation and who investigated IG Farben's postwar empire, returned home from Berlin to civilian life. MacLaren's analysis of IG Farben remains as incisive as ever. "It has been called a State within a State; in the end it almost became the State itself."[27] The defeat of Hitler was merely a temporary setback, MacLaren warned. His conclusions echoed the Red House Report on the Nazi industrialists' postwar plans and Puhl's conversations with McKittrick: "Men who built such an elaborate structure and who thought so thoroughly of every contingency in the past are not likely to disappear from the scene without leaving a group of younger men who wait for the day when our backs are turned and our interest wanes to gather again their scattered resources of money and men to engage once more in an attempt of economic domination of the world."[28]

MacLaren was correct. The key man was indeed younger, born nineteen years after Hermann Schmitz. A BIS veteran who had worked in Basel during the early 1930s, he would be fulsomely welcomed onto

the bank’s board.

"What a Blessing we have a Blessing."

— The American view of Karl Blessing, appointed the first president of the Bundesbank in 1958[1]

After fifteen years at the New York Federal Reserve, Charles Coombs was not easily awed. But even he was impressed at the financial firepower present at the BIS governors' meeting in December 1960. Gathered in one room, sipping their coffee in an anonymous former hotel near Basel railway station, were the governors of the banks of England, France, Germany, Italy, Sweden, Belgium, and the Netherlands. But despite their urbane appearance and easy familiarity with each other, the governors were worried men—as was Coombs himself.

The combined dollar holdings of their banks totaled $6 billion. Under the Bretton Woods system the dollar-to-gold exchange rate was fixed at $35 an ounce. As long as the London gold market stayed around that price, the value of their dollar reserves was stable. But earlier that year the price of gold had jumped to $40 an ounce. The dollar was a victim of its own success. There were too many dollars in circulation or held by national banks as part of their reserves to be redeemable for gold at $35 an ounce. Thus the dollar's value against gold was declining. The central bankers could sell their reserves, but such a move would certainly crash the dollar and fuel global instability.

The central bankers wanted to ask Coombs about the financial plans of the new Kennedy administration, which would take office in January 1961, he recalled in his memoirs.[2] Coombs's book provides a rare and fascinating glimpse into the secret deals reached at the Basel governors' meetings. The central bankers "were very worried men that day, genuinely distressed by the impending clash between their sworn duty to protect the value of their countries' international reserves and their fear of precipitating a dollar crisis by cashing in dollars for gold."[3] Much was riding on Coombs's answers. If he could reassure the other bankers, the dollar would retain their confidence. If not, he might trigger a worldwide financial crisis.

The bankers were reassured. The new US government would firmly maintain gold parity at $35 an ounce and would work to reduce the balance of payments deficit, Coombs promised. The governors welcomed his assurances and requested that he, or a representative of the Federal Reserve, attend every Basel meeting from now on, even if only as an observer. Thirty years after the founding of the BIS, the United States officially still kept itself at a distance. Three of the BIS's presidents had been American—Gates McGarrah, Leon Fraser, and Thomas McKittrick—but the Federal Reserve had never taken up the stock allocated to it at the bank's founding. Coombs was honored to be invited to the Sunday evening dinner, the "inner sanctum from which all lower ranking officials were normally excluded."

Coombs regularly attended the governors' meetings from 1960 until his retirement in 1975. He relished his time at the BIS. He usually left New York on Thursday afternoon, after the meeting of the directors of the New York Federal Reserve, and went straight to Idlewild Airport to fly to Zürich, arriving on Friday. From there he traveled to Basel and his usual room at the Schweizerhof Hotel, near the BIS. It was exhausting but exhilarating, with meetings and discussions on Friday night and all through the weekend until Monday morning when he flew back to New York. But his jet lag soon evaporated. "As the central bankers converged on Basel from all the European capitals and from Ottawa, New York, and

Tokyo, the fatigue of our journey seemed to vanish as we greeted old friends and listened to the inside story of what was really going on in the financial markets of the world."

Basel was the "ideal meeting place for central bankers seeking a refuge for quiet and confidential discussion of highly charged financial issues." In between the formal meetings, the bankers drifted down the corridors between their private offices, "always stopping to shake hands in the continental fashion with any colleague going in the opposite direction." The meetings were worth the trip in themselves, wrote Coombs, providing "not only a quiet testing ground for new ideas and approaches but also an early warning system when things were beginning to go wrong." The dinners, especially, gave "priceless access." "I could generally tell from those dinner discussions which birds would fly and which would not," he recalled.

Like couples who had been married for years, the bankers could read each other's minds. "There is something deeply satisfying in dealing with fellow professionals in any technical field. Never any speeches, everyone focusing clearly on the issue at hand, sentences frequently left unfinished because everyone instinctively knew the rest and in an almost uncanny way, a simultaneous realization of the appropriate technical solution. None of us were romantic internationalists, but where we could see a clear overlapping of national interests our minds instinctively reached out to one another in a true camaraderie of professional cooperation."

Coombs was especially impressed with Karl Blessing, the president of the Bundesbank, the new West German national bank, who "played a towering role":

> *As a young man he had worked on the staff of the BIS and once recounted to me his anguished memories of those days as he watched from Basel the breakdown of international financial cooperation in the early thirties. Now as President of the Bundesbank with the mark entrusted to his care, he wielded his enormous authority with courage and sensitive discernment of his world financial responsibilities. A cheerfully resolute man, Blessing was an unfailing source of strength and morale in all of our Basel meetings. I thought of him as truly a great man of his times.*

Blessing was indeed a man of his times, although not in the way that Coombs believed. The Bundesbank president embodied the new class of rulers in West Germany, many of whom were the same people who had managed Nazi Germany. Former Nazis ran or held senior positions in the banking and finance sectors, the military, the intelligence service, and government administration. Hans Globke, the national security adviser to Chancellor Konrad Adenauer, had helped write the Nuremberg anti-Jewish laws. Richard Gehlen, the head of West Germany's intelligence service, was the wartime chief of military intelligence on the Eastern Front, where the German army and SS troops had slaughtered hundreds of thousands of civilians. The directors of IG Farben, as we have seen, swiftly returned to lucrative business careers.

The unfortunate past of these men was rarely discussed. And Blessing, too, was adept at rewriting history, none more than his own. He had worked at the BIS during the 1930s, although his claim of "anguished memories" is risible. He had joined the BIS under instructions from his employers at the Reichsbank, with the express purpose of not facilitating, but wrecking international financial cooperation. Blessing's 1930 memorandum, "Opinion on How the Reichsbank Should Conduct Itself in the BIS," called for German officials to argue that reparations were "completely utopian," to make impossible demands, and to undermine the BIS's legitimacy in order to derail the Young Plan.

Blessing had returned to Germany in 1934 to work as an adviser at the Ministry of Economics. His patron, Hjalmar Schacht, then brought him back to the Reichsbank and appointed him its youngest director. Blessing loudly proclaimed his loyalty, declaring, "National Socialist economic and financial policy, like National Socialist policy for freedom and equality, has taken upon itself the law of action. We will allow no one in the future to strike this from our hand."[4] Blessing joined the Nazi party, and after the 1938 Anschluss—the absorption of Austria—he was rewarded with the job of absorbing the Austrian National Bank. It was joyous work for a true believer: "Just three months separate us from the memorable day, which will remain unforgettable for us. And yet in this short period, all the measures have been put into place with the goal of forging together the two economies into an unbreakable whole."[5]

Blessing was also forward thinking. When Germany's Jews were fined one million Reichmarks for the cost of the Kristallnacht pogrom in November 1938, he worried that Jews would sell their government bonds to raise the cash, which would drive down the market. The answer was for the Reichsbank to limit sales of Jewish-owned securities to one thousand Reichmarks.

The following year Blessing, together with Schacht, left the Reichsbank. Blessing had also signed the directors' memorandum criticizing Hitler's armaments spending. But the former BIS official was a canny survivor. He swiftly courted Walther Funk, Schacht's successor as president. With Funk's imprimatur, Blessing returned to the Reichsbank as a member of its advisory board. Blessing moved in the highest circles of the Third Reich. He attended thirty-eight meetings of the Himmlerkreis, the circle of Nazi industrialists who channeled funds to the SS chief through Special Account "S" at Kurt von Schröder's J. H. Stein bank. Blessing went on two trips with the group to visit concentration camps, guided by Himmler himself. Blessing later said of the Himmlerkreis, "I thought it was just for beer evenings."[6]

Blessing's importance went far beyond the monies he donated to the SS. He embodied the kind of intelligent, sophisticated technocrat who was essential both for the Nazi regime and for the perpetuation of German economic interests after the war ended. Hannah Arendt, the German-Jewish writer and philosopher, described the bureaucrats who organized the Holocaust as "desk-murderers." They did not raise a gun to the naked victims standing over the death-pit or pull the lever to release the gas. They merely stamped and moved pieces of paper from one government department to another and kept the money moving. But without them the Third Reich could not function. Blessing, too, was a desk-murderer.

In April 1939 Blessing joined the board of the German subsidiary of Unilever, a giant Anglo-Dutch company that manufactured fats and oils. The following year Germany invaded the Netherlands, and Blessing was appointed one of three administrators looking after Unilever's interests across the Reich. Meanwhile, Hermann Goering—the chief of the Luftwaffe, the German air force, and the minister in charge of the four-year plan—set up Kontinental-Öl to exploit the oil reserves of central Europe and the Balkans. This was a project after Blessing's own heart. He recognized the importance of Germany's allies in the east and south—Croatia, Hungary, Romania, and Bulgaria—as a means of ensuring Nazi economic hegemony and supplies of raw material. The Danube, he said, was the "river of the future," and petrol and grain would flow up it to Germany.[7]

Together with Walther Funk, the president of the Reichsbank, and Heinrich Bütefisch of IG Farben, Blessing was appointed to the board of Kontinental-Öl. As Christopher Simpson notes, the establishment of the Reich's oil company represented a triumph for the businessmen and bankers. The hardline Nazi ideologues around the SS wanted state control, government ownership, and centralized planning of the economy, especially of vital strategic industries. However the business elite, such as Schacht and Blessing, favored a more commercial approach.[8] Germany should dominate world markets, they believed, but there was no need to control every aspect of them. Kontinental-Öl was the answer: a government-supported monopoly to take over the oil industries of eastern Europe, with financial services provided by

Hermann Abs at Deutsche Bank.

Kontinental-Öl, like IG Farben, was built on plunder, exploitation, slavery, and murder. As the Nazi oil empire expanded eastward, Kontinental became one of the Third Reich's largest users of concentration camp inmates, ghetto workers, and prisoners. The firm ran at least ten concentration camps in Poland alone, where the workers were leased from the SS. In Ukraine, for example, Kontinental paid the SS and the German police administration five zlotys a day for a man, and four for a woman. The average life expectancy of a slave laborer was between three and six months. When Kontinental's camps were shut down, many of the inmates were shot. The Borisow camp was closed in March 1943 with about eight hundred prisoners still alive. According to Red Cross records, about eighty men and twenty women were evacuated to Smolensk, and the rest were executed.[9]

As the financial director of Kontinental-Öl, Blessing was at the epicenter of this nexus of death and profit. He oversaw its acquisition of new firms in the east. He managed the company "payroll," much of which was concerned with payments to the SS for the concentration camp labor the firm used—labor that was also used to build the new company headquarters in Berlin. Unfortunately for Blessing and his managers, the half-starved, traumatized labor force was not very productive. As late as March 1945, one of Blessing's underlings complained that work in Upper Silesia was being held up by the "use of concentration camp prisoners of low performance."

Blessing was arrested and imprisoned at the war's end, while the Allies considered whether to charge him with war crimes, as he certainly deserved. But behind the scenes, Blessing had powerful allies: Allen Dulles and Thomas McKittrick. The Nazi bankers and industrialists were correct in their belief that the western powers would need them to rebuild the German economy. In the contest between justice and realpolitik, Dulles would make sure that the latter would triumph.

In July 1945 the US occupation authorities asked Dulles to furnish a list of Germans "eligible on the basis of ability and political record for posts in a reconstituted German administration." The first set of lists was quickly submitted. But by autumn, Dulles, now running the OSS station in Berlin, had more detailed information about suitable German bankers. Much of this would have come from McKittrick.

In September 1945 Dulles submitted his new white list. It was divided into two categories: A and B. On the A list were three names judged suitable for "higher posts in a ministry." The B list contained five names that were suggested for "lesser posts such as Bureau head or division chief." [10] Among the names in group A was that of Ernst Hülse, the former head of the BIS banking department. Hülse, said Dulles, enjoyed "excellent connections with banking circles abroad," had a Jewish wife, and was definitely anti-Nazi. Hülse was appointed to the Reichsbank in the British zone and was named president of the central bank for the federal state of Nordheim-Westfalen.

The first name on the B list was that of Karl Blessing, whom Dulles described as a "prominent businessman and financial expert" with "considerable experience in international trade."[11] Dulles was well informed about Blessing's central role at Kontinental-Öl, which the American spymaster described as a "government-owned holding company organized to coordinate German-controlled oil properties throughout Europe." Dulles hedged his bets. Blessing's relationship with Kontinental-Öl might, he wrote, disqualify him for a "high government position." However Blessing had accepted the job "under pressure" and had been in touch with the German resistance. In addition, Dulles added, Blessing had not been a member of the Nazi Party. In fact Blessing had joined in 1937. And Blessing's party records were held by the US authorities, had Dulles bothered to check. Blessing's main claim to anti-Nazi activity was being included on the list of the July 1944 anti-Hitler plotters as a potential minister for economics. When the conspirators were arrested, Blessing was protected by Walther Funk, who told the Gestapo that Blessing had not known anything about the plot.

The whitewashing of Blessing was not the exception, but the rule. Declassified telegrams revealed that Dulles had long planned to rescue important German industrialists and scientists. In January 1945, Dulles wrote to William Casey, who was running operations inside Germany and who later served as CIA director in the 1980s:

> *My project contemplates that in normal course of events and without any prior contact with us but merely to escape impending chaos, important German industrialists, scientists, etc., will desire to find some haven, preferably Switzerland. If Switzerland is closed to them, these men might possibly turn to Russia as their only alternative. . . . Discreet preliminary conversations indicate some hope of securing Swiss cooperation."*[12]

Not everyone in Washington approved. The following month First Lady Eleanor Roosevelt wrote to her husband, "Memo for the President. Allen Dulles who is in charge of Bill Donovan's outfit in Paris has been counsel, closely tied up with the Schroeder Bank. That is likely to be the representative of the underground Nazi interests after the war. There seems to be in Paris a great many people who are pretty close to the big business side!"[13]

The president's wife was certainly well informed about the importance of the Schröder bank network, which reached from Germany to London and New York, and to the BIS via Kurt von Schröder. But by summer 1945, after the death of her husband, Mrs. Roosevelt's opinions counted for little in Washington.

Blessing was not charged with war crimes. Instead, with Allen Dulles's help, he was freed and returned to his old job at Unilever. He became one of the highest paid executives in Europe, earning $75,000 a year. Blessing took a pay cut to $50,000 a year when he joined the Bundesbank in 1958, but the power and prestige was ample compensation. By the early 1960s, when Blessing was a regular attender at the Basel governor meetings, he had transformed himself into a former member of the resistance.

Hermann Abs, of Deutsche Bank, was the most powerful commercial banker in the Third Reich, and he was not on Dulles's A list. Rather, he was high on an Allied blacklist of important Nazi officials to be arrested. In the American zone Colonel Bernard Bernstein, the head of the Finance division, had Abs, indeed all the Nazi financiers in his sights. Bernstein ordered that every banker and industrialist be detained as a suspected war criminal.

Luckily for Abs, he was living in the British zone. There he met his old friend, Charles Gunston of the Bank of England, whom he used to see in Basel during the 1930s at BIS meetings. Gunston was a senior official in the British occupation authority. Gunston had no interest in the Nazi atrocities. All he cared about was getting the banks working again. Gunston asked Abs to help rebuild the banking system in the British zone. Abs was more than happy to oblige. Bernstein was enraged and demanded that Abs be extradited to the American zone. Gunston refused, but in early January 1946 he returned to England. Abs was then finally arrested as a suspected war criminal, and he spent three months in prison before being released and was never charged. Instead Abs went to work, fulfilling his promise to his old friend Charles Gunston.

KARL BLESSING, LIKE Hermann Abs, certainly understood when to be helpful. In 1960 the gold spike threatened to undermine the stability of the postwar financial system. The United States and Britain proposed joint operations on the London market to protect the value of both countries' reserves. Blessing quickly offered to make some of West Germany's reserves available to the Bank of England. But any coordinated international action would need bilateral agreements, which would necessitate lengthy

negotiations with governments. Britain persuaded the United States that there was a much simpler approach to organizing multilateral interventions: through the governors' meetings at BIS. Between them the countries represented there, as well as the United States, accounted for about 80 percent of the world's reserves. The BIS staff was not enthusiastic about the idea. As the world pioneer in transnational finance, the BIS was a firm believer in the primacy of market forces. The market was now being shunted aside, wrote one official, "so that the inconvenience of certain financial policies can be avoided."[14]

Any such doubts were ignored by the governors. In November 1961 the London Gold Pool (LGP) was set up. The United States, West Germany, France, Italy, Britain, Belgium, the Netherlands, and Switzerland contributed a total of $270 million to the pool. The funds would be used to maintain dollar parity at $35 an ounce, in line with the Bretton Woods agreements. The banks would keep the gold price stable, by buying and selling when necessary. All of the participating banks agreed not to buy gold themselves on the London market while the pool was in existence. The BIS gold cartel was constructed on conditions of complete secrecy. There was not even a formal written agreement. The bankers' word, and a handshake, was enough to seal the deal. As Coombs noted of the governors' meetings, "However much money was involved, no agreements were ever signed nor memoranda of understanding ever initialized. The word of each official was sufficient, and there were never any disappointments."[15]

The Bank of England carried out the LGP's monetary transactions, but the BIS was essential to its operations. Every month the Bank of England reported to an experts' group of officials from BIS member banks and the BIS itself, which met at the BIS.

Eventually, word got out. The story was picked up by *The Times* (of London), then by *The Economist*. The LGP was forced to release detailed accounts, which were published in the Bank of England's quarterly bulletin. For the first five years, the LGP worked. The price in London stayed between $35.04 and $35.20 per ounce. The group of gold experts expanded their briefs to cover the foreign exchange market. The gold pool became the Committee on Gold and Foreign Exchange. It still exists today and is known as the BIS Markets Committee. The committee's agenda and deliberations remain secret.

THERE WERE TIMES, especially during crises, that the mutual trust engendered over the lunches and dinners in Basel proved crucial in stabilizing the global financial system.

November 23, 1963, was such a day. The assassination of President John F. Kennedy triggered panic selling on the stock market. Coombs was at work at the New York Fed when the news came through. He put aside his shock and horror and focused on the task at hand: the immediate defense of the dollar. Coombs considered banning foreign exchange transactions to prevent panic selling, but such a decision would be slow to implement and would need political support. Immediate action was needed, though, and he decided that closing the foreign exchange market was anyway not feasible. It would send a signal of panic and desperation. There would be a frenzy of selling of both dollars and gold.

The answer, Coombs decided, was for the United States to sell massive amounts of foreign currency to defend the dollar. The question was where could Coombs get it? He had access to only $16 million worth and held none at all of several major European currencies. He could sell gold to cover the purchases. But once news got out that the United States was selling its gold reserves after its president had been assassinated, the dollar would immediately plunge.

The best option was to borrow and sell foreign currency by drawing on the Federal Reserve's currency swap network. Currency swaps allowed Central Bank A to hold reserves in Central Bank B's currency (or a third currency), which Central Bank A could draw on, without having to purchase the foreign currency from Central Bank B. This was an excellent solution apart from one small problem: the time difference. No bank could draw on currency swaps without the approval of the partner bank. The

president had been shot at 1:30 p.m. Eastern Standard Time, six hours behind Europe. The European governors that Coombs urgently needed to contact had left their offices and were on their way to dinner or home. There were no mobile telephones or Internet. The governors were unreachable.

Coombs now faced the most important decision—or rather, gamble—of his life. If he bet wrong, not just his career would end. He would be remembered as the man who wrecked the dollar at a time of a national crisis. There was no time to consult or get the support of his superiors. A run on the dollar could start at any moment. Could he count on the governors of Europe's central banks to underwrite the sale by the Federal Reserve of hundreds of millions of dollars' worth of their currencies without their prior consent or knowledge? For if the sales went ahead, and the governors protested, or refused to authorize the transactions, both he, and the dollar, would be finished. The governors, he decided, would back him.

At 2 p.m., Coombs instructed the foreign exchange desk to offer 10 million deutschmarks for sale and to inform the bank acting as the Fed's agent that more such offerings would follow. Eight minutes later the Fed offered substantial amounts of sterling, followed by large holding of Dutch guilders and Swiss francs. Meanwhile, the Bank of Canada had stabilized the US-Canadian dollar exchange rate, and the Fed reciprocated.

At 2:30 p.m. Coombs ordered his officials to inform the market that the Federal Reserve would supply foreign exchange in unlimited amounts to defend the dollar and would call in its entire $2 billion of available credit swaps if necessary. Only then did Coombs report to Alfred Hayes, the president of the New York Fed. Meanwhile, the New York Fed's telephone operators were searching for the other central bankers. They reached Roy Bridge, of the Bank of England, first. He immediately agreed to help. Bridge told Coombs he could ask for "all that he wanted." The Bundesbank was equally cooperative. As soon as the Frankfurt foreign exchange market opened on the following Monday, the Bundesbank made sure to show itself as a buyer of dollars. In Bern the Swiss bankers agreed to enlarge the Fed's credit facility by another $100 million. Coombs's strategy worked. The stock market recovered. When the markets opened on Monday, the dollar remained stable.

THE BIS WAS going from strength to strength. In 1961 the ten key industrial IMF member states, known as the G10 (which largely overlapped with the membership of the BIS) set up the General Agreement to Borrow (GAB). The G10, plus Switzerland (which did not join the IMF until 1992) put aside $6 billion as a stand-by credit for the IMF. The GAB funds were to be made available if an IMF member was suddenly threatened by short-term capital flight. Two years later, the IMF began a detailed study of the international monetary system. It asked the BIS to provide information on the gold and Eurocurrency markets and central banks' short-term credit arrangements.[16] When the IMF report was published in 1964 it recommended that all G10 central banks send the BIS confidential statistics about their monetary reserves. The BIS, as the depository of this data, could then act as an early warning system if a country's reserves were being depleted and might need to draw on the GAB. So it seemed only natural that the Sunday evening governors' dinners at the BIS should be expanded to include Canada and Japan. (The two countries were members of the GAB but did not join the BIS until 1970.) The BIS had effectively relocated one of the most important international meetings of the key IMF members from Washington to Basel.

When in 1964 the central bankers of the European Economic Community set up their Governors' Committee to coordinate monetary policy, the committee was located not in Brussels, the home of the European project, or Frankfurt, the site of the Bundesbank, but at the BIS headquarters. The BIS helpfully provided the Governors' Committee with the necessary secretarial and administrative support. The following year, in 1965, the BIS even reached agreement on its 1930s investments in Germany—the

Young Plan loans. The Reichsbank had serviced the loans and paid interest until the end of the war in April 1945. After a twenty-year break, Germany agreed to resume paying interest on the loans but deferred the capital repayment until 1996.

The deal was brokered by Hermann Abs, who had returned to Deutsche Bank. Like Karl Blessing, Abs had expertly whitewashed his Nazi past. There was no mention of Abs's role at the bank that organized the plunder of Nazi-occupied countries, or his former position on the board of IG Farben. Abs had been the most powerful commercial banker in the Third Reich and now enjoyed similar status and acclaim in the new West Germany. He was also a welcome guest in the world's treasuries and chancelleries. Abs sat on the board of so many companies, including Daimler Benz, the Federal Railways, and Lufthansa, that a law, known as "Lex Abs," was passed limiting the number of positions an individual could hold to ten.

When Per Jacobssen died in 1963 after just seven years at the IMF, Abs became a founding sponsor of the Per Jacobssen Foundation. The list of his cosponsors reads like a roll call of the transnational financial elite and includes some familiar names, such as Eugene Black, the former president of the World Bank; Marcus Wallenberg, tutor to Thomas McKittrick and vice chairman of Enskilda Bank; Roger Auboin, the former general manager of the BIS; Rudolf Brinckmann, the veteran BIS director; Jean Monnet, the architect of European unity; and Marius Holthrop, the BIS president. Abs died in 1994 at the age of ninety-two, garlanded with honors and acclaim. A gushing obituary in the *Independent* newspaper, a normally skeptical British publication, acclaimed him as the "outstanding German banker" of his time. Which was true enough, as Abs had embodied a century of German banking, although not in the adulatory sense that the writer had envisaged.[17]

ALWAYS QUICK TO adapt to changing circumstances, the BIS spotted a new opportunity during the 1960s. The continuing drain on Britain's economy of its empire and the country's general economic malaise made sterling increasingly vulnerable. But sterling was also a reserve currency, especially across Britain's current and former dominions. Thus sterling, like the price of gold, had to be stabilized. The BIS was not a lender of last resort, but it could arrange loans to troubled central banks. In June 1966 a group of European central banks, the New York Federal Reserve, and the BIS agreed to make around $1 billion available to the Bank of England to defend sterling. This was significant, not just because of the sums involved, but because the BIS was its center. All the monies involved, apart from French and American funds, would be paid through a single account at the BIS. The bank was now coordinating a long-term strategic rescue of one of the world's reserve currencies.

However opaque the governors' meetings were, they were a more edifying spectacle than the farcical and very public scenes at the November 1968 G10 conference in Bonn. With the franc and sterling under pressure, and German reserves up by $4 billion, the conference was always going to be difficult.

This time the finance ministers were in charge. The bankers were banished to the lounges and corridors. Paris and London pressed for a devaluation of the mark, but Germany resisted. Roy Jenkins, the British finance minister, mentioned that the governors' meeting at Basel had favored revaluation of the mark. Karl Schiller, the German economics minister, rounded on Karl Blessing, the president of the Bundesbank. He demanded to know on what authority Blessing had discussed the national currency value with foreign officials, as though unaware that such discussions had been taking place at Basel since the BIS was established in 1930, and indeed were one of the main reasons for its existence. Schiller demanded that Jelle Zijlstra, the BIS president, provide him with a full report on the Basel governors' meeting. Zijlstra politely told him to "go to hell."

Excluded from the discussions, the governors spent their time playing Ping-Pong, drinking champagne

and hunting down an ever-shrinking supply of canapés, all of which were encased in aspic. At one stage Charles Coombs and the governor of the Bank of France eyed a single frankfurter on a waiter's tray. They agreed to divide it. Outside the conference center, hordes of television crews and reporters were besieging the building, while German protestors angrily demanded that those inside "save the mark." In fact, it was the French franc that needed to be saved, and the general consensus was that the currency would need to be devalued by around 11 percent.

Zijlstra went into action. He convened an emergency governors' meeting over lunch on Friday to see what support could be raised for the franc. It was an impressive performance. Zijlstra secured a pledge of $2 billion within half an hour. In the event, Charles de Gaulle, the president of France, decided that the franc would not be devalued. He introduced stringent exchange controls and other monetary restrictions. They worked until spring 1969, when French reserves began to drain away once more. Fresh attacks followed. The franc was finally devalued in August 1969, by 11.1 percent, just as had been discussed in Bonn.

IN DECEMBER 1969, Karl Blessing retired. His friends and admirers held a gala dinner in his honor. Blessing told those assembled—many of whom, like him, had airbrushed their past of inconvenient episodes—that "monetary discipline" had always been the center-point of his banking career. The Nazi regime, which he had loyally and enthusiastically served for all of its twelve years of existence, was smoothly dismissed. "We lived until 1945, or, rather, until 1948, with this many-headed, never-loved monster of the Reichsmark, going downhill all the time."[18] Blessing planned, he said, to spend much of his retirement in the south of France.

The following year, in 1970, McKittrick passed away at a nursing home in New Jersey at the age of eighty-one. The *New York Times* ran a glowing story about the "world financier," as it described him. McKittrick had stayed at the Chase National Bank until he retired in 1954. He later headed a World Bank mission to India. The former BIS president had been decorated by Belgium, Italy, and Romania, the article noted. McKittrick's secret deals with Nazi industrialists, his friendship with Emil Puhl and the BIS's acceptance of looted Nazi gold were not mentioned.

Montagu Norman had died in 1950, but Hjalmar Schacht continued roaming the world. Asian and Arab countries had no interest in his tainted history and welcomed his expertise. But others remembered. Around 1960 Schacht met with Sigmund Warburg because Schacht wanted Warburg to take a stake in a banking operation in the Philippines. The encounter was heavy with things unsaid. Schacht was unusually nervous, and his speech was repeatedly punctuated with the phrase "in short." Warburg listened politely and promised to think over Schacht's idea, but he never followed up.[19] Schacht finally retired in 1963 and lived in Munich with his second wife, Manci. He died in 1970 after he slipped and badly hurt himself while trying to put on his formal dinner trousers.

Blessing's retirement was short. In April 1971, at the age of seventy-one, he suffered a heart attack while on holiday in Orange, in France. Even in death, the myths and lies endured. The *New York Times* marked Blessing's passing with an article as laudatory as its summary of McKittrick's career. After Blessing left Unilever, the Times noted, he had "held various less exposed positions in the mineral oil industry."[20] As for the slave laborers, leased for a few zlotys a day from the SS before being worked to death or executed at Kontinental-Öl's network of concentration camps, it was as if they had never existed.

"To be frank, I have no use for politicians. They lack the judgment of central bankers."

— Fritz Leutwiler, BIS president and chairman of the board, 1982–1984[1]

By 1970 Rudolf Brinckmann had served on the BIS board for almost two decades. But his membership in the world's most exclusive club had not made the German banker any more amenable to settling the bitter dispute with the Warburgs over the name and ownership of the bank they both claimed. Eric Warburg, now seventy years old, remained a partner in Brinckmann, Wirtz & Co. He still went to work each morning to the building, which had once belonged to his family and which he felt was rightly theirs. Warburg and Brinckmann both attended the bank's morning meeting, then ignored each other for the rest of the day. The whole situation, Warburg said, was "unbearable."

The Warburgs suggested that the bank be renamed M. M. Warburg, Brinckmann & Co. The BIS director offered Brinckman, Wirtz–M. M. Warburg & Co., and so it went on. But Brinckmann could feel that Germany's bankers were turning against him. Hermann Abs described the imbroglio as a scandal. But it may have been Jacob Wallenberg, of the Swedish banking dynasty, who finally forced Brinckmann to change his mind. On a visit to the bank's Hamburg headquarters, Wallenberg told Brinckmann that when he had first come to the building, in 1913, the name of the firm was "M. M. Warburg & Co, and not, as today, Brinckmann, Wirtz & Co."

Brinckmann finally surrendered in 1969, and the bank was renamed M. M. Warburg–Brinckmann, Wirtz & Co. The following year, he stepped down from the board of the BIS. Brinckmann retired from his, that is, the Warburgs', newly renamed bank on the last day of December 1973, at the age of eighty-four. Their battle won, the Warburgs proposed that the bank hold a farewell reception for Brinckmann at the Hamburg branch of the Bundesbank. The gala event was planned for January 2 the following year. The two sides planned a gracious closure, both of Brinckmann's career and of a long and often turbulent relationship that had spanned five decades. But it was not to be. As Eric Warburg and Rudolf Brinckmann walked toward the Bundesbank building, Brinckmann suddenly gasped for air, collapsed, and died.[2]

THE PASSING OF Brinckmann, like that of Hjalmar Schacht and Karl Blessing, marked the end of the postwar era, the transition to the modern, globalized, economy and the rise of the new generation of central bankers. Money moved faster, markets reacted quicker, and countries were now interconnected in ways that would have seemed inconceivable when the BIS was founded in 1930. Its headquarters, at the former Grand Hôtel et Savoy Hôtel Univers, at Centralbahnstrasse 7, had served the central bankers well for several decades. But it had been built as a hotel, not as the headquarters of an international bank that was rapidly growing in power and influence and which stood at the heart of the European integration project. In 1958 the BIS employed 158 staff. By 1971 that number had grown to 237. The bank's membership was steadily expanding, as was the bank's growing global reach. The national banks of Spain, Portugal, Iceland, South Africa, Turkey, Canada, Australia, and Japan had all joined. BIS membership was now a point of pride for the newly emerging economies. The monthly governors' meetings needed to cater not just to the central bankers, but to the legions of assistants, staff, and junior officials who invariably accompanied the governors.

Richard Hall returned to the BIS in 1972, rising to become assistant general manager (the equivalent of deputy manager) before his retirement in 1992. Hall had first spent eighteen months at the bank in 1955 and 1956, seconded from the Bank of England to work on the European Payments Union. That era now seemed something from the pages of a dusty history book. "Things like exchange controls and the gold standard had occupied a lot of people's time then. But the world had changed tremendously between 1956 and 1972, and the BIS had changed with it," he recalled. The BIS had survived, evolved, and was now certain of its place in the world. "The bank felt more confident. Not only had it survived the immediate postwar problems, but it had gone on to demonstrate its usefulness to central bank governors as a place for coordinating, consultation, and even weeping on each other's shoulders sometimes about how dreadful these governments are. The central bankers would share their worries and responsibilities and someone else would say, 'Yes, I have one of those as well, do you have any good ideas for dealing with this?'"[3]

The BIS commissioned Martin Burckhardt, a local architect, to design a new, custom-built headquarters. Burckhardt drew up a plan for an ultramodern circular tower block with twenty-four floors. The first version was rejected as too high. Even after the tower was shortened, some local residents objected. A city-wide referendum was held, and the building's supporters won an overwhelming majority —32,000 in favor, while 14,000 voted against.[4] The foundation stone was laid in 1973, and the bank moved into its new offices in 1977. The move was essential, said Richard Hall. "Some of the staff had regrets, but others thought it was about time. The old building had its limitations, and we had burst out of it. We needed more space for more people."

For a staid and secretive organization, the BIS had chosen a surprisingly high-profile headquarters. Where once the entrance to the BIS had been tucked away next to a chocolate shop, the new building, at Centralbahnplatz 2, was eighteen stories high. It loomed almost menacingly over downtown Basel, like a rocket about to take off and launch itself into space. The sunlight glinted off the rows of opaque, bronze-tinted windows. The national flags of member banks stood in a row by the entrance, like a miniature United Nations. The bank's circular corridors and globular 1970s furniture were very stylish, if not daring, for staid central bankers. Even now, the building, which is still in use, appears to have been transplanted from a 1970s James Bond film, as though a steely eyed villain might suddenly stride down its long, looping corridors and frog-march an unwary visitor into a secret annex.

The veterans of the bank grumbled about the "Tower of Basel" as it soon became known. The BIS was no longer invisible. Tourists gawped, and locals took pride that the world's most influential bank was now on display for all to see. Fritz Leutwiler, the president of the Swiss National Bank as well as the BIS, did not approve at all. In the old building, Leutwiler knew when the governor of the Bank of England was in the neighboring office, because he could hear him walking down the corridors and opening his door. The building's prominence infuriated Leutwiler, who like many bankers of his generation believed that the BIS's affairs were best conducted with as low a profile as possible. "That was the last thing we wanted. If it was up to me, it would never have been built," he said of the new headquarters.[5]

The new headquarters were not just stylish, but enjoyed state-of-the-art technology. The BIS managers had realized early on the importance of computers for international finance. They understood that the rapidly globalizing economy would demand ever faster and more secure means of transmitting and storing data. The bank would play a central role in collating, analyzing, and cross-border banking transactions. It provided the secretariat for the G10's group of computer experts who were developing electronic systems for messaging and automated international payments. The BIS also operated an experimental data bank, which provided macroeconomic data for central banks. All this demanded high levels of security. The BIS's safety and security features are now standard on government and corporate headquarters, but in 1977 they were ahead of their time. The bank, still protected by international treaty, guards its sovereignty

as keenly as its secrecy. Thus the architects, and the bankers, tried to plan for every conceivable eventuality. That meant making the building as self-contained as possible. The Swiss authorities need the permission of the management to enter the premises. By far the best thing was to ensure that there would never be a reason to summon them.

The Tower of Basel boasts its own bomb shelter in the basement, a sprinkler system with two backup levels, in-house medical facilities, and lengthy underground corridors to house its archive. Most visitors —apart from central bankers—may not walk anywhere unattended and must call for an escort to walk from room to room. They are not allowed into the staff canteen, which serves lunch every day from 12:30 to 2 p.m, and they must leave the bank at this time. The security guards, who keep a close watch on the building through an extensive CCTV system, will quickly terminate any unauthorized wanderings, and the errant stroller will likely be escorted from the premises. The top floor, which hosts a superb restaurant, is certainly out of bounds, for that is where the governors gather for dinner on Sunday evenings. The aim, said Gunther Schleminger, the bank's general manager under President Leutwiler, was to provide "a complete clubhouse for central bankers." The BIS staff also have their own luxurious country club just outside Basel, with tennis courts and a swimming pool.

It takes a certain verve to build an eighteen-story circular block in the middle of one of Switzerland's most important and historic cities, especially when the organization housed inside is not subject to Swiss jurisdiction. But the BIS has always been a survivor, swiftly adapting to changing circumstances and decisively building itself into the evolving global economy. The new headquarters was a statement—in concrete and tinted glass—that, at the age of thirty-seven, the BIS had come of age. The Tower of Basel, like the bank itself, was nearly invulnerable. Naturally, the high-profile building did not bring any relaxation of the bank's obsessive secrecy. Passers-by could stare at the building but still had no idea what went on inside. The details of the BIS's transactions for the central banks, the deliberations of the governors' meetings, and the bank's powerful committees remained confidential.

The rapidly globalizing economy, argued the governors, made that confidentiality and trust between the central bankers and the BIS even more crucial. During the Second World War, the BIS had acted as an information channel between the Allies and the Axis. It served the same purpose during the Cold War, as a neutral and extremely comfortable meeting point for the Communist and capitalist worlds. Central bankers from behind the Iron Curtain regularly visited the BIS, not just to obtain credit, but also to draw on the bank's expertise in the gold and foreign exchange markets. The BIS was always generous to its visitors from behind the Iron Curtain. It covered their travel costs and paid them a per diem in hard currency. Once in Basel, plied with fine food and wine, with some Swiss francs in their pockets, the Eastern Bloc bankers were friendly, loquacious, and a most useful source of economic intelligence.

This worked so well that by 1976 the central bankers of the Eastern Bloc countries even had their own biannual governors' meetings at Basel, hosted by the BIS. The more the Communists adapted to capitalism, the sooner their system would collapse, the BIS managers believed—correctly as it turned out. Senior BIS officials also regularly visited East European capitals to meet with central bankers. Budapest, where life was much more pleasant than in Warsaw or Bucharest was a favorite. Hungary was often at the center of the BIS's Cold War intrigue. As the BIS annual report for 1982–1983 primly notes, the BIS and the National Bank of Hungary had a "long-standing business relationship."

The central European nation was one of the BIS's earliest members. One of the bank's first acts was to extend credit to Hungary and several of its neighbors, in 1931. The relationship had endured through the Cold War and by the early 1980s was about to flower. János Kádár, the Hungarian leader, was tentatively experimenting with limited private enterprise. Kádár's "Goulash Communism," as it was dubbed, was being watched with great interest in the West. Hungary's economy was the most liberal in

the region, and the country applied to join the IMF in 1980. Frigyes Hárshegyi, a veteran Hungarian banker, first visited the BIS in 1978. Hárshegyi was then the Hungarian delegate to the International Investment Bank in Moscow, which served the Soviet Union and its socialist allies. At this time Western commercial banks were lending to the socialist countries, but capitalist banking mechanisms demanded a steep learning curve from the East European financiers who were used to operating in a state-controlled economy. The meetings at Basel helped Hárshegyi and his colleagues to understand how a free market banking system worked, he recalled. "The BIS was like a stock exchange of information. The atmosphere was always friendly, avoiding political statements and concentrating on financial and professional questions."[6]

But Hungary had a problem. Foreign borrowing had financed Goulash Communism, which had brought social peace by providing work, housing, holidays, and limited travel to the West. By 1982 Hungary owed more than $10 billion in foreign debt, much of it short-term.[7] The imposition of martial law in Poland and the subsequent debt crisis together with the parlous state of the neighboring Romanian economy had alarmed investors and the international markets. Even though Hungary was in a completely different situation, with a far more liberal regime and some promising economic indicators, the "regionalization" factor meant that Hungary's creditors were rushing for the exit. Money was flooding out.

János Fekete, a senior official of the Hungarian National Bank, was charged with persuading the BIS to help. He had excellent contacts at the BIS and regularly attended meetings there. Fekete was optimistic that Hungary would be allowed to join the IMF, and indeed the country would not have applied without positive signals from the fund's Washington headquarters. IMF membership would anchor Hungary firmly in the global financial system, instead of the Soviet make-believe equivalent. But the fund moved slowly, and Hungary's creditors were pressing hard. The legendary ingenuity of Hungarians was being tested to the limit. The Hungarians have brought the world numerous inventions, from the ballpoint pen to nuclear weapons. Indeed they are famed for being so wily that the old joke defines a Magyar as "someone who enters a revolving door behind you but comes out in front." Fekete proved similarly inventive.

Hungary desperately needed funds, Fekete explained to Fritz Leutwiler, but lacked sufficient foreign exchange or gold reserves. The Hungarian banker suggested that the BIS organize a bridging loan, until Hungary could join the IMF and apply for financial assistance. The BIS loan would be returned as soon as Hungary was in the IMF and received its first credit. Leutwiler was minded to look sympathetically on Fekete's request. Leutwiler understood that the regionalization approach, which equated comparatively liberal and forward-looking Hungary with totalitarian Romania or Poland, languishing under the rule of the generals, showed poor judgment. Hungary, and Fekete, were old friends of the BIS. The BIS was always very helpful, says Hárshegyi, Fekete's former colleague. "They saw that this was a short-term crisis and that Hungary's economic philosophy was always to service its debts."[8]

Once again, the personal connection proved crucial. Leutwiler called Jacques de la Rosière, the managing director of the IMF, in Washington. The BIS president wanted to know two things. How was Hungary's membership application progressing? And would Budapest be likely to receive IMF assistance?

With hindsight, a lot was riding on this telephone call, probably more than either Fekete or Leutwiler realized. Had de la Rosière signaled that Hungary's IMF membership application was not likely to be approved, or even just that it was stalling, Leutwiler would likely have politely ushered Fekete from his office with no firm commitment to help. The capital exodus from Budapest would have continued, the economy would have faced collapse, and the country's tentative experiments with the free market would doubtless have ended. The reformers within the Hungarian politburo would have been weakened and the hard-liners, who opposed what they saw as dangerous capitalist experiments, been greatly strengthened.

Such a course of events would certainly have been "regionalized." The defeat of the Hungarian liberals would likely have been mirrored across the Soviet bloc, perhaps even in Moscow, where Hungary was regarded as a licensed wild card, able to test the capitalist waters in ways the Soviet Union could not. De la Larosière was able to reassure Leutwiler: Hungary would soon be a member and qualify for financial assistance. Thus reassured, Leutwiler agreed to Fekete's request for a bridging loan. In March and May 1982 the BIS arranged two loans to Hungary for a total of $210 million, and a further $300 million followed in September. By the end of the year, Hungary had joined the IMF. The fund's board approved a credit line of $520 million. Hungary repaid its debt to BIS.

Unbeknown to him, Leutwiler had set in motion a series of events that would soon help to redraw the map of Europe. The backing of the BIS and the IMF sent a powerful signal that the Fund, and the BIS and its shareholders—other central banks—had faith in the Hungarian leadership's plans for reform. The Hungarian reformers further liberalized the country's economy. Private entrepreneurs began to push the limits of freedom, and foreign investors looked at Hungary with renewed interest. Hungary's international bankers, like Hárshegyi and Fekete, already saw the deficits of the socialist system. Their visits to Basel only reinforced their understanding of its profound inefficiencies and stultifying effect on business. The central banks in the socialist bloc had very different functions to their capitalist counterparts. The Hungarian National Bank was a state commercial bank, supplying credit and financing foreign trade. The Basel meetings were also valuable tutorials in how to turn a socialist state bank into a traditional central bank, responsible for controlling the money supply and controlling interest rates.

By the late 1980s, even the old guard realized that the one-party state did not work. The Hungarian leader Kádár resigned, and negotiations began for a peaceful transition to democracy. The Iron Curtain was first opened in Hungary, three months before the Berlin Wall was breached. One day in August 1989 tens of thousands of East German refugees gathered on the Hungarian-Austrian frontier. By then it was clear that Communism was dying. As they surged forward, the border guards stood by and let them through. By the end of the year the entire Soviet bloc had collapsed. The BIS had played an important role in this process. The bank's bridging loan had reinforced international confidence in the Hungarian reformers, which in turn had boosted their political standing at home, which had weakened the grip of the Communist party and allowed the opening of the Iron Curtain. That in turn triggered a domino effect across the region and accelerated the collapse of the one-party system.

The Soviet Union itself was less welcome in Basel. Part of the problem was that Moscow still claimed ownership of the gold holdings of the Baltic States—Latvia, Lithuania and Estonia—which Thomas McKittrick had refused to hand to the Soviets back in 1940. By 1980 the three states no longer existed and had been absorbed into the Soviet Union. But the gold did exist, and the Russians wanted it. The Soviet Union continued to inquire about membership possibilities during the 1960s, but the bank remained steadfast. The BIS continued, correctly, to keep possession of the Baltic reserves—and was duly vindicated when the three Baltic States regained their independence in 1991 and the Soviet Union collapsed. The Bank of Russia was finally admitted in 1996.

Mexico too was on the brink of going bust in 1982—and taking the international banking system down with it. Mexico was saddled with an $80 billion external debt. In order to meet its obligations, Mexico had been borrowing overnight funds in New York to pay the interest. But the loans were eating themselves: each day Mexico had to borrow more to pay the interest on the previous day's loans. The Mexican economy was in danger of entering a death spiral. The IMF was prepared to loan Mexico $4.5 billion, but the fund moved slowly, and the paperwork might take months to be approved. Here, too, the BIS connection helped save the country. Paul Volcker, the chairman of the US Federal Reserve, and Fritz Leutwiler, the BIS president, organized a rescue package.[9]

Back in 1968 when Jelle Zijlstra, the BIS president, had sought to secure the French franc at the Bonn IMF conference, he managed to secure pledges of $2 billion over lunch. Volcker and Leutwiler took slightly longer, although their mission was slowed by the fact that the bankers were not gathered around a single table, as they had been in 1968. As with Hungary, the BIS financing was not intended as a substitute for the IMF rescue package but would be a temporary stopgap, until the IMF loans were authorized.

Volcker's initial suggestion of $1.5 billion was bumped up to $1.85 billion, with $925 million from the Federal Reserve, and the remainder to come from the central banks would be channeled through the BIS. Similar arrangements soon followed for Brazil, Argentina, and Yugoslavia. These arrangements suited everyone involved. The rescue packages were presented as BIS-led. The bank had arranged the loans, but the United States and the other G10 countries made the actual funds available. The rescue packages carried substantial political risks for the participating central banks, especially the Federal Reserve. But the central role of the BIS internationalized the bailout.

BY THE MID-1980S, the controversy over the Tower of Basel had faded away. The sleek, modernist building, looming over Centralbahnplatz, had become part of the Swiss city's urban skyline. The circular tower block, pointing skyward, symbolized the bank's new reach and ever more ambitious aspirations. The bank had shown a protean ability not just to survive but to flourish in rapidly changing circumstances. The ostensible reason for the BIS's foundation—the management of German reparations payments for the First World War—was now a fading memory. So was the Bretton Woods conference, where Henry Morgenthau and Harry Dexter White had tried to have the bank closed down. The financial system designed there, which fixed the price of gold at $35 an ounce was also gone, ended by President Nixon in 1971.

But the BIS now stood at the center of the global financial system. Leutwiler, the BIS president, had saved the Hungarian economy with a telephone call and accelerated the process of political reform that would eventually bring down Communism. The bank was managing multiple bailout packages that were easing the Latin American debt crisis and so preventing a potential catastrophic run on American banks. Some banks however, could not be rescued. There, too, the BIS positioned itself at the center of events. In 1974 the Franklin National Bank in New York and the Bankhaus Herstatt in Germany went bust after overextending themselves. At the time, Franklin was the biggest American bank in history to fail. Herstatt was a much smaller private bank but did substantial foreign exchange business in the United States. In response the BIS and the G10 governors set up the Basel Committee on Banking Supervision to begin the long, complicated, and still ongoing process of regulating commercial banks. The committee, naturally, was based at the BIS, from where it operates to this day. By hosting and providing secretarial and administrative services to new transnational financial groupings, such as the EEC Governors' Committee and the Basel Committee on Banking Supervision, the bank was steadily making itself indispensable for the functioning of the global economy. The committees' location in the Tower of Basel brought prestige, a stream of admiring visitors and dignitaries, and a new sense of permanence. There were no modern equivalents of Henry Morgenthau or Harry Dexter White, demanding that the BIS be closed down.

The BIS was also surprisingly nimble. The bank had been an early adopter of computer technology and its ultrasecure databases, which were hosted in the tower, were fast becoming the essential reference store for information on central banks and cross-border banking transactions. Some of that information was collated in the bank's annual reports that were ever more informative and had become required reading in the world's treasuries, finance ministries, and trading houses. The *58th Annual Report*, published in June 1988, was 223 pages long. Its eight lengthy, detailed sections included the bank's analyses of general economic developments, international trade and payments, domestic and international

financial markets, monetary policy, the international monetary system, and the BIS's own banking activities. These were increasingly lucrative. The accounts for the year ending March 31, 1988, showed a net tax-free profit of almost 96 million Swiss gold francs, an increase of almost five million more than the previous year.

Tucked away on pages 197 and 198, under the report of the bank's functions as agent, trustee, and depositary, and written in a banker's dry prose, were telling details that highlighted the BIS's central and vital role in the European integration project. Behind the scenes, the BIS continued to provide the financial expertise and technical assistance for the most significant economic development in postwar history: the drive toward European union. From the secret wartime discussions between Per Jacobssen, the bank's economic adviser, and Emil Puhl, the BIS director and Reichsbank vice president, to the detailed plans for the implementation of European Monetary Union in the late 1980s, the BIS played a driving role at every stage.

The BIS managed the 1947 Paris agreement on multilateral payments. Three years later the accord grew into the European Payments Union and the BIS was appointed the new system's agent. When European currencies became convertible, the EPU became the European Monetary Agreement that was managed, naturally, by the BIS. The BIS was deeply entwined with the European Coal and Steel Community, the first supranational European organization. It had signed an Act of Pledge with the ECSC in 1954 and subsequently handled all the loans issued by the ECSC. The BIS imprimatur gave the fledging organization vital credibility on international markets. The last ECSC loan had been redeemed in 1985–1986, and all unused funds had been returned to the European Commission in Luxembourg, the bank's 1988 annual report noted.

The BIS had hosted the Committee of Governors of European Economic Community Central Banks since it first met in 1964 and provided its secretariat. The EEC Governors' Committee coordinated and integrated the monetary policies of its members, a precursor to eventual European economic union. The committee was independent of the BIS, but its members later included Alexandre Lamfalussy, the bank's general manager from 1985 to 1993. The committee managed the first limits on exchange rate fluctuations within European currencies, a mechanism known as the "Snake in the Tunnel," which was an important step toward European monetary union.

The EEC Governors' Committee was significant, said Richard Hall, the former assistant general manager of the BIS. "The discussions in the European Economic Community were intergovernmental and central bankers were always number two to ministers. But the central bankers had been coming to Basel for many years, before monetary union was discussed. They were accustomed to talking together and doing things together and they did not want to be upstaged by finance ministers. They were already in Basel once a month for the BIS meetings, so they set up the committee there and the bank was very happy for them to do that."[10]

The BIS was the agent for the European Monetary Cooperation Fund, which had been set up by the Committee of Governors to manage short-term credit arrangements for members of the European Economic Community, the predecessor of the European Union. The bank was also the agent for the clearing and settlement system for the European Currency Unit (ECU) that was the precursor of the euro.

The establishment of the European Coal and Steel Community and its evolution into the European Economic Community were presented as an unmitigated boon for the countries concerned. But the most dramatic and far-reaching peaceful re-ordering of Europe in modern times—the steady and relentless erosion of national sovereignty—was implemented by sleight of hand. The key, for both the European project and the ever-broader mandate of the BIS, was to present decisions, policies, and actions as "technical" and "apolitical," of no concern to the average informed citizen. In fact, the opposite was true.

There could hardly be anything more political than the handing over of national powers to unelected supranational bodies, while the necessary financial mechanisms were arranged and managed by a secretive and completely unaccountable bank in Basel.

By the late 1980s this process was effectively unstoppable. In the summer of 1988 the EEC central bank governors were asked to serve, in their personal capacity (so that they would not be seen as representing their national banks), on the Committee for the Study of Economic and Monetary Union (EMU), which prepared for the adoption of a single European currency, the euro. The committee was better known by the name of its chairman, Jacques Delors, a French civil servant and politician.[11] Delors was president of the European Commission, which oversees the implementation of European laws and policies.

The Delors Committee had seventeen members, including Karl Otto Pöhl, the president of the Bundesbank; Robin Leigh-Pemberton, the governor of the Bank of England; and Willem Duisenberg, the president of the Netherland National Bank, all of whom were board members of the BIS. The questions of how, when, and even if EMU should be carried out were left to the politicians. The committee was concerned with the technical aspects, rather than the political implications. Once again, the BIS was at the center of events. The Delors Committee did not meet in Brussels, the site of the European Commission, or Strasbourg, the home of the European Parliament, or Frankfurt. It set up shop in Basel. There it enjoyed its own dedicated support staff, supplied by the BIS.

Behind the scenes, one of its most influential members was Alexandre Lamfalussy, the Hungarian-born BIS general manager. Lamfalussy had fled his homeland after the Soviet takeover in the late 1940s. He moved to Belgium and taught at the Catholic University of Louvain and later at Yale. Lamfalussy joined the BIS in 1976 as economic adviser, the post once held by Per Jacobssen. In 1985 he was appointed general manager. Lamfalussy was widely regarded as the intellectual powerhouse behind European economic integration and, from the project's earliest beginnings, had a deep grasp of both its practical operation and theoretical underpinning. When the Snake, the fixed-limit exchange rate mechanism, had run into trouble, for example, the governors had turned to Lamfalussy for advice.

So it was only natural that the Delors Committee would frequently defer to Lamfalussy's opinions, all of which greatly annoyed European officials visiting from Brussels. They could not understand why the great European monetary integration project was being directed from a suite of rooms in a tower block by Basel central railway station, which was out of their political and legal jurisdiction. But Delors's primary concern was not the prickly Eurocrats, but the central bankers. He understood that without them EMU could not take place. "It was the genius of Delors, who was a great manipulator—in the good sense of the term—who realized that he absolutely did not want to and would not hurt the feelings of the governors of the central bank," Lamfalussy recalled.[12] Logistics also played a role. Many of the Delors Committee's most important members, such as Pöhl and Leigh-Pemberton, already came to Basel for the governors' meetings. There, at the Sunday evening G10 governors' dinner, the central bankers decided what Lamfalussy described as the "norms of cooperation," in circumstances as secretive as ever. "This was the dinner where we talked about the most difficult issues, with no notes or anything."[13]

The Delors Committee also had two rapporteurs: Gunter Baer and Tomasso Padoa-Schioppa. Baer had worked as an economist at the BIS. Padoa-Schioppa was an Italian economist who is considered one of the intellectual founding fathers of the euro. The rapporteurs were immensely influential. They prepared the meetings, wrote reports, and "held the fountain pen," as Lamfalussy put it. "It was my officials that prepared the meetings in Basel of a project that was primarily European."[14]

The Delors Committee presented its report on EMU in April 1989. Central banks' reserves would be off limits to governments. Borrowing in non–European Community currencies should be limited. There

would be sanctions against countries that exceeded a budget deficit threshold (currently three percent). Crucially, the sanctions would apply not just to members of the future Eurozone, but to all European Union member states. The report called for European countries to take substantial steps toward economic convergence, budgetary discipline, and price stability, before moving decisively toward economic and monetary union.

However it was unclear how this strict, common financial discipline would be imposed. A common monetary policy, based on a shared currency, demanded a common fiscal policy with shared rules for government taxation and spending, Lamfalussy argued in a memo in January 1989, but there were no plans for this:

> *In short, it would seem to me very strange if we did not insist on the need to make appropriate arrangements that would allow the gradual emergence, and the full operation once the EMU is completed, of a Community-wide macroeconomic fiscal policy which would be the natural complement to the common monetary policy of the Community.*[15]

As Harold James notes, Lamfalussy's memo was both "apposite and intellectually compelling."[16] It neatly summarized the contradiction of a transnational currency with no transnational fiscal policy—a contradiction that remains unresolved and has both triggered and fueled the Eurozone crisis. The following month, Lamfalussy, during a discussion of the kind of controlling and supervisory budgetary methods needed for EMU, even suggested adding the word "enforceable" to the final draft. His suggestion was not incorporated into the report. Nonetheless, even without a common fiscal policy, Lamfalussy argued that Europe must press ahead with monetary union, if only because the European Monetary System (EMS), which limited exchange rate variations, had fallen victim to the law of unintended consequences. The system intended to stabilize currencies was having the opposite effect.

Speculators were pouring money into Italy. There inflation in 1988 was around five percent, compared to Germany at 1.3 percent. High inflation meant higher interest rates, but as the lira was locked into the EMS, its value was guaranteed. For investors there was no downside. The liberalization of capital movements had accelerated this process. The EMS was vulnerable, argued Lamfalussy and Europe must move to EMU as soon as possible. "It is for this reason that I would be in favor of a first stage that could be implemented as quickly as possible and not in a two or three year distant future, but starting this autumn or at least at the end of the year."[17]

The Delors Report, as it became known, was forty-three pages long. It was accompanied by a collection of fifteen papers which were written by the members of the committee. The influence of the BIS was clear. Jacques Delors wrote two of the papers, the first with the kind of grandiose title beloved of French politicians: "Economic and Monetary Union and Re-launching the Construction of Europe." Three papers were written by Alexandre Lamfalussy. Lamfalussy's articles dealt with some of the most important technical aspects of the process of monetary and economic union: the macro-coordination of fiscal policies in an economic and monetary union; the European Currency Unit banking market; and a proposal for centralizing monetary policy.

Back in the 1920s, Norman had mused to Benjamin Strong, the chairman of the New York Federal Reserve, about the need for a "private and eclectic Central banks' club, small at first, large in the future." When Norman had summoned Walter Layton, the editor of *The Economist*, to his office to ask him to draft the bank's statutes, he had emphasized that they must, above all, guarantee the BIS's independence. The Delors Report confirmed that crucial principle. Governments would be excluded from monetary policy

making. The Delors report called for the creation of a new institution to centrally decide and coordinate member states' monetary policy operations, to be called the European System of Central Banks (ESCB). Montagu Norman may not have approved of a Europe-wide currency, but he would certainly have applauded the report's demand that the ESCB must be completely independent from both national governments and European authorities.

The Delors Report's recommendations that the European Union should adopt a single currency and a unified monetary policy were accepted. The momentum toward monetary, economic, and political union was unstoppable. A new bank, the most powerful institution within the ESCB, would be created to define and implement monetary policy. The European Central Bank's primary task would be to ensure price stability while remaining free of all political pressures. It sounded all too familiar.

PART THREE: **MELTDOWN**

"European economic unity will come, for its time is here."

— Walther Funk, 1942[1]

The Reichsbank president and BIS director was half right. European economic unity did indeed arrive, but it came sixty years after he predicted. Walther Funk lived to see two of the most important early milestones: the establishment in 1951 of the European Coal and Steel Community, Europe's first supranational institution, whose loans were managed by the BIS, and the signing of the Treaty of Rome in 1957, when the six core countries—Germany, France, Italy, Belgium, Luxembourg, and the Netherlands—established the European Economic Community.

Funk was released from Spandau Prison in Berlin the same year and died in 1960, but his pan-European plan for a continent free of trade and currency restrictions lived on and flourished. A European customs union came into existence in 1968. Just over a decade later, in 1979, Europeans voted in the first elections for the European Parliament. In 1992 twelve European countries signed the Maastricht Treaty, which brought the European Union into existence. On January 1, 1993, the European single market began operating across the twelve member states of the European Union. Its citizens could live and work freely wherever they wanted, companies could sell their products, and currencies and capital flowed unhindered.

Funk would certainly have applauded. The Nazi economics minister had raised the idea of European monetary union as early as 1940, to be introduced incrementally by harmonizing currency fluctuations and constraining exchange rates, as indeed happened.

To point out any similarities between the Nazis' postwar economic plans for Europe and today's European Union is to risk ridicule and invective. The European integration project, has, for many, become an untouchable truth, an article of faith in the world's inexorable progress toward a brighter and more secure future. Certainly, European integration has many achievements to its credit: speeding up reconstruction after 1945; opening the continent for free trade and nurturing a new generation of pan-Europeans who think beyond national borders. By incorporating the shaky democracies of post–Communist Europe the European Union has helped stabilize the eastern half of the continent. The oft-stated values of the European Union: human rights, democracy, and protection of minorities are the very antithesis of the Third's Reich's ideology.

But it is a massive and illogical mental leap to claim, as did Helmut Kohl, the German chancellor, in 1996, "The policy of European integration is in reality a question of war and peace in the twenty-first century."[2] Kohl's statement embodies the technocrats' belief, reaching back to Jean Monnet and Montagu Norman, that the wise guidance of a managerial and financial elite is all that is needed for Europe to prosper—and to prevent its fractious, ungrateful peoples from reverting to their natural warlike state. The historian Antony Beevor makes a more convincing counterclaim: Western Europe has remained free of wars since 1945, not because of the European Union, but because of democracy. "It is simply a question of governance. Democracies do not fight each other."[3]

The uncomfortable, unspoken truth is that the parallels between the plans of the Nazi leadership for the postwar European economy and the subsequent process of European monetary and economic integration are real. The BIS runs like a thread through both. Funk's deputy Emil Puhl described the BIS

as the "only real foreign branch" of the Reichsbank, because it was the crucial connection of the Reichsbank to the international network of central bankers.[4] These connections outlived the war. The BIS helped ensure that the postwar successors to the Reichsbank, the Bank deutscher Länder, and the Bundesbank, would continue to dominate the economies of postwar Europe. The BIS provided the BdL and the Bundesbank with both legitimacy and prestige. The BdL, followed by the Bundesbank, took the Reichsbank's former place at the governors' meetings. The BIS gave the Bundesbank an instant network of connections to other central banks and a platform to shape the debate about the postwar European economy. Nor did the personnel change much: Karl Blessing, Schacht's protégé, worked at the BIS during the early 1930s, transferred to the Reichsbank, oversaw an empire of slave laborers during the war, then returned to the BIS in 1958 as the president of the Bundesbank.

During the 1930s and '40s, like the 1980s and '90s, the politicians laid out the general theory of European unification, while the technocrats—such as Funk—outlined the practical steps. As early as 1940, Arthur Seyss-Inquart, the ruler of the Nazi-occupied Netherlands, called for a new European community "above and beyond the concept of the nation-state," which would "transform the living space given us by history into a new spiritual realm."[5] The new Europe would benefit from "the most modern production techniques and a continent-wide system of trade and communications developed on a joint basis." Rapidly increasing prosperity was inevitable "once national barriers are removed."[6]

When Hitler called for the "clutter of small nations" to be removed, Funk readily agreed. "There must be a readiness to subordinate one's own interests in certain cases to that of the European Community."[7] The Reichsbank president laid out his thoughts in a detailed, eight-page memo called "Economic Reorganization of Europe," a copy of which is stored in the BIS archive in Basel. The document was translated by Per Jacobssen's staff and passed to Thomas McKittrick on July 26, 1940.[8]

All sorts of slogans were flying around about the "construction and organization of the German and the European economic system after the war," and the favorite was "European large-unit economy," noted Funk in his 1940 paper. Such a construct did not yet exist, but "the new European economy must be an organic growth" and will result from "close economic collaboration between Germany and European countries." The Reichsmark would be the dominant currency, but the currency basis of postwar Europe was of secondary importance to economic leadership. "Given a healthy European economy and a sensible division of labor between the European economies, the currency problem will solve itself because it will then be merely a question of suitable monetary technique." Here Funk seems to anticipate the arguments of the euro enthusiasts who, fifty years later, claimed that a common currency, if properly constructed in the right economic conditions, could not fail.

Funk's analysis and prediction are unsettlingly prescient of the subsequent course of postwar European economic and political history. The Reichsmark would be the dominant currency, and once it had been freed of foreign debt, its currency area must "continue to widen." Bilateral payments must be transformed into multilateral economic transactions and clearing arrangements, "so that the various countries may enter into properly regulated economic relations with one another through the intermediary of clearing arrangements of this kind"—just as happened with the 1947 Paris agreement on multilateral payments and its successor mechanisms, such as the European Payments Union (EPU).

Foreign exchange controls could not be abolished in one move or monetary union quickly introduced. The process must be incremental, Funk argued, anticipating the need for a halfway system like the EPU, which liberated non-residents from exchange controls, although they remained in place for citizens. "The problem is not one of free exchange or European monetary union, but in the first place, of a further development of clearing techniques for the purpose of ensuring a smooth course for payments within the countries participating in the clearing." The conversion rates must be controlled and kept stable. This was

also the aim of the Snake in the Tunnel and the European Monetary System, which were, like the EPU, managed or serviced which were, like the EPU, by the BIS.

An actual monetary union was more complicated, Funk presciently argued, as it demanded "a gradually assimilated standard of living, and even in the future the standard cannot be the same in all the countries participating in the European clearing"—a statement that neatly anticipated the modern disequilibrium between Germany and Greece. But once the European central clearing system was operating, foreign exchange restrictions would be abolished, first for travelers crossing frontiers and then for import trade. There would be a bonfire of regulations that slowed down trade and commerce; Funk wrote, "Meticulous surveillance and all the regulations, which weigh down on the individual business enterprise with a mass of forms, will no longer be necessary."[9]

Funk also predicted, correctly, that the future European currencies would not be linked to gold. The new multilateral monetary system would provide the necessary backing. The deciding factor in trade relations would be the quality of German goods for export, "and in this respect we really need have no anxiety." German needs would be central to the new European economy. Germany would reach long-term economic agreements with European countries so that they would plan their long-term production on the German market, and there would also be "better outlets for German goods on European markets."[10]

The Nazi leadership welcomed Funk's plans. In 1942, The German Foreign Ministry created a "Europe Committee," whose members drafted plans for a German-dominated European confederation. That same year the Berlin Union of Businessmen and Industrialists held a conference at the city's Economic University, entitled "European Economic Community." As the writer John Laughland notes, the titles of the speeches delivered at the conference are "eerily reminiscent of modern pro-European discourse." They include "The Economic Face of the New Europe," "The Development Towards the European Economic Community," "European Currency Matters," and the hardy perennial, still much discussed today: "The Fundamental Question: Is Europe a Geographical Concept or a Political Fact."[11] In June a German official drafted the "Basic Elements of a Plan for the New Europe," which outlined how the new confederation would work. Much of it sounds very familiar. The section entitled "The Economic Organization of Europe" called for a European customs union, a European clearing center that would stabilize currency rates with the eventual objective of European monetary union, and the "harmonization of labor conditions and social welfare."[12]

Germany's postwar remodeling of itself as a penitent bastion of democracy was predicted by Heinz Pol. Pol, a former editor of a Berlin newspaper, had fled from the Nazis to the United States. The BIS, wrote Pol, was a central pillar of this policy of expediency: the recognition that the war was lost, and Germany needed to make a deal with Allies that would preserve its dominance of Europe. During the war, both Hermann Schmitz, the CEO of IG Farben, and Kurt von Schröder, the Nazi banker, used their positions as BIS directors to keep channels open to the Allies, wrote Pol in his book, *The Hidden Enemy*, which was published in 1943. "Since the beginning of this war, both have maintained contacts, through go-betweens, with their business friends in all the countries of the United Nations."[13]

The OSS Harvard Plan documents detailing Thomas McKittrick's role in negotiating deals with German industrialists confirm Pol's assertion that the BIS was a contact point for negotiations about Germany's plans to dominate postwar Europe. Pol's predictions of how postwar German leaders would rapidly abandon the outward trappings of Nazism still make unsettling reading:

> *To obtain a peace, which would leave them in power, they will suddenly flaunt "European spirit" and offer worldwide "co-operation." They will chatter about liberty, equality, and*

fraternity. They will, all of a sudden, make up to the Jews. They will swear to live up to the demands of the Atlantic Charter and any other charter. They will share power with everybody and they will even let others rule for a while. They will do all this and more, if only they are allowed to keep some positions of power and control, that is, the only positions that count: in the army—were it even reduced to a few thousand men; in the key economic organizations; in the courts; in the universities; in the schools.[14]

Which is precisely what happened, when, after 1945 former Nazis took many of the key positions of "power and control" in the new Germany. Their legacy has proved extremely profitable. Germany now has the largest economy in the European Union and the fourth largest in the world. Greece faces collapse, and Spain is mired in recession, but Germany is booming, with growth rates of 3.7 percent in 2010 and 3 percent in 2011. Much of this success is based, as Funk predicted, on the high quality of German exports. Germany's total share of world trade is about 9 percent. The country is especially strong in the biotechnology, genetic engineering, and pharmaceutical sectors.

BASF and Bayer, two of IG Farben's successor companies, are dominant in their fields. BASF is the world's largest chemicals company with annual sales of 73.5 billion euros. Bayer, which makes aspirin, employs 112,000 people. Bayer felt no shame about its roots in IG Farben. In 1964 Bayer set up a foundation to honor Fritz ter Meer on his eightieth birthday with a donation of 2 million deutschmarks. Ter Meer had handled IG Farben's negotiations with Standard Oil and oversaw the building of IG Auschwitz. Found guilty of war crimes, ter Meer was sentenced to seven years imprisonment in 1948. He was freed in 1950 and later joined the supervisory board of Bayer. Bayer's foundation honoring him was renamed in 2005 and existed until 2007.

By the early 1990s, Funk's "European Large-Unit Economy," perhaps better known as the Eurozone, was clearly in sight. The technical preparations had been going on for decades—at least since 1964, when the Governors' Committee of European central banks had first met at the BIS to coordinate monetary policy, if not 1947, when the Paris accord on multilateral payments was signed. The positive reception for the 1989 Delors Report, which had been drafted at the BIS and which laid out the plan for EMU, meant that the political momentum was unstoppable.

In December 1993 Alexandre Lamfalussy stepped down as general manager of the BIS to start work as the director of the European Monetary Institute (EMI), the precursor of the European Central Bank. He would be much missed. "Lamfalussy put the BIS on the map. He was superb, very bright," said Geoffrey Bell, the founder of the G30 advisory group, an international think tank. "Lamfalussy was a thinker, especially when the bank started to move into intellectual issues such as bank regulation and the general state of the world."[15]

The EMI opened its doors the following month. Lamfalussy did not have far to go: the institute was based at the BIS. The president was charged with a mammoth task: the construction of the first trans-European monetary institution, in preparation for the introduction of the single currency. Nobody was better qualified for the job. Lamfalussy had been at the center of the drive to European monetary unity almost since its inception. The Hungarian economist had once boasted that it was his subordinates who "held the fountain pen" and "prepared the meetings in Basel of a project that was primarily European."

After eleven months, in November 1994, the EMI had outgrown the BIS and moved to Frankfurt. Its new home was a skyscraper at Willy-Brandt-Platz, known as the "Eurotower." The small number of staff that Lamfalussy brought from the BIS was not sufficient. The EMI president had to recruit 150 people in six months, and the network of contacts he had built up over seventeen years at the BIS was invaluable. "I knew everyone, and when I saw that there was a hole in the organization, or that we needed someone . . . I

knew exactly who to ask, and I could ask them for everything. It was a phenomenal advantage." Lamfalussy's network was also an advantage for the EMI's governors, he recalled, "because they also knew each other and the staff too."[16]

The Eurotower was forty stories tall, more than double the BIS's eighteen floors. The size of the Frankfurt skyscraper symbolized its role as the home of an idea that had been nurtured at the BIS but which had now far outgrown its birthplace. Nonetheless, the small, clubbable world of the Tower of Basel was soon replicated there. Back in the 1960s Charles Coombs, of the New York Federal Reserve, recalled that the central bankers at the BIS governors' meetings frequently did not even need to finish their sentences "because everyone instinctively knew the rest and in an almost uncanny way, a simultaneous realization of the appropriate technical solution." The EMI president enjoyed the same kind of telepathy with Hans Tietmeyer, the president of the Bundesbank, and Jacques Delors, the president of the European Commission.

When Europe's most powerful bankers and politicians came to Frankfurt to discuss the single currency project, Lamfalussy sat at the head of the table. "When Tietmeyer or Delors . . . would put up his hand to ask a question, I would know exactly what he would ask, and he also knew that I would know exactly what he wanted to ask. It was enough just to look at them and I knew what they wanted to talk about because I knew what they thought."[17]

THE DEPARTURE OF the EMI for Frankfurt left a void at the BIS. The long, looping corridors were quieter, the air of excitement that the bank was at the center of the most ambitious monetary project in European history had dissipated, and the chatter in the staff restaurant was more subdued. Even the Governors' Committee, which had met at the BIS since 1964, was gone. The committee's members—the governors of the European Central Banks—now formed the council of the EMI.

Once again, the BIS faced an existential crisis: Did it still need to exist? The bank was certainly still profitable. The accounts for the year ending March 1995 showed a net profit of 162.4 million gold francs. But if the BIS had no international role, it would be increasingly difficult to justify its existence and the extensive legal privileges that helped guarantee those profits. The bank had a new manager, Andrew Crockett, a British economist who had worked for the IMF from 1972 to 1989. Crocket came to the BIS in 1994 from the Bank of England, where he had spent four years as an executive director. There he could observe firsthand the after-effects of the "Big Bang," the 1986 deregulation of the City of the London.

Until the Big Bang, the Square Mile had been still a clubby, comfortable place of old school tie connections and long lunches, where Montagu Norman would have felt at home. That world vanished almost overnight. Wall Street investment banks poured into the Square Mile, bringing aggressive new tactics. The 1933 Glass-Steagall Act, which separated investment banking and deposit taking, was still in force in the United States. London, newly unburdened from cumbersome regulations, offered fabulous opportunities, heightened by the rapid growth of computer technology, which accelerated trading. The BIS gave the Big Bang a cautious welcome. "It was feared that if nothing was done, the Stock Exchange would be unable to compete with foreign institutions and business would move abroad," the BIS noted in its 1987 Annual Report.[18] The changes had brought a "major inflow" of capital to British and foreign banks, the BIS noted, but had highlighted the importance of Chinese walls within firms to avoid conflicts of interest. The Chinese walls however, soon crumbled under the tsunami of money. The city firms' new American partners often had few qualms about conflicts of interest. They advised a company on a merger, and then sold the new shares.

Some said that the BIS job was Crockett's consolation prize for his failure to get the top job at the IMF. Either way, he had not joined the BIS to see it fade away. Crockett's international background

brought valuable perspective to what could still be a cozy and parochial institution. Crockett understood that the establishment of the EMI marked the end of an era for the BIS. The bank was sixty-four years old, of pensionable age. Its original mission, of managing German reparations payments from the First World War, had long faded away, the details of the arcane disputes preserved in dusty files in the bank's archives.

Suddenly the BIS looked like an anachronism, a hangover of the era of credit controls and currency restrictions in a global economy that was ever more interlinked, dynamic, and faster moving. Small, unimportant countries such as Belgium and the Netherlands sat on the board, but where were the central banks of China, Brazil, Saudi Arabia, and Russia? True, Japan, Canada, and Turkey had joined, but many, especially in the United States, regarded the bank as a thoroughly Eurocentric institution. William White, from the Bank of Canada, joined the BIS in May 1995 as head of the Monetary and Economic Department, the bank's research arm. "When I arrived, people were asking what is the BIS going to do after the euro? It was a legitimate question. It was a very heavily European organization. Once the EMI was set up, all the Euro stuff was going to get done somewhere else."[19]

The BIS had to find a new purpose. To Crockett it was clear, White recalled. "Crockett said, we are going to go global." But for that to happen, the United States needed to be on board. More than sixty years after the BIS was founded, the Federal Reserve still kept its distance and had not taken up its tranche of shares, despite the BIS's deep American roots. The United States had always followed what was happening at the bank and the discussions taking place there. But the American Federal Reserve officials who traveled to Basel were there as observers, not as representatives of a member bank. Crockett wanted to end this anomaly. All the countries that took part in the G10 Sunday evening governors' meeting at the BIS should be members of the bank and be represented on the board of the bank, he believed. The Federal Reserve needed first to join the bank, then the board.[20]

During the 1970s and '80s, Washington had not been especially interested in the BIS. The focus then had been primarily on trade, rather than finance, said Karen Johnson, a former Federal Reserve director for International Finance. "Trade behaves in a rather predictable way. It's hard to change, but it's also hard to surprise you. That began to alter in the 1980s and changed hugely in the 1990s." Rapidly increasing globalization, the growing power of international markets and money's ability to flow ever faster around the world highlighted how the United States economy was inextricably linked to the global financial system. "Financial linkages had become vastly more important. The actions occurring in the financial markets were much faster. Crises or unanticipated events were far more likely to occur on the financial side," said Johnson.

Crockett's lobbying worked. In 1994 the Federal Reserve finally took up its shares in the BIS, joined the bank and appointed two directors to the board: the chairman of the Federal Reserve and the president of the New York Federal Reserve. The decision to join the board was made, noted Charles J. Siegman, a senior official in the Federal Reserve's International Finance Division, "in recognition of the increasingly important role of the BIS as the principal forum for consultation, cooperation and information exchange among central bankers and in anticipation of a broadening of that role."[21] The American decision sent a powerful signal to the world suggesting that the BIS was still relevant, necessary and could contribute to international financial stability. Two years later, in 1996, the central banks or monetary authorities of China, India, Russia, Brazil, Hong Kong, Singapore, and Saudi Arabia joined. The BIS's future was assured.

As director of the Division of International Finance, Karen Johnson attended the governors' meetings for nine years, from 1998 until her retirement in 2007, accompanying either Alan Greenspan, the chairman of the Federal Reserve or his successor, Ben Bernanke, or their deputies. Johnson successfully pushed for

the Federal Reserve to pay attention to the BIS. "The American attitude to the BIS changed because the world changed. The BIS was expanding its membership because countries in the rest of the world now mattered in ways they hadn't mattered before. The BIS went from being a Eurocentric thing to which the United States paid little attention, to something global and international. Once we took up our shares the degree to which senior members of the Fed became involved changed completely."[22]

The Federal Reserve and the New York Federal Reserve, like all visiting central banks, opened up a micro-branch in the BIS headquarters during the Basel weekends. Both had their own offices, as well as a shared extra room for staffers or other governors who might also be attending. Johnson enjoyed her trips to Basel. From Stanford University, she had joined the Federal Reserve in 1979—a rare woman in the male-dominated world of central banking. "Going to these international meetings, I was again the only woman in the room, but because I had the Fed on my nametag, that opened every door I wanted."[23]

IN JUNE 1998, four years and five months after Alexandre Lamfalussy left the BIS to set up the EMI, it was closed down—a mark of its success, rather than its failure. The European Central Bank opened for business. Seven months later, on January 1, 1999, eleven countries launched the euro. Technically, the birth of the single currency was an extraordinary achievement, justly earning the former BIS manager the title of "Father of the Euro." The euro finally replaced national currencies in January 2002. The press coverage, much of which was jubilant, focused on the benefits. These were considerable, at least in terms of convenience and ease of monetary transactions, and markedly similar to those predicted by Funk in his 1940 memo. Travelers could use the same currency from Portugal's Atlantic coast to Finland's Arctic border. So could companies trading in the Eurozone. Bank charges for European foreign currency accounts, commission on changing currencies, cumbersome record keeping, all these vanished instantly. The Stability and Growth Pact, signed in 1997, would theoretically ensure budgetary discipline and keep the currency stable. National budget deficits would not be allowed to exceed three percent of GDP.

Among the jubilation, less attention was paid to the political aspects of the single currency. Once again, the creeping removal of national sovereignty was portrayed as a fundamentally technocratic innovation, rather than a political decision—as indeed had been the case since the establishment of the European Coal and Steel Community in 1951.

When a country joined the Eurozone, its central bank automatically became part of the European System of Central Banks, whose centerpiece was the ECB. The member country surrendered control over its monetary policy, although it was represented on the ECB's Governing Council. There was logic to this: a common currency would soon go out of business if each member state were running an independent monetary fiefdom.

In London the idea of surrendering monetary sovereignty was regarded with horror. In Washington, DC, Paul Volcker took a more nuanced view. He supported the idea of a European Central Bank, but still thought, "It was a very peculiar thing to have a central bank without a government."[24] The chairman of the Federal Reserve could see the reasoning behind a single bank and currency but thought that they needed to be properly integrated with fiscal discipline. "There were negative factors as well as positive ones. Someone was always devaluing a currency. Then they would make attempts to stabilize it, and then it would fall apart. So it made sense to me to have a common currency if you are having a lot of problems. But it was too optimistic to think that the mere fact of a common currency would force discipline on individual members because they could no longer devalue their currencies."[25]

For many, it seemed that the introduction of the euro was, in part, a continuation of the Second World War by other means. The real issues were not monetary, but political. French politicians believed that the single currency would solve the German problem forever. Twice in a century Germany had laid waste to

Europe. But now that Germany was locked into the European integration project, or even shackled to it, it would neither want, nor be able to go to war again. Germany's future and prosperity would be inexorably linked to that of its most important neighbor and rival: France. Of course, national rivalries would continue, but the Germans would be part of a trans-European currency that would dilute their monetary sovereignty and finally lay the ghosts of the Second World War to rest. The French believed—erroneously as it turned out—that Berlin would no longer be able to dominate the European economy. In fact, for the Bundesbank shaped the design of the ECB, ensuring that it was focused on price stability, and retained enormous influence over the ECB's operations.

The creation of the euro was a political compromise, said Zsigmond Jarai, a former governor of the National Bank of Hungary and minister of finance. "France let Germany unify in 1989. But France was worried that a unified Germany would dominate the whole continent and would be too strong. So Paris said, OK, you can unify but without the deutschmark, and we will have the euro instead. The German accepted and also won a new market in Eastern Europe for their exports." The deutschmark was the basis of the euro, said Jarai. "The aim was to export German economic stability to France and Italy. The deutschmark was always the strong currency, and the Bundesbank was the bank that could control inflation. France and Italy were unable to do that. The aim was to use the ECB to force France and Italy to keep their money under control."[26]

The new currency, intended to symbolize a new era of European cooperation was really a means of settling old scores, said Rupert Pennant-Rea, who served as deputy governor of the Bank of England from 1993 to 1995.

> *The euro was a monstrous creation. It was driven by the politics of the Franco-German relationship, which had its obvious echo in the relationship between the Bundesbank and the Bank of France, where, on the whole, what the first did the second did immediately afterward. The French political class hated the fact that they had to dance to the Bundesbank's tunes. You could argue that, from a French point of view, the euro was little more than a way out of that continuous insult to their national pride. The French felt they were more or less equal with the Germans on most subjects, but on monetary issues they were always, always second and subservient. They hated that.*

AND FOR ALL the technical expertise supplied by Lamfalussy and his BIS-in-exile in Frankfurt, the project was doomed from the start, the British former central banker argued. "It was completely misdesigned. You should not create a monetary union of such disparate economies because it doesn't work. There were a lot of economists saying that, but the politicians said we know better, we are creating history. We have an evangelical legitimacy which you mere mortals don't understand."[27]

Why, then, did the Germans agree? The Bundesbank, said Pennant-Rea, always hated the idea of the euro, because it clearly saw that monetary union would dilute German monetary sovereignty. But Chancellor Helmut Kohl, President François Mitterrand, and Jacques Delors were fixated on their place in the history books. The loss of monetary sovereignty was a small price to pay for redesigning a continent—to a plan drawn up in Berlin as much as Paris and Brussels. "I think it was a matter of great men and their moment. This is us creating the new Europe, where all that ghastly history of the last century we can now firmly say is gone and will never return, because we have now created something utterly different. But that bore no relation to what the great majority of the German people were thinking or wanted, their leaders never tested public opinion. It was horrific."[28]

Whatever his inner doubts, Lamfalussy got on with the job of making the euro happen. The Hungarian economist was a modest and likeable person, said Pennant-Rea. "He was trying to find the truth in the economics of it. But he was working on the creation of the euro in a highly politicized environment, trying to be faithful to his economic analyses and not let the politics turn his head."

Even those more sympathetic to the project admit it was flawed from the outset. The Eurozone had two inherent flaws. First, it was not a homogeneous currency area. Uniting countries as diverse as Germany and Greece—or Italy or France for that matter—each with different cultures, histories, economic and fiscal policies, and attitudes toward the role of the state and rights to raise taxes was always going to be a hazardous enterprise, as indeed Walter Funk had predicted in 1940. Second, the Eurozone needed a credible transnational fiscal system, with rules and an enforcement mechanism, as Lamfalussy had argued. National governments in the Eurozone retained the rights to raise taxes and control their public spending, even though those decisions ultimately impacted on the other members. Thus all the Eurozone members were, in effect, held hostage to each other—with no means of controlling those outside influences.

The counter argument is that the momentum toward full union was now unstoppable. The euro was a currency whose time had come. Like Hjalmar Schacht's rentenmark that was introduced to wipe out the hyperinflation in the 1920s, or the deutschmark that was brought in to stabilize the postwar economy, the euro would work, or have to work, because enough people, especially among Europe's ruling class, believed that it would. And the euro was always about more than a common currency. The introduction of EMU, the technocrats believed, would somehow force a resolution of the euro's contradictions and then catalyse the process of full European monetary, economic and political union. "The member countries of the Eurozone and the European Union have always used somewhat narrow decisions about economic structure to try to build a broader political economy in Europe," said Malcolm Knight, who served as BIS manager from 2003 to 2008.[29]

In other words, technical decisions about financial and monetary policy have been used to introduce the supranational state by stealth—often via the BIS. The warnings about the single currency's contradictions went unheeded and Europe is now paying the price. Some of the Eurozone's problems should have been foreseen, argued Nathan Sheets, who served as head of the Federal Reserve's division of International Finance from 2008 to 2011. "When they drew up the treaties, they didn't have any B-plans. They made it impossible for somebody to leave or be expelled. There are no clear mechanisms for dealing with a country whose sovereign debt is under stress. There was an insufficient commitment to surveillance and making sure people stayed within the rules."[30] These flaws were exacerbated by the subsequent expansion of the Eurozone to seventeen members. "They started the Eurozone with a very heterogeneous group of countries and then they made it even more so by bringing in those additional countries."[31]

It was obvious from the outset that the euro could not work, said Zsigmond Jarai, who attended numerous meetings at the BIS and was well acquainted with his compatriot, Alexandre Lamfalussy. "Before the crisis, Lamfalussy told me, because it was clear to everybody, that if you have a common currency you have to have a common economic and fiscal policy from the beginning. Lamfalussy told me that the idea was they create the currency first and that will force the creation of a more common economic and fiscal policy."[32] Europe, however, is still waiting.

"I had a file six inches thick on Freddie Mac and Fannie Mae."

— William White

The BIS's decision to collect statistics on international banking activity and computerize its data repository had paid handsome dividends. The bank rapidly became one of the best-informed financial institutions in the world, especially about cross-border banking transactions and the flow of international capital. Commercial banks, including some that were domiciled in off-shore financial centers, supplied data on their assets and liabilities and foreign currency and cross-border transactions to a central banking authority—usually the national bank or its equivalent—which aggregated the data and forwarded it to the BIS. The bank then published some of the information in its *Quarterly Review*. The BIS had been designed as a bank for central banks. But agile as ever, it had remodeled itself as an essential point of reference for information on the commercial banking sector and all that flowed from that.

The *65th Annual Report*, covering 1994–1995, was 228 pages long and was a veritable encyclopedia of economic and financial statistics and indicators. It covered international trade in both the Western and developing world: monetary policy, bond markets, exchange rates, capital flows in emerging and Western markets, and developments in international financial markets. It offered summaries, analyses, and guidance, and called for greater cooperation and coordination between banks and regulatory authorities.

When William White arrived in Basel from Ottawa in 1995, he took over a highly regarded economic research department. The bank's prescriptions had remained more or less constant since Per Jacobssen had arrived in 1931 and written the first reports: tight control of credit and the need to control inflation. "If there is one thing that distinguishes the BIS way of looking at things from virtually everybody else," said White, "it is that they do put more emphasis on the bad things that can happen from excessive lending. That goes back to the 1930s and the bank's founding after the hyperinflation in Germany."[1]

The bank had warned about the excessively easy credit that was fueling the Asian economic boom during the 1990s. When the Asian debt crisis exploded in 1997 and the Thai baht collapsed and spread contagion across the region, the BIS was vindicated, although that was meager comfort. "People said the Southeast Asian debt crisis came out of nowhere and was impossible to predict," said White. "This is all nonsense. The BIS banking statistics made it very clear in the 1990s that huge amounts of money were being borrowed in foreign currencies for very short terms, then being lent out in domestic currency at much longer maturities. The Asian debt crisis was an accident waiting to happen."[2]

Knowing there was a problem, however, did not mean the bank could always persuade policymakers to take preventative or remedial measures. Just a few years later, in the early 2000s, the United States was also facing a similar potential financial meltdown. The repeal in 1999 of the Glass-Steagall Act that separated banks' deposit taking and broking activities had helped fuel a credit boom and asset bubble. Glass-Steagall had been passed in 1933 during the Great Depression. The warnings of those who said that repealing the act would trigger another cycle of boom, bust, and depression were ignored.

BIS officials were especially concerned about the Federal National Mortgage Association (FNMA), known colloquially as Fannie Mae, and the Federal Home Loan Mortgage Corporation (FHLMC), known as Freddie Mac. The two institutions were government enterprises that provided liquidity to the mortgage

system. They purchased home loans, providing the loans met their criteria, and turned them into mortgage-backed securities. Freddie and Fannie then sold the securities to outside investors and guaranteed both the principal and the interest payments. Thanks to the government's imprimatur, the system worked and remained stable.

But in the early 2000s, Wall Street worked out how to purchase and securitize mortgages without going through Freddie or Fannie. Finance houses such as Lehman Brothers and Bear Stearns bundled high-risk subprime mortgages—those granted to borrowers with a poor credit rating—into securities. The Wall Street finance houses then sold them to investors, few of whom understood the risks they were buying.

The global credit system was vastly overstretched. The BIS had repeatedly warned that excessive global credit growth, poor lending practices by commercial banks, private sector excesses and global imbalances were fueling a potential crisis. But as rivers of easy money flowed around the world, it seemed nobody was listening. BIS officials did not consider Freddie and Fannie to be a contaminant of global markets. Rather, they were a potential trigger for disaster. The central bankers needed to take notice. The place to discuss Freddie and Fannie was the BIS Committee on the Global Financial System. The committee, composed of deputy governors of central banks and other officials, was charged with analyzing and responding to stress in global financial markets. But it seemed that the central bankers did not want to talk about Freddie and Fannie. The issue was considered politically untouchable.

The United States was not the only country with powerful and risky government-sponsored enterprises —commercial companies backed by the state. France had its Caisse des dépôts et consignations, a state development and investment fund; each German state had its own bank, known as a Landesbank, and Japan offered banking services at its post office. The combination of state guarantees for commercial risks was potentially explosive, whether in Tokyo, Toulouse, or Texas. Attempts were made to get the committee to consider the whole question of government-sponsored enterprises, without focusing attention on any one country. These too, failed.

Long after he left the Bank of England, the BIS annual reports remained essential reading, said Rupert Pennant-Rea.

> *The BIS started warning about the problems with excessive credit growth, excessive interconnectedness and some of the other major frailties in the financial system back in 2003 or 2004. Everybody says nobody foresaw 2007–2008; that's not true. One organisation that did was the BIS. Not in every detail. But in terms of warning, that things were going wrong, that there was far too much debt on every sector's balance sheets, that banks were in a very dangerous interconnected area, with positions against each other and overleveraged, a lot of that is in those rather dull looking annual reports.*[3]

The work of hosting the BIS committees is less glamorous than, for example, preparing for the governors' meetings. But in the long-term the committees are at least as useful for the bank: the BIS has made itself a central, indispensable pillar of the forums dealing with the most important questions about the global financial system. Every year more than five thousand senior executives and officials from central banks and supervisory authorities travel to Basel. The bank organizes specialist gatherings on topics including monetary and financial stability, reserve management, information technology, and internal auditing. Over the years the BIS has made itself the central hub for the world's central bank governors and their staffs.

Among the bank's six committees, only the Basel Committee on Banking Supervision that deals with commercial banking supervision, usually receives media attention, as its work directly affects the public that hold their accounts in commercial banks. The aim of the Basel Committee, as it is usually known, according to the BIS website, is to "enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide."

PARADOXICALLY, THE INCREASE in globalization was highlighting national banking disparities. Not only banking supervision standards varied from country to country, but so did the definitions of capital assets. Some banks counted long-term debts and off-balance sheet items as assets, while others did not. In 1988 the Basel Committee drew up new rules, which said, in essence, that bank capital must equal at least 8 percent of its assets, including its loans and liabilities. If a bank did not have sufficient capital, it must reduce its liabilities and risk exposure. The committee has no powers of enforcement, but it does have enormous moral authority. Any bank wishing to operate on international markets must adhere to the 8 percent rule.

Basel I, as the 1998 accord is known, has continued to evolve. Basel II, published in 2004, further honed and regulated capital requirements, quantified risk, and standardized international regulations, so as not to create competitive inequality, meaning that customers search for banks with looser controls. Regulating capital requirements while leaving banks free to lend is a delicate balancing act, said William McDonough, who served as chairman of the New York Federal Reserve from 1993 to 2003, and chaired the Basel Committee from 2000 to 2003. "One recognizes that there is an inherent conflict. The avoidance of financial crises is the public good, so for that a higher capital requirement is better. On the other hand, the whole capitalist free market system works by the savings of some being transferred and made available for the investment of others. So there has to be a trade where one does the best one can."[4]

Looking back with hindsight at the economic crash of late 2007, it is clear that the capital requirements of Basel II were insufficient, said McDonough. "The aim of Basel II was to bring up capital requirements but to do so in a way that would not stifle the world economy. In the event the rules were not as strong or as fine-tuned as they needed to be when the crisis came."[5] The Basel III accords, which have not yet been implemented, aim to further hone the regulations governing banks' capital requirements.

No matter how dedicated the regulators are, they are always behind the traders. McDonough said, "We did not anticipate the blowing up of the exotic instruments that brought down Lehman Brothers and the spin effect that resulted from that. If it had been, then hopefully somebody would have tried to avoid it."[6] But the regulators, like generals, are inevitably fighting the last battle. Capital moves faster, the global economy is ever more entwined, and financial instruments are more complex. Each time a new set of rules is issued, Wall Street hires the best and brightest financial and legal brains to find a way to push compliance to new limits. Despite its legions of experts, the BIS was unable to predict or prevent the Libor scandal, when commercial banks made vast profits by manipulating interbank lending rates for their own advantage. The Basel banking accords did not deal with Libor.

For all its endorsement of good bank governance, the BIS has been criticized over its own commercial actions. The BIS's main shareholders have always been central banks, but after the bank was founded in 1930 some of the original shareholders—US, French, and Belgian banks—sold part of their holdings. At the end of 2000, almost 14 percent of the BIS's capital, 72,648 shares, was still in private hands and being traded. The BIS announced that it would buy back those shares in a compulsory re-purchase. Thanks to the BIS's legal status, the decision could not be contested. But the price could. The bank offered 16,000 Swiss francs per share.

Three shareholders refused to accept the price. It was around twice the shares' trading price but still

less than the shares would be worth if valued as a proportion of the net asset value of the bank, they argued. First Eagle Funds, a New York–based group of mutual funds, and the other two, small private investors, took the case to the Hague Arbitral Tribunal, which governs disputes with the BIS. The tribunal ruled in their favor. It said that the BIS had miscalculated the shares' value. The tribunal awarded the private shareholders an extra 7,977.56 Swiss francs per share, plus 5 percent interest, bringing the total extra to 9,052.90 Swiss francs—over 50 percent more than the original offer.[7] The decision, noted the *Central Banking Journal*, was a "humiliating rebuff" for the board of directors who had signed off on the original price, including Jean-Claude Trichet, chairman of the Federal Reserve Alan Greenspan, and the governor of the Bank of England Sir Eddie George.[8]

The problem was not the compulsory squeeze out of private shareholders, said Charles de Vaulx, then the portfolio manager of First Eagle Funds, and now chief investment officer and portfolio manager at International Value Advisers. "I could understand that it was an accident of history that the shares happened to be listed, and the bank wanted to buy them back. But the price has to be fair. A squeeze-out deal, which is compulsory, has to have higher standards. The supreme irony is that the BIS has always portrayed itself as promoting proper capital adequacy, transparency, corporate governance, all these good things, which make the world a better place. But when it came to buying back their own shares, why aren't they holding themselves up to the same standards?"[9] Andrew Crockett, the BIS's general manager from 1994 to 2003, said at the time that he believed the offer was "fair" based on the valuation by J. P. Morgan.[10]

MEANWHILE, IN FRANKFURT, the European Central Bank flourished. The ECB is now one of the world's most powerful central banks. It manages monetary policy for seventeen Eurozone members, an area that reaches from the Atlantic coast of Portugal to the Turkish frontier, and which is home to more than 330 million people.

The influence of the BIS, the ECB's parent bank, is clear. The ECB is an ultramodern, even a postmodern institution—as Paul Volcker noted—a central bank without a country or national reserves. It is the ultimate financial expression of Jean Monnet's supranational dream. But the ECB's founding ethos is firmly rooted in the Norman-Schacht era. Its structure, modus operandi, and lack of accountability mirror that of the BIS. Like the BIS, the ECB is rigorously protected by international law, in its case the Maastricht Treaty that founded the European Union.

This is partly because the ECB was always a political as much as a monetary construct, rooted in trade-offs and behind-the-scenes deals. As the most powerful central bank in Europe, the Bundesbank was extremely influential in the design of the ECB. The Bundesbank ensured that the ECB's "primary objective," as the ECB notes on its website, is to "maintain price stability" with inflation rates below 2 percent.[11] (The Federal Reserve, in contrast, has a dual mandate of combating unemployment and inflation.) "The Germans take a very narrow view of the proper role of central banks, that it is to do almost exclusively with the preservation of price stability," said William White. "That comes from their history and experience of hyperinflation."[12]

To whom then is the ECB democratically accountable? In effect, nobody. The ECB's Governing Council has direct control over the tools of monetary policy. It is prohibited from taking advice from Eurozone governments.[13] The European Parliament has no meaningful authority over the ECB. "The ECB enjoys an extraordinary amount of independence," wrote Professor Anne Sibert, an expert on bank governance, in a 2009 paper. "It has an unusual amount of target independence; its degree of operational independence is probably unprecedented; it is almost completely financially independent; it is nearly

functionally independent," meaning that the ECB has control over most instruments of monetary policy and the freedom to use them as it sees fit.[14]

The ECB does issue a press release after the monetary policy meetings of the Governing Council, detailing any changes in bank rates and the ECB's president holds a press conference. The bank also publishes a monthly bulletin. But this is the bare minimum of reporting requirements – and a long way from proper accountability. Like the BIS, the ECB keeps its inner workings secret. "The ECB lacks transparency, especially procedural transparency," noted Professor Sibert. "We do not know how decisions are reached; it appears that votes are not even taken. Press conferences are no substitute for a failure to publish minutes."[15]

The US Federal Reserve issues a press release after each meeting of the Federal Open Market Committee (FOMC). The release includes the vote of the FOMC and the views of any dissenters. After each meeting of the FOMC, the minutes of the previous meeting are released, with a detailed summary of the reasons for the policy decisions taken. The Federal Reserve is accountable to Congress. The bank's chairman appears twice a year before Congress, and before each appearance the board submits a comprehensive report. It is a meaningful, comprehensive analysis, taking in the interconnections between monetary and fiscal policy and the impact of the Federal Reserve's decisions. The Bank of England also publishes the minutes of its monetary policy meetings, with a two-week delay.

The European Parliament has passed repeated resolutions demanding that the ECB publish the minutes of the Governing Council meetings and to release a summary of the vote, without naming names. The central bank governors who are members of the ECB's governing Council use the same arguments as to why this should not happen as those advanced by BIS officials for not releasing any minutes of the governors' meetings: that they would limit the free exchange of ideas at the meeting. The minutes of the ECB Governing Council might also reveal, how despite the ECB's claim to be above national politics, the governors of member central banks can still put their home countries' interests before those of the Eurozone as a whole.

ECB officials argue that the European Parliament's lack of power over the ECB does not take into account its specific role as a unique, supranational bank. "This does not imply that the ECB might be less accountable than the other central banks . . . it merely points to specific features of the European way of holding the bank accountable."[16] The ECB says that it enjoys "input legitimacy," as an institution established through the treaty that brought the European Union into existence. However "input legitimacy" is less impressive than it may sound. As the crisis in the Eurozone has worsened the ECB's "input legitimacy" has steadily evaporated.

In a nod to democracy, it was decided that the Maastricht Treaty needed to be ratified by all twelve EU members. But only three of the signatories trusted their citizens sufficiently to hold a referendum. Perhaps the politicians anticipated the results. Denmark narrowly rejected the treaty in 1992, with 50.7 percent voting no. France stunned the federalists when just 51 percent of the population voted in favor. Only Ireland was enthusiastic, with a 68.7 percent vote. The remaining nine members delegated the vote to their parliaments, all of which approved the treaty. Denmark voted again the following year. Copenhagen negotiated four opt-outs from the treaty, including the right not to join the European Union. This time the yes vote won, with 56.7 percent.

The ongoing experience of European union seemed only to dampen its citizens' enthusiasm. In 2005 France and the Netherlands both voted no in referenda on the new European constitution, which would have replaced previous treaties and further accelerated the federalization process. European officials then stepped around this by renaming the constitution as the Lisbon Treaty and arguing that it merely amended previous treaties—thus there was no need for referenda. Only Ireland held a referendum on Lisbon, in

June 2008, when 53.4 percent voted no. After sufficient political and pressure was applied, a second referendum was held in October 2009. This time Irish voters voted yes.

The more the European politicians and officials talked of democracy, it seemed, the less the citizens of the continent were able to exercise it. But the course of events in postwar Europe had been decided decades before the ECB opened for business.

Back in October 1941, Thomas McKittrick had received an inquiry from a friend of his living in Louisville, Kentucky, asking about the plans for the postwar financial system. The BIS president replied, "People everywhere are talking about federalisation accompanied by partial abrogation of national sovereignty. . . . The extent to which national sovereignty in this direction is limited must fix the boundaries of international financial authority."[17]

For Europe at least, those bounds were now fixed, permanently, at the ECB's headquarters in the Eurotower at Willy-Brandt-Platz, in downtown Frankfurt. But despite the technocrats' best efforts, real life was proving more complicated than the bank's monetary framework for the new Europe. Germans saved; Greeks spent. Italians did not pay their taxes. The French refused to give up their six-week holidays. Germany and France both broke the Stability and Growth Pact's rules governing public debt. But some things were immutable. The ECB's price obsession, engraved in its statutes, to keep inflation below 2 percent, forced Eurozone governments to slash public services and cut public spending. That in turn reduced consumer demand, stalled economic growth, increased unemployment and triggered a slide into recession that has resulted in Europe's gravest political and economic crisis since 1945.

AS THE GLOBAL financial crisis deepened, the politesse at the BIS governors' meetings began to crack. There is no formal policy coordination at the bimonthly gatherings, but the central bankers try to harmonize their monetary policies for maximum benefit where possible. Yet, paradoxically, as the world's economy has become more globalized, central bankers are turning to local solutions. It has become clear that since the crash of 2007 the governors—who, after all, govern *national* central banks—will work to protect their countries' interests first, even if that has deleterious effects on other nations' economies.

Insiders have said that the divide between those countries that shape the global economy and those that are buffeted by decisions taken in Western capitals is now ever more evident at the Global Economy Meetings. The United States, Japan, and Britain have been injecting trillions of dollars' worth of liquidity into their economies to try and boost growth. The theory is that asset purchases known as "Quantative Easing" will boost commercial banks' balance sheets, increase liquidity, and encourage more lending, which will in turn boost spending, growth, and create jobs. At the same time, the United States, Britain, Japan, and the European Central Bank are implementing a loose monetary policy of ultralow interest rates.

This results in an outflow of hot money, chasing better returns around the world, which causes asset bubbles in the destination economies and distorts exchange rates, making currencies such as the Malaysian ringgit and the Korean won more expensive and thus affecting exports from those countries. "The disagreements on this were more pronounced," said a former central banker, who wished to remain anonymous, of the governors' meetings in late 2012. "Most of the developing countries were saying, 'We don't see that low interest rates are adding to your economic growth and at the same time it causes us problems because of the capital inflows. Our exchange rates go up and we are having real estate bubbles.'" The central bankers remain polite. "Everyone is very careful because you cannot tell other countries what to do. But the developing countries are saying, look, this is what these policies are doing to us. They are causing us problems."[18]

Much of the criticism was directed at the United States, with the main complaints coming from Southeast Asian countries and some Latin American countries. "The more successful they are, the more upset they are. This policy is creating large capital flows into these developing countries, which they don't necessarily need." The governors at the Global Economy Meeting never speak publicly about the discussions that take place inside the BIS, but similar debates are happening in other fora, where they feel less constrained. In December 2012 Glenn Stevens, the governor of the Reserve Bank of Australia, gave a speech in Bangkok that was seen as a barely veiled attack on the Federal Reserve, the Bank of Japan, and the European Central Bank. Stevens even accused the three of "exporting their weaknesses" in language unlikely to be used at a governors' dinner.[19]

But there was more optimism about the euro. "Everyone was waiting for Mario Draghi's magic touch," said the former central banker. A Greek exit from the Eurozone looked less likely. Bailout funds were being released, and Greece's fiscal targets were being relaxed. The European Stability Mechanism (ESM), the 700 billion euro rescue fund for Greece, Ireland, and Portugal, is now a permanent institution. Mario Draghi did, indeed, seem to have a "magic touch." By stating that the ECB would do "whatever it takes" to stop the euro breaking up, and by stating that the bank was ready to buy "unlimited amounts" of short-dated bonds of indebted countries provided the country met certain conditions, the bank's president reassured the markets. Spain and Italy's borrowing costs quickly fell.

Draghi's plan was a move of "genius," according to the former central banker. "The ECB says it will buy debt, but the conditions the bank has imposed make it next to impossible for it to actually make the purchase. But the market applauds them and says all the problems are solved. This is the ultimate result that a central bank can achieve. You say something, and without doing anything, without spending one cent, you totally change the market sentiment. Every central banker dreams of this. It is close to a miracle."[20]

DRAGHI WAS NOT the only central banker basking in media attention. Central bankers are now the rock stars of the financial crisis. The men—they are nearly all men—in sober suits have "achieved a new prominence and become pivotal members of the policy-making establishments of both national and intergovernmental organizations," noted a report co-authored by Ernst & Young, a financial consultancy, and the Official Monetary and Financial Institutions Forum (OMFIF), a forum for central bankers and regulators.[21] The financial crisis and the subsequent need for rapid, coordinated global responses have blurred the traditional distinction between governments' fiscal policies (taxes and public spending) and the central banks' mandate of monetary policy (interest rates and control of inflation). In many countries, central bank governors are "as well known as the government leaders they serve, and their words and deeds are the subject of heated debate in newspapers, bars, and taxicabs."[22]

When Mark Carney, the governor of the Bank of the Canada, was appointed governor of the Bank of England in November 2012, he received the kind of media coverage usually reserved for royalty and soccer players. The *Sunday Times* newspaper ran a hagiographic profile, under the headline "A Superhuman to Push the Old Lady," meaning the Old Lady of Threadneedle Street in the City of London, a synonym for the Bank of England. Carney, who is trim and photogenic, was the first foreigner to be appointed to the job since the bank was founded in 1694. The article enthused that he had "charm, talent, and [George] Clooney looks." He even had a social conscience and had made understanding noises about the Occupy Wall Street movement.[23] This winning combination brought Carney a salary package worth around $1.4 million per year, and he will enjoy a substantial expansion of powers: the bank will now have regulatory control over Britain's commercial banks and insurers.[24]

Carney is a well-known figure at the BIS. He is a member of the board, representing the Bank of Canada. He has served as chairman of the BIS Committee on the Global Financial System, which is a forum for central banks to coordinate polices on monetary and financial stability. He is also chairman of the Financial Stability Board (FSB), which coordinates international financial supervisory and regulatory policies. The BIS hosts the FSB, and insiders say it is likely to assume increasing importance, reflecting the growing mandate of central bankers. Some are now required to supervise national commercial banks, oversee risk management and national financial systems, and stand ever ready as a backstop should disaster strike. "The idea that central bankers should have a primary responsibility for financial stability, as well as price stability, was considered a pretty dramatic break with orthodox central bank thinking, especially in the United States," said Malcolm Knight.[25]

Carney's years at the BIS have brought him a priceless network of personal relationships, nurtured at the bank's dinners and lunches. These connections and the mutual trust that grows between the central bankers fostered by the BIS "matter a great deal," said Sir Mervyn King. "They bring personal trust and confidence, which is very important. Finance ministers do not have the same length of tenure and so do not get to know each other so well."

The governors' personal relationships are crucial in times of crisis. When President Kennedy was shot in 1963, Charles Coombs, of the New York Federal Reserve, was able to take immediate, decisive action to save the dollar, knowing he would be supported by his European counterparts. The same held true after the terrorist attacks on September 11, 2001. King recalled, "We can say things to each other, knowing they won't be leaked. You can do things without going through all the formalities. After 9/11, Alan Greenspan was out of the United States, and Roger Ferguson was in charge of the Federal Reserve. He and I were able to negotiate a swap agreement to supply liquidity in dollars for banks that needed them but could not get them at the Fed. The fact we could do that personally because we trusted each other enabled us to give confidence to our banks that they would be able to get dollars. That is a good example of where an informal connection can make a connection in practice, and that cannot happen unless you have had a long period of personal contact and interaction.

"Normally in that sort of situation, without that personal trust you would have to wait until all the legal details had been sorted out before you can tell someone it can go ahead, by which time it would be too late. Our ability to step in and say, 'Don't worry—it's going to be all right,' was very important."

The governors' weekends are a kind of sanctuary, says Nathan Sheets, who served as head of the Federal Reserve's division of International Finance from 2008–2011. "You are there with like-minded people, and there really is a sense of central bankers' brotherhood. At many other international meetings there is a sense of 'You Americans are doing this' and 'You Europeans are doing that.' At the BIS, the questions are what kind of challenges do we face? And how can we solve these together? Those relationships make it easy to pick up the telephone and call counterparts abroad. The governors know each other, they like each other and they know how each other think, thanks to these meetings."[26]

The BIS gatherings can bring constructive criticism, said Peter Akos Bod, a former governor of the National Bank of Hungary. "If something happened in your country, and you did or did not do something, the others raised questions. You had to face some friendly criticism if your inflation was out of line. The Bundesbank president, for example, would say, this measure that you have taken, why didn't you do that instead? And you would go home, and ask your staff, 'Why didn't we do that?'"[27]

The influence of the BIS is indirect but real, said a former central banker. "You hear things, they stick in your head, you come home, and you use them. Central banking is a very special business because you don't have competitors. If you are a car producer and you meet another car producer, you hide your cars. If you meet another central banker, you ask questions because you have a hell of a lot to learn, and he has

no reason to hide from you. From that point of view, these discussions are extremely useful."[28]

The governors' sense of common interest and their mutual trust has proved especially important during the crisis. King said, "We have adopted different forms of communication with the markets, and learned from the experience of others about what worked and what didn't work. The BIS meetings have helped us to formulate views about what we should do, and about the financial instruments we use. All the governors feel they benefit from sharing experiences, which is different from just getting documents."

Nonetheless, the governors' meetings are still dominated by a tight-knit, inner-core of the governors of the Federal Reserve, the ECB, and the Bank of England, who share decades-old connections. Ben Bernanke, Mario Draghi, and Sir Mervyn King all spent time at the Massachusetts Institute of Technology economics department. Bernanke and Draghi earned their PhDs there, while King taught there for a short time in the 1980s and shared an office with Bernanke.[29] The emphasis on status and hierarchy adds to the mystique of the BIS, said Pennant-Rea. "When you strip down the membership, only a relatively small number really matter. The United States above all, Germany and Britain to a minor extent. There is a very strong sense of pecking order."

But like all self-referential groups that rely on each other for mutual advice and reinforcement, the central bankers, cocooned in luxury and discretion at the BIS, can easily forget that they are public servants, said Andrew Hilton, the director of the Centre for the Study of Financial Innovation, a think-tank based in London. "It's a tricky one because you don't want them to be affected by day-to-day populist pressures. On the other hand, you do want them to know how much a pint of milk costs. The fine line you have to draw is between not being pressured by what's happening on the street, but also being aware of it. It's all too easy as a central banker to float over the political economy and throw bread to the masses. Central bankers should probably never be allowed to go anywhere in a limousine. They should take the Basel tram."[30]

Those central bankers who implement austerity programs do not personally suffer the consequences. Jean-Claude Trichet served as president of the ECB from 2003 to 2011. Europe's economies have slid into recession in part because of the ECB's relentless demands to keep inflation below 2 percent. Despite his role in the unfolding Eurozone crisis, Trichet is now a much sought-after speaker on the international conference circuit.

In May 2012 Trichet spoke at the Peterson Institute for International Economics in Washington, DC, offering his thoughts on the "Lessons from the Crisis." To an outsider the scene seemed an extraordinary spectacle: as Spain's economy began to collapse, neo-Nazis patrolled the streets of Athens, beating immigrants, and an entire generation of young Europeans faced years of unemployment and poverty. Trichet, however, was garlanded with praise and lauded for his insight. The French banker, said Peter G. Peterson, "played a decisive role in the Europe crisis as president of the European Central Bank until he stepped down last fall," which was indeed true, although not in the sense that Peterson intended.

The solution to the Eurozone crisis, argued Trichet, was not less supranationalism and technocratic rule, but much more. Trichet called for what he described as "a quantum leap" of economic governance, to accelerate the next stage of European integration. If a Eurozone member refused to obey instructions "coming from the center"—meaning European authorities—there should be the "activation of a federal government by exception." This policy, which even Trichet admitted would be at the "very, very, limit" of what would be acceptable, would mean that if "Your parliament is not behaving properly, we fine the country."[31]

Apparently oblivious to Europe's growing backlash against rule by technocrats, Trichet will have plenty of time to further hone his ideas for the end of national sovereignty in his new position as chairman of Bruegel, one of the foremost think tanks on European economic integration. The first president of the

ECB retired having wreaked "the sort of destruction on the European economy that hostile powers could only dream about," said Dean Baker, of the Centre for Economic and Policy Research, a liberal think tank. Trichet embodies the type of central banker who sees the economic crisis as something quite distinct from their responsibilities, said Baker. "Their job is to get inflation down, to 2 percent. The economic crisis is something bad that happened. It would have been nice if it did not happen, but it was not their responsibility, you cannot hold them accountable for it, and they don't have the tools to deal with it."[32]

Central bankers strongly reject this argument. Inflation, they say, is not a tap to be turned on and off when governments like to stimulate growth. "This is not something that you toy with," said one former central banker. "It is very easy for politicians to basically rob people of their savings by creating inflation. It is immoral, and anyway capital is much more mobile than it was ten or thirty years ago. The money will say you are creating inflation, goodbye, we are going to China or wherever, in a few seconds. It is much cleaner if we deal with the problem head on and do the painful things."[33]

Or as Stephen Cecchetti, the head of the BIS Monetary and Economic department, said, high debt levels are a "drag on growth." There can be no growth without structural repair and a gradual but credible reduction in debt levels. "As we have learned from years of experience with crises in both emerging market and advanced economies, the choice between austerity and growth is a false one. The true choice is between austerity and collapse. And that really is no choice at all."[34]

But the BIS's view is outdated. There is a choice, as even the IMF now argues.

> *"And they said, 'Come, let us build a city, and a tower with its top in the heavens, and let us make a name for ourselves, lest we be dispersed across the whole earth.'"* [1]
>
> — Genesis 11.3, The Tower of Babel

The story of the Tower of Babel is often read as a parable of the price of arrogance. Its builders started to construct the tallest building in the world, one that would reach to the very heavens as a physical manifestation of their greatness and ambition. Things ended badly.

The BIS tower, at Centralbahnplatz 2, in Basel does not reach to the heavens, but many of those working inside believe themselves possessed of a near-celestial mandate. Now seventy-three years old, the bank has evolved into one of the world's richest and most influential anachronisms. Montagu Norman's "cozy club" has sixty members. They circle the globe, from Colombia to the Philippines, Iceland to the United Arab Emirates, although the developing world remains underrepresented. The BIS employs around six hundred staff from more than fifty countries. Thousands of central bankers and their officials flock every year to the bank's numerous committees, meetings, and conferences.

Since 2007 the ongoing financial crisis has neither reduced the value of the BIS's assets nor dented its profits and prestige. The bank makes much of its money from the fees and commissions that it charges central banks for its services, such as short-term liquidity and credit, gold swaps, and by providing a range of investment opportunities and instruments. The BIS is a much sought after commercial partner. Its record is solid and conservative, its credit rating superb. In Basel at least, the crisis has, overall, been good for business. For the financial year ending in March 2009 the bank made net, tax-free, profits of 446.1 million Special Drawing Rights, the equivalent of around $650 million.[2] Its total equity was valued at the equivalent of almost $20 billion.[3] By the end of March 2012, profits had nearly doubled, to the equivalent of around $1.17 billion—almost $100 million a month—and the bank's total equity had increased by 40 percent to around $28 billion.[4] These are extraordinary sums for a single financial institution with just 140 clients and two local offices, in Mexico City and Hong Kong.

Even at a time when the IMF, not usually an advocate of generous public spending, has warned publicly and repeatedly against excessive austerity, at the BIS the legacy of Hjalmar Schacht, Montagu Norman, and Per Jacobssen endures.[5] The bank's managers regularly warn against the dangers of excessive lending and inflation. Austerity is seen as a necessary medicine, no matter how unpleasant its consequences. Such warnings are listened to.

The bank's influence is profound: the BIS is one of the world's most effective instruments of soft power. The bimonthly governors' meeting gathers central bankers from countries that control more than four-fifths of the world's GDP. The discussions at the Basel weekends have shaped the debate about the global financial crisis and the world's response to it. The committees hosted at the BIS are rebuilding the world's financial architecture and coordinating regulatory and supervisory policies. The Basel Committee on Banking Supervision oversees the capital requirement of commercial banks. Its work, wrote Ezra Klein, a columnist for the *Washington Post*, "will shape the future of global finance, and, by extension, the economy." Klein awarded the committee the title of the "Most Obscure-Yet-Important Regulatory Agency of the Year," noting, "its actions may only rarely make the front pages, but the work

done in Basel is crucial to creating a more stable world economy."[6] "Obscure yet important" surely brought knowing looks and quiet smiles at the BIS headquarters.

The bank's annual reports are regarded as essential reading in the world's treasuries and governments. The head of the bank's Monetary and Economic Department, who writes and oversees the annual reports, is one of the world's best read and most influential financial and economic analysts and commentators. The BIS hosts one of the world's largest restricted databases of banking information. Its mainframe computers sweep up data about the flow of transnational finance, including money flows in and out of offshore domiciles. Such information is of great interest to governments. Three months after 9/11 the Basel Committee on Banking Supervision hosted a meeting to coordinate central banks' and regulatory authorities' strategies on the prevention of terrorist financing and the sharing of records to prevent terrorist financing.[7]

The Financial Stability Board, hosted at the BIS, is likely to become the fourth pillar of the global financial system, after the BIS itself, the IMF, and the World Bank. The FSB coordinates national financial authorities and regulators. Its members include the Federal Reserve, the ECB, the Bank of England, and the national banks of China, Saudi Arabia, Switzerland, Russia, Japan, and Korea. The IMF, the World Bank, the European Commission, and the BIS itself are also members of the FSB, as are three of the most powerful committees hosted at the BIS: the Basel Committee on Banking Supervision, the Committee on the Global Financial System, and the committee dealing with payment and settlement systems. The writer Matt Taibbi once memorably described Goldman Sachs, the giant investment bank, as a "vampire squid."[8] The BIS is now the vampire squid of the regulatory world, hosting a myriad of committees that in turn spawn a raft of subcommittees, many of which are composed of the same central bankers and officials, each producing reams of reports that are passed back and forth from Basel to national central banks and governments in an endless merry-go-round of resolutions and recommendations.

Others argue that the answer to the banking crisis is not more insider committees and regulatory bodies hosted at the BIS, or anywhere else, but much less, or none at all. "Banking should become a normal industry, like manufacturing bicycles," said Andrew Hilton, of the Centre for the Study of Financial Innovation. "Banking should be regulated to protect against fraud, to protect consumers, and to protect the banks' integrity, but nothing else. That sounds crazy because everyone says that banking is special. Banking is only special because the sums of money flowing through these institutions are so large they can bring society down. If the banks were smaller, if they did simpler things and they were not a systemic threat, either individually or within a cluster, you would not have to regulate them. The banks would take out insurance and the system would be protected."[9]

Such views are regarded with horror in Basel. Yet, the heart of the matter is that BIS is an opaque, elitist, and anti-democratic institution, out of step with the twenty-first century. The BIS should have been closed down in the early 1930s, after the collapse of the German reparations program. Instead it funded the Holocaust and the Nazi war machine. Its staff members, such as Thomas McKittrick and Per Jacobssen, passed vital economic intelligence to the Nazis—often with the knowledge of the Allied authorities. The bank embodied the most cynical kind of capitalism. While millions died, it kept financial channels open across the frontlines.

After 1945 the BIS and its allied committees shaped much of the postwar financial world. Behind the scenes the BIS provided the necessary financial mechanisms, support, and technical expertise for the financial aspects of the Euro-integrationist project. Without the BIS the euro would not exist. The BIS gave birth to the European Central Bank, a bank that is accountable neither to the European Parliament nor to any government, even though it controls the monetary policy of seventeen countries. The BIS has

survived through the decades just as it was born—by opacity, secrecy, and by hiding behind a carapace of legal immunities. These protections perpetuate the technocrats' belief that a tiny, self-selecting elite, unaccountable to everyday citizens, should manage global finance. The BIS's privileges are a hangover from a thankfully vanished age of deference to authority, at least in the developed world.

Andrew Crockett, the bank's general manager from 1994 to 2003, did peel back some of the bank's obsessive secrecy. When the BIS was drawn into the torrent of revelations about Swiss banks, looted gold, and collaboration with the Nazis that erupted in 1996–1997, Crockett opened up the bank's wartime archives. It was a sensible decision and a boon for historians and investigators. "Our view was that if anyone had done anything bad it was a long time ago, so there was nothing in it for us to hide it. We decided that the only answer was complete transparency," recalled William White.[10] The bank spent two hundred thousand Swiss francs on specialized computers to digitize and microfilm the records, which had been neglected for decades, and hired a specialist historian, Piet Clement. (Crockett also made himself available for interview on the BIS's wartime record and spoke at length to the author, which is included in the author's 1998 work *Hitler's Secret Bankers: The Myth of Swiss Neutrality During the Holocaust*.) The bank's archives, which are open under the thirty-year rule, are a valuable resource for historians.

But the BIS is far less forthcoming about its present-day governance. The bank's annual reports and other documents are available on its website, and it has a Twitter feed: @bis_org. In February 2013, it had more than thirteen thousand followers. The bank often tweets several times a day, with links to speeches by central bankers as well as studies and working papers published by the bank, thus providing a continuous update to the documents available on the bank's website. But this information is already in the public domain. Information about the bank's internal operations, such as the agenda and themes of the governors' meetings, the elite Economic Consultative Committee, or the attendance list, and the transactions the BIS carries out with the public funds held by central banks whose reserves it manages are not tweeted and nor, at least for the foreseeable future, are they ever likely to be. Rather, the emphasis remains firmly on confidentiality. When the author asked Stephen Cecchetti, the bank's economic adviser, about the high level of secrecy around the governors' meetings and the BIS's activities, he replied, "Banks have confidentiality agreements that bind them not to disclose information about their customers. In the conduct of its banking business, the BIS strives to exceed best practice in its customer relationships."[11]

There is usually no press conference or press statement after the governors' meetings, but the BIS has for years held a press conference after the Annual General Meeting and the release of the annual report. The 2011 gathering, which can be viewed online, was a low-key, even desultory affair.[12] Jaime Caruana, the general manager, read a prepared statement. He and Cecchetti then invited questions from the handful of journalists present. There were four questions: three about the work of the Basel Committee and one about monetary policy. Cecchetti did not speak. The press conference lasted seventeen minutes. The journalists were specialist correspondents. There was no press conference in 2012. The journalists covering the BIS told the bank it was not necessary as the bank releases the annual report with a long embargo and also organizes a teleconference. Had there been a press conference in 2012, a general reporter would have honed in on a much stronger story—one which raises profound questions about the bank's tradition of secrecy, its legal immunities and their implications for the bank's future.

IN 1991 ARGENTINA went bust and defaulted on almost $81 billion worth of debts. The Argentine government eventually offered creditors thirty-five cents on the dollar—previously bankrupt countries had offered fifty to sixty cents. Nonetheless, by 2010 93 percent of creditors had accepted the offer. The

remainder, however, were still holding out, demanding a higher payout for their $6 billion worth of debt, including accrued interest. The two main groups are around sixty thousand people in Italy, some of whom bought Argentine bonds to fund their retirement, and a pair of investment funds—Elliott Management and an affiliate, NML Capital—known as "vulture funds," which chase countries in default and which bought many of the bonds in secondary markets. Elliott has chased the Argentine central bank through the American courts. The Italian bondholders are fighting their case at the International Centre for Investment Disputes, which is part of the World Bank group. Both the funds and the Italian investors have won several legal victories.[13]

However, the Argentine central bank has shipped a substantial part of its reserves to the BIS, where the monies are out of the creditors' reach. The funds are now suing the BIS and drawing unwelcome attention to the bank's hyper-privileged legal immunities. The funds allege that the BIS has allowed the Argentine central bank to store between 80 and 90 percent of its $48 billion in foreign reserves in Basel (most central banks keep a small proportion of their reserves there). Lisa Weekes, the bank's head of press, declined to answer detailed questions from the author in December 2012 about the Argentine reserves but pointed to a letter she had published in the *Wall Street Journal* in July 2011.[14]

Weekes confirmed in that letter that the Argentine central bank holds an account at the BIS. The BIS will not disclose the actual sum deposited by the Argentine central bank, citing client confidentiality, but said that the figure of around $40 billion is "grossly overstated." The letter noted that the Swiss Federal Tribunal, Switzerland's highest court, rejected the funds' action and upheld the BIS's immunities, noting that "accepting central banks' deposits is part of the BIS's mission, enabling it to fulfill its statutory function as an international settlement hub for central banks." The BIS, wrote Weekes, like other international organizations, is "protected by immunities that that allow it to carry out its functions in the public interest."

The definition of "public interest," however, looks rather different to the holders of Argentine bonds. The Argentine BIS deposits are a "clear deviation of the bank's standards," wrote Claudio Loser, a former director of the Western Hemisphere Department of the IMF. "The BIS has a serious conflict of interest: it is playing the interests of one national depositor against the interests of many others."[15] In December 2012 the Swiss Federal Council (the Swiss federal government) confirmed that the funds cannot sequester any of the Argentine deposits held at the BIS. The council ruled that there had been no abuse of immunity of the 1987 headquarters agreement between the BIS and the Swiss Federal Council, which governs the bank's legal statues and immunities.

So for now, at least, the BIS seems to have won the battle over the Argentine reserves. But the wider questions remain. What if other countries seek to use the bank as a refuge from their creditors? "Argentina is a big question for the bank," says one former BIS official. "Is the government depositing with the BIS because it is a good place to put its money, or because its deposits are immune and the BIS cannot be sued and forced to surrender them?"[16] The BIS has also helped to repatriate looted money. After the death of the Nigerian dictator Sani Abacha in 1998, the Nigerian authorities pursued hundreds of millions of dollars that had been looted and deposited in Swiss banks. In 2004 the Swiss authorities ordered that almost $500 million be transferred from Swiss banks to a holding account at the BIS for Nigeria, before being transferred to the country's central bank.

The Argentine reserves and the Nigerian looted assets highlight how the BIS's immunities are a double-edged sword: they arguably provide safe haven for a country fleeing its creditors but also ensure that the BIS is the bank of choice for diplomatically sensitive transactions such as the return of looted assets. "It's very important that an institution that is mainly dealing with the central banks of sovereign countries should have full immunity in its financial transactions from the jurisdiction of national legal

systems, as do the IMF and World Bank," said Malcolm Knight.[17] Every country dealing with the BIS should be required to sign a single, consistent agreement similar to that required by the IMF, that would provide immunities for all the financial transactions of the BIS with residents of that country, as well as other immunities necessary for the operation of an official international institution, such as immunities for its staff while traveling, said the former BIS general manager.

The BIS "has not become a refuge in any sense at all," said King.

> *It's very important that in the future sovereign debt issues will not lead a sovereign debtor into a position where it can be exploited by a small minority of creditors who will not go along with the restructuring. The BIS is not special in this debate. This is a much broader debate about how we deal with sovereign debt restructuring. Should creditors such as vulture funds be able to buy their way into sovereign debt and then try and extract a position that is much more favorable to themselves than any other creditor? In the future, sovereign debt should be issued with "collective action clauses" to prevent such holding out behavior, but in a way that is part of the legal rules of the game. The BIS is no different to the IMF or any other international body that has a degree of legal exemption.*[18]

The bank's belief that it should be so rigorously protected embodies its central contradiction: that it is shaping the regulatory future of global finance and calls for good governance, yet its own affairs are kept firmly hidden behind a thicket of legal immunities and protections.

THE BIS PROGRESSES through the twentieth-first century with ever more confidence, even though there is no need for it to exist. Its banking services could be carried out by commercial banks, which would be legally bound to observe the necessary confidentiality to prevent market speculation on the central banks' interventions. Its research department and its databases could be relocated to any decent university. Its famed hospitality could be easily replicated in any number of luxury hotels or conference centers. The committees hosted by the BIS that regulate banking and the international financial system could be relocated to the IMF or housed in a new think tank, with open and transparent governance. Breaking down the bank into its constituent parts would help democratize global finance.

Yet the bank is not worried. It has powerful friends, who, it believes, will ensure its inviolability and survival. The Swiss Federal Council, the governing body of the country where the bank is based, has strongly re-affirmed its commitments to the BIS's legal inviolability. The board of directors, which manages the bank's affairs, reads like a who's who of the world's most powerful central bankers. It includes Ben Bernanke, Sir Mervyn King, Mark Carney, Mario Draghi, Jens Weidemann of the Bundesbank, and Zhou Xiaochuan of the Bank of China. The bank's management can reach any one of these with a telephone call, knowing that the governors will make time for them.

The bank's collective memory is reassuring too: in 1945, the BIS outmaneuvered powerful enemies, such as Henry Morgenthau, the US Treasury secretary who wanted the bank to be closed down for collaborating with the Nazis. Whatever legal or political travails may lie ahead, such as the breakup of the Eurozone, a deepening of the financial crisis, or even a new war, banking insiders say there will always be a need for a financial intermediary operating across the lines and behind the scenes.

The BIS helped give birth to the euro and will also be ready to step in should it fail. If the euro crisis worsens and the single currency breaks up, the BIS's expertise will be deemed essential to ensure that the fallout is contained. In early 2013, as this book went to press, there were signs that the Bundesbank,

which had been forced against its will to adopt the single currency, was now placing its faith in the oldest store of value of all: gold. The Bundesbank announced that it plans to repatriate 300 tons of the gold it holds in the vaults of the New York Federal Reserve. Germany stores more than two-thirds of its gold reserves, which are worth $183 billion, in New York, Paris, and London. All 374 tons will be removed from Paris, although the German holdings will stay in at the Bank of England.

The decision to move the gold out of Paris but leave it in London was immediately interpreted as a loss of faith in the euro and the supranational project. As the Eurozone and European superstate project totters, gold mania is sweeping through Germany. Humanity's favorite store of value is seen as a safer bet than a currency barely a decade old. In 2012 the German state auditing agency demanded that the Bundesbank carry out an inventory of all German gold stored abroad. Bundesbank officials said that they personally checked all the holdings, which were accounted for. The gold mania would seem very familiar to Hjalmar Schacht and Montagu Norman. Folk memories run deep, especially in Germany, which has twice faced economic meltdown in the last century—in 1918 and 1945. The much-vaunted German economic miracle was always rooted in massive injections of foreign capital, by Wall Street in the 1920s and by the United States government after 1945. Such largesse is unlikely to be repeated nowadays. If the euro collapses, gold is a safer bet than hoping for another transatlantic bailout.

The new emphasis on gold can only be good news for the BIS, and is a return to the bank's roots. As Gianni Toniolo, the author of the BIS official history, notes, the gold standard—fixing the value of a currency to a weight of gold—was "embedded in the very DNA" of the BIS.[19] The gold standard is long gone, but gold prices continue to rise, and gold still has a powerful hold over investors' psyches. It is certainly ever more central to the BIS's banking operations, so much so that the *Financial Times* has described the bank as "the ultimate bullion pawnbroker."[20] The BIS 2012 annual report revealed that the bank holds 355 metric tons of gold (worth almost $19 billion) in connection with its gold swap contracts, meaning that the bank exchanges currencies for gold, which it returns at the end of the contract.[21]

The BIS would be an essential part of any rescue operation if the euro fell apart, said Rudi Bogni, a veteran international banker. "The BIS could certainly help technically; it has the skills required for any intervention in the markets, should it be required." The BIS could also prove useful in darker scenarios, such a major new war. And it certainly has extensive experience of keeping financial channels open between warring parties. In the modern, globalized economy, preserving those links would be judged even more important than in the Second World War. "When people start shooting at each rather than talking to each other, the economies and trade still continue. There is always an interest that is bigger than war," said Bogni. "Even in death you have financial interests that continue after the death of the individual. So in a war where the parties are not dead, they will want to continue those interests after the war."[22] Basel would doubtless, once more, be the place of choice to keep those channels open.

Yet the second decade of the twenty-first century could yet turn out to be the most challenging, even perilous, for the bank. The bank has profited immeasurably from the rapid pace of globalization and economic development and will further do so as new members join from the developing world, all eager to profit from the BIS's expertise and banking services. "There are many emerging market economies for whom the BIS banking operations have real value," said King. "They would feel they would lose something without a bank for central banks."[23]

But the ongoing financial crisis has changed more than banks' balance sheets. Citizens and activists around the world are demanding accountability and transparency from banks and financial institutions. Yet, most have never heard of the BIS, an information deficit that this book has hopefully filled. The bank's management views the BIS's legal inviolability, which is protected—like that of the United Nations and the European Central Bank—by international treaties, as its greatest strength and believes the

BIS to be protected in perpetuity. Yet the bank's statutes, written in 1930 for another age, of deference and obedience, may turn out to be its Achilles heel.

The question of the Argentinian reserves raises profound questions about the BIS's legal inviolability. The BIS's immunities could soon be tested again. By early 2013 most observers expected Greece to renegotiate its sovereign debt, which would demand that investors holding Greek bonds would have to take a "haircut" and write off some of the value of their holdings. What would happen, then, if Greece, like Argentina, shifted its foreign reserves to the BIS to avoid angry creditors? If Greece followed Argentina, perceptions of the bank will shift. The BIS's claims of moral probity and of acting in the "public interest" will start to appear decidedly shoddy. For now, the bank has the protection and support of the Swiss courts and the Federal Council. But even in the land of the anonymous, numbered account, public—and legal—opinion is shifting about the country's reputation as a refuge for those seeking legal inviolability. Switzerland is under sustained pressure from the US and European authorities to ease its secrecy and guarantees of anonymity.

As long as Argentine foreign reserves remain out of the creditors' reach, the BIS sets a unsettling precedent: that if a BIS member country defaults, or is about to, it could ship its national reserves to Basel for safekeeping. There are the beginnings here of uncomfortable—for the BIS—parallels with the 1930s and '40s. In March 1939 Montagu Norman, one of the bank's founders and most powerful directors, and Johan Beyen, the BIS's president, refused to stop an order from the National Bank of Czechoslovakia to transfer some of its gold holdings from its BIS subaccount at the Bank of England to the Reichsbank BIS subaccount. It was obvious that the transfer order, given after the Nazis had invaded Czechoslovakia, had been issued under duress. Yet Norman deliberately took the view that the interests of the BIS and the new, transnational financial system were more important than refusing, or even delaying the request. Beyen went along with this decision. The gold was credited to the Reichsbank's account. During the Second World War years, the bank acted as a depositary for looted Nazi gold, even though Thomas McKittrick, the president, was specifically warned that the gold might be stolen. He believed that the bank had no business asking where the gold came from and was anyway protected by its statutes. But even with its powerful allies, the bank still had to fight hard to escape being closed down because of its acceptance of looted gold.

For now, the BIS's statutes and the support of the Swiss legal system ensure that its reserves are untouchable. But laws—and treaties founding international banks—are made in a political context and can be changed. Legal and political pressure could mount. The change in perception of the bank is already happening. Influential analysts and economists, such as Claudio Loser, cited above, are questioning the bank's ethics, behavior, and legal inviolability. In the age of Twitter and Facebook, the BIS, once its central role and importance is known, could yet find itself at the center of a global firestorm.

The BIS's assets may remain untouchable, but as more activists understand the bank's role in the global financial system, its secrecy and elitism, they will increasingly question its operations, role, and need to exist. Such a shift in global perception of the BIS, and the demands to make it more accountable, will bring pressure on politicians, which will then be passed on to the central bank governors, who are independent but still appointed by governments. The controversy over the Argentine reserves could, in turn, corrode the basis of the bank's soft power: its regulation and supervisory frameworks. Commercial banks, might, for example, ask why they should adhere to the Basel Committee's banking rules, when the host bank itself is arguably protecting a central bank against its creditors?

For now, at least, the BIS can rely on its powerful friends. But if the political climate continues shifting toward transparency and accountability, the bank's managers may find that their calls take longer to be returned and are briefer in duration. The bank needs to reform in three areas to ensure its survival:

transparency, accountability, and corporate social responsibility.

The first is the simplest. The BIS should hold a press conference after the bimonthly governors' weekends and make it available on the Internet. The bank should publish the attendance list and the broad themes of discussion at the weekend meetings, in particular of the elite Economic Consultative Committee that meets for dinner on Sunday evenings; the Global Economy Meeting the next day, the BIS directors' meeting that deals with the bank's governance, and deliberations of the Markets Committee, which deals with the international financial markets.

The BIS and the central bankers argue that such a move would inhibit discussion. King said,

> *The BIS has moved quite a long way to being open about the state of its finances, its legal position, its board membership, and how it works. The membership of the BIS is well known, and from that you can infer that the governors of the member countries will come to the meetings. The themes and subjects of discussion are of value solely because they are confidential. I would contrast the BIS meetings with the G20 and the IMF where communiqués are published, which purport to be transparent and report what is said. But the expectation of publication constrains useful discussion.*
>
> *The whole point of the BIS conversations is that they are private and are confidential. There has to be a role for private conversations for them to be useful. You cannot have every conversation between central bank governors being minuted and reported. Then there are no useful conversations, simply people making public statements at each other.*
>
> *We don't do deals at Basel. It is too strong to say that this is coordination or harmonization as responsibility, for policy making remains with national central bank committees. The BIS meetings do make us much better informed about why people have done various things and maybe what they intend to do in the future.*[24]

It is true that central bankers do need to be able to speak freely to one another. But there is no need to put a camera in the room and post the video on YouTube or even release a transcript. But the bank should publish minutes: the broad themes of discussion, the lines of debate, and the overall conclusions of the meetings. All the central bankers and officials present at the governors' meetings are public servants, charged with managing national reserves, which are public money. The central bankers are accountable to the citizens who pay their salaries and pensions. It is no longer acceptable for them to gather in a secretive cabal and refuse to release even minimal details of their meetings. The US Federal Reserve is a useful model here. Before each meeting of the Federal Open Markets Committee, the bank releases edited minutes of the previous meeting. The Federal Reserve's website already carries detailed information about which bank officials are attending the BIS weekends and their hour by hour itinerary while in Basel. Neither the Federal Reserve nor the dollar nor even the BIS have collapsed as a result.

Central bankers argue that the comparison is not valid as the BIS is not a decision-making body. King said, "We publish minutes at the Bank of England because we take a formal decision that we have been mandated to take by the UK government. There are no formal decisions like that taken at the BIS. If the BIS was taking interest rate decisions, it would be right to have that degree of transparency. We don't generate decisions at the BIS. We have informal discussions, then we go home and we take our decisions."[25]

Secondly, the BIS should be stripped of its legal inviolability. The BIS is a bizarre hybrid—an extremely profitable commercial banking operation protected by international treaty. Its founding statutes

are certainly out of step with the modern age. The statutes provide unnecessary levels of legal protection for a bank dealing in public funds, and they warp the psychology of the BIS. They fuel the peculiar arrogance of much of its senior management. The bank claims to have a mission of public service, yet is structured in such a way that the public is kept as distant as possible, behind the bank's wall of legal immunities. Such a change would demand an Extraordinary General Meeting (EGM). There is a precedent here. In recent years, EGMs were called to change the bank's unit of account from the gold franc to the Special Drawing Right, to forcibly buy back the shares held in private hands, and to distribute the shares held by the former Yugoslavia to its successor states. Voting is decided at EGMs by member central banks. If the governors and officials of the member central banks were mandated by their national governments to vote for the change and modernization, the bank would have to accede to the changes.

Thirdly, such an EGM could also mandate the bank to spend some of its profits on corporate social responsibility and philanthropy. The bank has for decades reaped rich rewards of its stewardship of public funds. In the financial year 2011–2012 the BIS made tax-free profits of almost $100 million each month. It is time to return some of those profits to a wider society, beyond the annual dividends paid to the central bank shareholders. The bank refused to answer questions from the author on how much it spends on charity and philanthropic projects. The words "philanthropy" and "charity" do not appear in the 2011–2012 annual report. Lisa Weekes, the bank's head of press, said that as most of the bank's staff live in or near Basel, the BIS provides "modest financial support for selected initiatives or institutions within the Basel region . . . with a social or cultural purpose."[26] The bank also makes ad hoc donations in response to major natural disasters, such as for the typhoon victims in the Philippines in December 2012, but refuses to say how much.

This is feeble. It is time for the BIS's much-vaunted globalism to extend to its social conscience. The bank should set up a charitable foundation—George Soros's Open Society Institute could be one model—to support global training, education, internship, and development programs for young business people and bankers. One day's worth of annual profit—$3.2 million—would be enough to kick-start such a program, which with the BIS's imprimatur would soon attract corporate sponsorship. The bank's staff could be encouraged to contribute, in lieu of the income tax they are spared. The foundation should be given a block of shares to ensure that civil society has a vote at the bank's annual general meeting. A group of real people at the meeting, outside the charmed circle of the central bankers and their officials, would provide a useful and refreshing reminder that the central bankers' policies and decisions, and those of the BIS, have consequences in the outside world.

Central bankers counter that the BIS already gives something back to society through its numerous seminars and meetings, and by hosting the Financial Stability Institute, which was set up by the BIS and the Basel Committee on Banking Supervision in 1999 to work with financial sector supervisors. King said,

> *They do a lot of good work in providing opportunities for smaller members of the BIS to come and learn. There is an informal workshop about governance and the challenges of running a central bank, and smaller members of the BIS have found this of immense value. They belong to a club where they have a chance to quiz their central bank colleagues. At home there was no one to ask for advice. That kind of exchange is invaluable. That is the BIS using the resources of bigger countries to put something back into emerging markets and developing countries.*[27]

There are small but encouraging signs that some central bankers understand that with great financial power comes social responsibility. In October 2012, Andrew Haldane, executive director for financial stability at the Bank of England, gave a speech on "Socially Useful Banking" at a meeting hosted by Occupy Economics, the London branch of the social protest movement.[28] The Occupy movement, he said, had helped trigger the first stages of a "reformation of finance." Policymakers were listening to criticism and were acting to close the "fault lines" in the global financial system. "Occupy has been successful in its efforts to popularize the problems of the global financial system for one very simple reason: they are right." Over the years, there had been a "great sucking sound" as "people and monies" were drawn into banking, especially investment banking, draining human and financial resources from the rest of the economy. Even the BIS agrees. Haldane quoted recent research by the bank, which found that when the financial sector reaches a certain level it impedes growth because the financial sector competes with other parts of the economy for scarce resources. "More finance is definitely not always better," wrote Stephen Cecchetti and Enisse Kharroubi.[29]

WHAT THEN DOES the future hold for the BIS? Over the decades, from the Schacht-Norman era, through the Second World War and the birth of the euro, to the present-day jamboree of regulatory committees, the bank has demonstrated an extraordinary ability to make itself essential to the times, repeatedly jettisoning its historical baggage and re-inventing itself to preserve its central place at the heart of the global financial system.

Keenly aware of the growing global hostility toward bankers, the BIS now emphasizes its status as an international organization and its contribution to the common good. This is certainly an effective recruiting tool. "The quality of the people working at the BIS is very high," said King. "It helps, when recruiting really good individuals, to say this is an international institution for which you work, not just a think tank. People like to feel they are working in public service."[30]

But the bank's latest evolution, into a socially responsible institution, may prove the most difficult. Secrecy, opacity, and unaccountability—like gold—are embedded in the bank's DNA. The bank will find it difficult to adjust to the new demands, outlined by Andrew Haldane, that financial institutions be accountable and socially responsible. Yet to survive, it will have to. In an age when information flows as fast as capital, when citizens demand ever more transparency and accountability from the institutions that have power over their lives, when even Wall Street can be occupied for weeks, the Tower of Basel is no longer inviolable.

Unlike its biblical predecessor, the Tower of Basel reaches only eighteen stories above the city skyline. But the fate of the biblical tower-builders should give the bankers pause. For when God saw their work, he confounded their speech and introduced a multitude of tongues. The builders could no longer understand one another. The construction work stopped, they were dispersed, and their tower vanished into history.

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20. Keynes to Morgenthau, July 19, 1944. FRDML. Author's collection.
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22. Toniolo, 271.
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24. Orvis Schmidt to Henry Morgenthau, March 23, 1945, FDRML. Reel 241, Book 831, 328–333.
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— CHASING —

GOLDMAN SACHS

HOW THE MASTERS OF THE UNIVERSE MELTED WALL STREET DOWN . . . AND WHY THEY'LL TAKE US TO THE BRINK AGAIN

SUZANNE MCGEE

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FOREWORD

We think we're number one, but we'll leave that for others to decide." Back in 1983, when John Whitehead, then cochairman of Goldman Sachs & Co. made that statement to a reporter from New York magazine, the investment bank was already well on the way to becoming one of Wall Street's iconic firms. Its bankers proclaimed that they were "long-term greedy"; the denizens of Goldman weren't the type, they declared regally, to try to capture every fraction of a penny of fees and profits, particularly if there was even a question that they might be doing so at the expense of a client relationship. Goldman Sachs even felt itself to be above some businesses—no advising hostile bidders on takeover strategies, for instance; that was far too messy. Then there were some potential clients that a Goldman Sachs banker didn't want to be seen lunching with, much less transacting business with. Goldman's clients were the crème de la crème; preserving the firm's name and reputation by choosing who to deal with and what deals to do was more critical than grabbing at an extra few thousand dollars in fees.

Occasionally, something unpleasant would happen to remind Goldman bankers of the solid business reasons behind those lofty principles, such as the firm's brief but damaging relationship with Robert Maxwell. Many Goldman partners had felt skittish about accepting the media tycoon as a client; his checkered past included his being dubbed by a British government inquiry as "not a person who can be relied on to exercise proper stewardship" of a public company. But the allure of earning big fees overrode those concerns —that is, until Maxwell vanished off his yacht into the sea near the Canary Islands and a new investigation revealed that he had looted a billion pounds from his employees' pension funds. British regulators hit Goldman with a fine for its role in the fiasco in 1993; the size of the fine was somewhat less important than the public humiliation, however. Partners vowed that never again would Goldman Sachs be named and shamed in such a manner.

And yet, in the summer of 2010, Robert Khuzami, head of the enforcement division of the Securities and Exchange Commission, stood triumphantly in front of a group of reporters and an array of television cameras broadcasting his words globally. He announced that Goldman Sachs had agreed to pay a fine of $550 million—the largest penalty the SEC had ever imposed on a Wall Street firm—to settle a civil fraud case the agency had filed only months earlier. But Khuzami and the SEC had won more than their $300 million share of that settlement: Goldman had agreed to acknowledge publicly that the "fundamental basis" of the agency's lawsuit was accurate. Goldman had failed to live up to its own standards and disclose everything that German bank IKB might have wanted to know about the mortgage securities deal, dubbed Abacus, that lay at the heart of the suit. Specifically, the SEC had claimed Goldman hadn't fully explained to IKB and other potential investors buying the Abacus package of synthetic mortgage-based securities that hedge fund manager John Paulson had played a key role selecting the specific securities in that transaction—indeed, that the deal was being done at his initiative because he wanted to find a way to profit from what he expected would be a big decline in the value of the securities he chose. That's precisely what happened: Paulson walked away a billion dollars richer, while IKB became one of the first financial institutions to fall victim to the global financial crisis and require a bailout.

Goldman Sachs, the envy of Wall Street, now found itself under scrutiny for all the wrong reasons. Instead of its peers and rivals trying to figure out what it was doing to earn the astonishing rates of return it delivered like clockwork to its investors, regulators and legislators were putting its business under a microscope. To insiders, it seemed as if everything for which Goldman was once famous and lauded—its creativity in devising and structuring new products; its risk management prowess; the market insight displayed by traders deploying the firm's own capital to generate returns; the firm's ability to develop relationships with power players in Washington as well as on Wall Street—now rendered it infamous. Suddenly, everyone was asking what Goldman Sachs had

done to earn the gargantuan profits in recent years; profits that had left other Wall Street CEOs green-eyed with envy and fuming at their own inability to measure up.

But this book—conceived in early 2008, as Bear Stearns collapsed and Wall Street waited, holding its breath, for the next shoe to fall—is not the story of the transformation of Goldman Sachs from Wall Street's most envied to its most reviled power. Rather, it's the tale of the ways in which Goldman and the other Wall Street firms that sought to emulate its success underwent a fundamental transformation, and the impact of those changes for Wall Street, its clients, and the financial system as a whole. That transformation—which led to Wall Street being run solely in the interests of Wall Street entities themselves, with clients now viewed as counterparties—paved the way for the financial crisis whose ripple effects continue to reverberate on both Wall Street and Main Street. For the latter—indeed, for most of us—Wall Street's value lies in its role as a financial utility or intermediary. But as the financial results of Goldman and its rivals demonstrated all too clearly, that's not where the profit lay. And ever-bigger profits were what Wall Street's own investors—the shareholders who bought stock in Goldman Sachs, Merrill Lynch, Lehman Brothers, and other firms—demanded, loud and clear.

The SEC's fraud lawsuit against Goldman Sachs simply made public what many Wall Street insiders had long known: clients need to be able to look out for themselves. Wall Street firms are dealing cards from the bottom of the deck to their friends, while saving the low-value cards for other clients. In case there was any doubt of what Goldman bankers really thought of the deals they were taking to their clients, investigators rapidly made public a series of embarrassing e-mails and other documents. In one, top Goldman banker Tom Montag wrote of another mortgage-backed securities transaction—Timberwolf—that it was "one shitty deal." Certainly by the time John Paulson came knocking on its door, Goldman knew that being "long" subprime real estate in the spring of 2007 was likely to be a risky bet for anyone agreeing to take the other side of the trade that Paulson wanted to do: after all, the firm was pushing

its team to unload their own exposure to others as rapidly as possible. In an e-mail to a friend, Fabrice Tourre, the banker who structured the deal (and who has not yet been able to settle the SEC's charges against him) wrote of the CDO transactions he was crafting, "the whole business is about to collapse any time now … Only potential survivor, the fabulous Fab!" In another e-mail, the head of Goldman's structured products correlation trading desk warned Tourre that "the cdo biz is dead" and that "we don't have a lot of time left." None of that gave Goldman Sachs bankers a reason to stop, it seems. Even Bear Stearns had turned away John Paulson, concerned at the ethical implications of allowing a hedge fund manager to choose which securities he would bet against and thus which securities Bear would have had to coax a client to buy outright.

"In the old days, we would never have done business with just anyone who showed up on our doorstep," insists one former Goldman Sachs partner, who says the revelations left him "shocked and dismayed." In the old days, before Goldman Sachs sold stock to the public and its culture began to change irrevocably, "the question would have been 'John Who? Do we know this guy? What is he asking us to do? What are the consequences of this? Is this someone we want and need a relationship with?' Above all, we were always prepared to say 'no.' "

But by the dawn of the twenty-first century, saying "no" to deals wasn't how Wall Street worked anymore. From the mortgage brokers who underwrote the now-notorious "no income, no-docs" home loans all the way up to the investment bankers who just couldn't turn away a John Paulson, even when they had ethical reservations or, as Fabrice Tourre admitted, the securities that they were creating for their investors were "monstrosities"; the very word "no" seemed to have vanished from the lexicons of those toiling within the financial system. And the pressure was on to say "yes" to any deal that could generate a few pennies a share in quarterly earnings, because each and every investment bank and commercial bank was well aware of the extent to which its own return on equity fell short of that being generated by the Midas-like

bankers at Goldman Sachs. Swiss banking giant UBS hired a consulting firm to advise it on the best way to generate profits; Goldman alumnus Robert Rubin, who had moved on to work for Citigroup, only reluctantly acknowledged to colleagues that his new firm had neither the trading skills nor the risk management prowess to beat Goldman at its own game. (That didn't stop Citigroup from trying, of course.) Top bankers at Merrill Lynch & Co. knew to steer clear of their temperamental CEO Stan O'Neal on days that Goldman Sachs released its earnings. "Why can't we earn numbers like that?" he demanded of one subordinate in mid-2005.

The problem for Wall Street wasn't what Goldman Sachs did. It was the attitude that lay behind those actions, combined with the fact that its rivals and eager imitators tried to beat Goldman at its own game. When O'Neal's underlings set out to beat Goldman's return on equity, they succeeded in wiping out a decade's worth of profits by taking gargantuan risks in collateralized debt obligations (CDOs) made up of subprime mortgages. The fallout from UBS's effort to chase Goldman Sachs cost the Swiss bank billions of dollars in losses and writedowns. So far, much of the scrutiny of the financial crisis has been devoted to identifying and analyzing its proximate causes: the boom in risky, subprime lending; the role that securitization and derivatives played in amplifying that risk and spreading it throughout the financial system; and the inadequate risk management methodologies that were exposed by the crash. These are easier to understand and to grasp—but they also create the illusion that since we can name them so readily, they can be fixed with a few well-considered and carefully designed reforms.

There are deeper-seated causes, however, that are far more significant systemic issues that both Wall Street and Washington have yet to address. What purpose does Wall Street serve? What do we have to do to restore public confidence that it can act in the interests of all its stakeholders, not merely those who run it and view it as a way to generate vast profits for themselves? Certainly, Goldman Sachs envy hasn't abated on Wall Street, even if most of its rivals admit that they'd prefer to be known for its Midas touch

than the Abacus transaction. And as long as they keep chasing Goldman Sachs, and what Goldman is doing to earn its hefty profits is weakening the integrity of the financial system, then real reform is still far distant. The Financial Crisis Inquiry Commission's final report touched on this when it noted that both bankers and regulators "ignored warnings and failed to question, understand and manage evolving risks within a system essential to the wellbeing of the American public. Theirs was a big miss, not a stumble." Nor were those members of the FCIC who signed on to the report optimistic about the future. "Some on Wall Street and in Washington with a stake in the status quo may be tempted to wipe from memory the events of this crisis."

True, the playing field has never been a level one for those on Wall Street. Back in 1940, Fred Schwed wrote what has now become a classic book, Where Are the Customers' Yachts? In it, a visitor to Manhattan is being shown the sights near Wall Street, including a yacht basin around the Battery. "Look, those are the bankers' and brokers' yachts," his guide points out. "Where are all the customers' yachts?" asked the naive visitor. The punchline was obvious: Wall Street didn't make enough for its clients for them to own yachts. Not much has changed, except that in the wake of the financial cataclysm, some of Wall Street's customers have begun to feel as if they are setting out to sea in leaky rowboats, without their bankers and financial advisors being either ready or willing to dispatch a life raft in case of emergency.

The reason Wall Street exists and the reason it was bailed out by the American taxpayer is that it plays a vital role in our capitalist economy. We need Wall Street—and we need Wall Street to remember that function. But today's Wall Street is far from serving that "utility" role, and it remains to be seen whether the regulatory reform proposals will convince Goldman Sachs and its rivals to reconsider their raison d'être and redefine their responsibilities to both their clients and to the financial system itself. None of the survivors can resume chasing Goldman Sachs and lusting after its profits if what Goldman Sachs does and the others try to do in order to earn that rate of return succeeds in undermining the health of the

financial system as a whole. If there is one lesson we all, from the Oval Office on down, need to learn from the crisis, that's it.

DRAMATIS PERSONAE

Patrick Adelsbach: principal of event-driven strategies at Aksia LLC, a hedge fund research and advisory firm

Scott Amero: fixed-income fund manager at BlackRock, one of the largest asset management firms in the world

Phil Angelides: former state treasurer of California; currently head of the Financial Crisis Inquiry Commission

Jeffrey Arricale: portfolio manager at T. Rowe Price with a focus on investing in financial stocks

Sheila Bair: chairman of the Federal Deposit Insurance Corporation

Ben Bernanke: chairman of the Federal Reserve

Lloyd Blankfein: CEO of Goldman Sachs

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Brooksley Born: Washington securities lawyer and former head of the Commodity Futures Trading Commission; now a member of the FCIC

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Marshall "Marsh" Carter: deputy chairman of NYSE Euronext, former chairman of State Street Corporation, and a veteran commercial banker

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Jimmy Cayne: former CEO and chairman of Bear Stearns; he spent his professional life at the firm

Steve Cohen: manager of one of the world's biggest hedge funds; known as a ferocious and secretive competitor and an avid art collector

Gary Cohn: president and COO of Goldman Sachs

Leon Cooperman: former Goldman Sachs partner; now runs a large hedge fund group, Omega Advisors

John Costas: rose to head UBS's investment banking; after briefly running a hedge fund group for UBS, he was caught with short-term losses and resigned; launched his own trading and market-making group, Prince-Ridge, in mid-2009

Robert "Bob" Diamond: CEO of Barclays Capital and president of Barclays PLC; Diamond orchestrated the purchase of many of Lehman Brothers' investment banking operations after Lehman's bankruptcy filing; formerly worked for Credit Suisse, among other firms

Jamie Dimon: CEO of JPMorgan Chase, a former protégé of Sandy Weill whom the latter fired at Citigroup and who went on to have the last laugh as the heir to JPMorgan himself during the crisis

Mike Donnelly*: former Wall Street investment banker who spent most of his career at Morgan Stanley

Glenn Dubin: cofounder of Highbridge Capital, a large hedge fund group now owned by JPMorgan Chase

James "Jimmy" Dunne: CEO of Sandler O'Neill, a smaller investment bank that specializes in serving financial institutions

Ira Ehrenpreis: a general partner at Technology Partners, a Silicon Valley venture capital firm

Gary Farr: former Citigroup banker hired by KKR to build an in-

house investment banking division to assist its portfolio companies

Niall Ferguson: professor of history and business at Harvard University and Harvard Business School; specializes in economic and financial history

Jim Feuille: partner at Crosslink Capital, a venture capital firm

Richard "Dick" Fisher: late CEO of Morgan Stanley; his name often surfaces when people talk about competitive yet principled Wall Street executives

Martin "Marty" Fridson: veteran high-yield bond market analyst; founder of FridsonVision

Richard Fuld: former CEO of Lehman Brothers; a Lehman "lifer"

Timothy Geithner: Treasury secretary; formerly head of the New York Fed

Mike Gelband: former co-head of fixed income at Lehman Brothers

Lou Gelman*: former investment banker specializing in equity sales and trading at Morgan Stanley

James Gilleran: former head of the Office of Thrift Supervision who bragged about his willingness to cut red tape and make it easier to take risk

Lew Glucksman: Wall Street trader and briefly chairman and CEO of Lehman Brothers

Alan C. "Ace" Greenberg: former chairman of Bear Stearns, whose vision propelled it to the ranks of the "big five" investment banks

Robert "Bob" Greenhill: founder of Greenhill & Co., a merger advisory boutique firm, in 1996 after leaving Morgan Stanley, where he had run that firm's merger business

Ken Griffin: founder of Citadel Investment Group, one of the largest hedge fund groups in the world; now making a push into investment banking

Tony Guernsey: chief client officer at Wilmington Trust; has worked with many Wall Street figures over the last three decades

William R. “Bill” Hambrecht: former CEO of one of the “four horsemen” (boutique banks that played a decisive role in financing start-up companies), Hambrecht & Quist; since that firm was sold to Chase Manhattan in the late 1990s, has undertaken a variety of quests, all involved in improving financing access for fledgling firms

Nick Harris*: manager of a large hedge fund

Jeff Harte: banking analyst at Sandler O’Neill

Samuel Hayes: holds Jacob H. Schiff Chair in Investment Banking at the Harvard Business School; has been writing case studies about Wall Street since 1970

Mike Heffernan*: investment banker on Wall Street

Jaidev Iyer: managing director, Global Association of Risk Professionals; former senior risk manager at Citigroup and its predecessor institutions

Fred Joseph: late founding partner of Morgan Joseph, a boutique investment bank; formerly CEO of Drexel Burnham Lambert

Rob Kapito: president of BlackRock

Todd Kaplan: veteran Wall Street banker recruited by Ken Griffin at Citadel to launch the hedge fund’s push into investment banking; resigned in early January 2010 for personal reasons

Henry Kaufman: the original “Dr. Doom” and a prominent economist at Salomon Brothers; now president of Henry Kaufman & Co.

Dow Kim: briefly headed the fixed-income investment banking operations at Merrill Lynch; tried but failed to launch his own hedge fund after Merrill began to take write-downs

Michael Klein: one of the first architects of a sponsor group of bankers catering to private equity clients; a former Citigroup banker

Bill Kohli: fixed-income portfolio manager at Putnam Investments in Boston

Richard “Dick” Kramlich: cofounder of New Enterprise Associates, a

large Silicon Valley venture capital partnership

Henry Kravis: cofounder of KKR, one of the first large buyout firms

Sallie Krawcheck: former banking analyst and Citigroup chief financial officer; now runs the wealth management business at Bank of America Merrill Lynch

Ken Lewis: former chairman and CEO of Bank of America; negotiated the merger between B of A and Merrill Lynch but was ousted after revelations of large losses at Merrill and agreements to pay Merrill bankers big bonuses

Michael Lipper: architect of data and analysis firm Lipper Advisory Services (now part of Thomson Reuters, named Lipper Inc.)

John Mack: veteran investment banker who has worked at many of Wall Street's most significant firms; until 2010, CEO of Morgan Stanley; remains the firm's chairman

Jake Martin*: partner at a large New York–based buyout firm

Mike Mayo: veteran banking analyst and managing director at Calyon Securities (USA) Inc.

Larry McInnes*: veteran technology and telecommunications banker

Tom McNamara*: investment banker who works within a sponsor group at a Wall Street firm, putting together financing packages for private equity buyouts

Seth Merrin: founder of LiquidNet, a Wall Street trading firm

Michael Milken: at Drexel Burnham Lambert in the 1970s and 1980s, developed the high-yield/junk bond market into a real asset class, but violations of securities laws led to his being banned from the industry for life; now a philanthropist

Eric Mindich: youngest partner in Goldman Sachs history; left the firm to found a hedge fund, Eton Park Capital

Ken Moelis: began his career at Drexel Burnham Lambert; ultimately became president of UBS's investment banking division; left in 2007 to launch his own boutique firm, Moelis & Co.

Angelo Mozilo: chairman and CEO of Countrywide Financial until

2008; cofounder of IndyMac Bank; a symbol of the credit bubble, Countrywide is now owned by Bank of America; IndyMac collapsed

Duncan Niederauer: former partner of Goldman Sachs & Co., CEO of the New York Stock Exchange, and a pioneer in the world of electronic trading

Stanley "Stan" O'Neal: former CEO of Merrill Lynch & Co.; behind the firm's push into CDOs structured with subprime mortgages

Vikram Pandit: veteran banker and later a hedge fund manager; joined Citigroup and quickly became its CEO

Richard "Dick" Parsons: chairman of the board of Citigroup

Henry "Hank" Paulson: former Goldman Sachs leader who went on to become Treasury secretary in the administration of George W. Bush; an architect of the TARP plan

John Paulson: hedge fund manager who made billions betting that the housing bubble would burst; now betting on a turnaround in financial stocks

Pete Peterson: cofounder of Blackstone Group; previous posts included CEO and chairman of Lehman Brothers between 1973 and 1984

Anna Pinedo: partner at Morrison & Foerster specializing in corporate finance

Charles E. "Chuck" Prince: former CEO of Citigroup

Phil Purcell: former chairman and CEO of Morgan Stanley; ousted by firm dissidents unhappy with the company's lagging stock price, a reflection of its lack of risk taking

Leslie Rahl: founder of Capital Markets Risk Advisors LLC, a risk management firm that has handled a lot of derivatives debacles

Lewis "Lew" Ranieri: mortgage bond and securitization pioneer at Salomon Brothers

Clayton Rose: former banker at JPMorgan Chase; now an adjunct professor at Harvard Business School

Wilbur Ross: former investment banker and "workout specialist" at

Rothschild Investments; founded his own private investment firm, WL Ross & Co. LLC, in 2000

Nouriel Roubini: economist and professor at New York University's Stern School; known as "Dr. Doom" for his pessimistic economic forecasts

Jeff Rubin: director of research at Birinyi Associates; has studied the way financial markets function

Robert "Bob" Rubin: former Goldman Sachs partner and Treasury secretary during the Clinton administration; went on to work as a director and advisor at Citigroup

Ralph Schlosstein: CEO of Evercore Partners; cofounded BlackRock, a major asset management firm

Stephen "Steve" Schwarzman: cofounder of Blackstone Group; formerly an investment banker at Lehman Brothers

Peter Solomon: veteran Wall Street banker and Lehman Brothers alumnus; now runs his own boutique investment bank, Peter J. Solomon Co.

Larry Sonsini: chairman of Wilson Sonsini Goodrich & Rosati, a Silicon Valley–based national law firm that advises start-ups and Fortune 500 companies

Mike Stockman: former risk management officer at UBS

Richard "Dick" Sylla: Henry Kaufman Professor of the History of Financial Institutions and Markets, Stern School of Business, New York University

James "Jim" Tanenbaum: partner at Morrison & Foerster specializing in corporate finance

John Thain: former CEO of Merrill Lynch; previously CEO of the New York Stock Exchange and a partner at Goldman Sachs

Leo Tilman: president of L. M. Tilman, a risk advisory firm; contributing editor of The Journal of Risk Finance, and former executive at BlackRock and Bear Stearns

Mark Vaselkiv: fixed-income manager at T. Rowe Price in Baltimore

David Viniar: chief financial officer of Goldman Sachs

Paul Volcker: former Federal Reserve chairman; named chairman of Economic Recovery Advisory Board by President Barack Obama; championed the idea of re-creating a division between risk-taking and deposit-taking institutions on Wall Street

Sandy Weill: financier who combined risk-taking and deposit-taking institutions on Wall Street with the formation of Citigroup; his view of a financial supermarket was largely responsible for the repeal of the 1933 Glass-Steagall Act that separated investment and commercial banking

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* Indicates a pseudonym.

INTRODUCTION

The Chase

"Does Wall Street owe the American people an apology?"

Tom Casson* heard the question—the one on the minds of every American taxpayer furious at the very idea of footing the bill for Wall Street's excesses in the shape of the $700 billion bailout package under debate in a Senate hearing room—from the television on the trading floor just outside his office. He saw himself as part of Wall Street—it was where he had spent nearly all his working life—so the very idea that some senator from who knows where thought he should apologize to the country piqued his curiosity immediately. "Why would I and the rest of my guys do that?" he wondered. Still, listening to either Treasury secretary Henry "Hank" Paulson or Federal Reserve chairman Ben Bernanke struggle to answer the question in a way that would keep the members of the Senate Banking Committee happy had to be more fun than just watching the red lines on his Bloomberg terminal that signaled stock and bond market index levels inching their way lower and lower with every passing minute. In search of distraction, Casson got up from behind his desk and ambled toward the trading floor. Leaning against the glass wall that separated his small fiefdom from the hurly-burly of the floor, he waited for the answer.

It wasn't what he expected to hear. After a lot of hemming and hawing, Ben Bernanke finally replied that to most of America, "Wall Street itself is a … is a … is an abstraction." Casson felt as if he'd accidentally stuck his finger in an electrical socket. He stood upright, staring at the television in astonishment. What had Bernanke just said? Can he really have just described Wall Street as an abstraction? In Casson's eves. Wall Street couldn't be less abstract

—it's where businesses find capital, where investors with capital find places to put it to work in hopes of earning a return. Over the decade that he had toiled on the Street, Casson had raised money for some of those companies and helped others to negotiate multibillion-dollar mergers. Now the politicians were demanding that he and his colleagues apologize for what they spent their lives doing? Even worse, the head of the Federal Reserve—the individual who was the public face of banking regulation and monetary policy making—couldn't find a better word to describe Wall Street than abstraction. Months later, Casson was still bemused. "How could anyone say that Wall Street was an abstraction?" he wondered aloud. What had happened to make even the Fed chairman blind to Wall Street's real value?

The details of what happened during the weekend in September that preceded those Senate hearings, the weekend of frenetic deal making, hectic negotiations, and never-ending meetings within the Fed's fortress-like New York headquarters involving nearly every top figure on Wall Street, have by now been told and retold. We know that Merrill Lynch held its board meeting to approve the sale of the firm to Bank of America at the St. Regis Hotel in Manhattan; that Securities and Exchange Commission (SEC) chairman Christopher Cox accused a British counterpart of being "very negative"; that Hank Paulson commuted to the negotiations downtown from a suite at the Waldorf Astoria in midtown Manhattan. We even know the favorite route for the dawn runs by Timothy Geithner (then head of the New York Fed, who would succeed Paulson at the Treasury Department in the New Year) along the southern tip of Manhattan.[1] We know what happened—the names of the firms that failed, and those that rapidly returned to making money hand over fist. (We still don't know the names of those institutions saved from disaster by last-minute help from the Treasury Department, but if media organizations make a compelling freedom-of-information case to the courts, that information won't be long in coming.) We know the proximate

causes of the crisis: too much leverage, too much risk, and too much subprime lending.

This book will take you on a different journey. Instead of rehashing every detail of what happened to Wall Street, I'll take you behind the scenes and show you just why our financial system came so close to falling over the edge of the abyss. How did we reach the point where Wall Street was in so much jeopardy that the staid and somewhat self-important Paulson was willing to go down on one knee in front of House of Representatives Speaker Nancy Pelosi—a Democratic politician most investment bankers distrusted and even roundly disliked—to beg for her assistance in passing a financial aid package for the surviving firms, including his own alma mater, Goldman Sachs? Above all, what had happened to Wall Street that Bernanke could describe it as an "abstraction" and be greeted not with howls of outrage or confused questions by his audience but rather with nods of acknowledgment and understanding?

Truth is, Wall Street isn't an abstraction but a kind of public utility. That's a characterization liable to make those who work on the Street bristle in indignation. But in many ways, the financial system of which Wall Street is a critical part bears an uncanny similarity to any power company or water system. When you come home at the end of the day, you count on being able to flick a switch and see your lights come on; in the morning, you rely on being able to turn on a tap and get clean running water for your shower. You almost certainly rely on Wall Street in the same unconscious way. Wall Street offers us an array of investment ideas for our retirement portfolios; Wall Street institutions finance our entrepreneurial dreams and lend us the capital we need to help us buy homes, cars, and even birthday gifts for friends and family. (Sure, they make money doing that—but so do the power company and the water company.)

From its inception Wall Street had been there to serve Main Street, and it took that role seriously. "It was valued; serving your corporate clients, if you were an institutional firm like Morgan Stanley, or investors, if you were a retail-oriented firm like Merrill

Lynch, exceedingly well was the ticket to success on Wall Street," says Samuel Hayes, professor emeritus at the Harvard Business School. The problem is that from the 1970s onward, serving as a public utility and performing these intermediary functions for the people on both ends of the "money grid" (investors and companies needing capital) just wasn't as profitable as it used to be.

That's the starting point for this book, which will explain just how and why Wall Street drifted away from its core intermediary function and morphed from utility to casino, under pressure from those running Wall Street firms and from their investors. Both of those groups put a priority not on fulfilling Wall Street's role as a utility but on finding the most profitable products and business strategies, of which subprime lending and structured finance were only the latest—and, so far at least, the most toxic—manifestations.

Eventually, these insiders came to treat Wall Street as if it were any other business, only as valuable as the profits they could extract from it. Instead of turning to proprietary trading or structured finance only to supplement their returns from the less profitable utility-like or intermediary operations, many Wall Street firms deemphasized Main Street altogether in favor of catering to Wall Street clients: hedge funds, private equity funds, and their own principal investing and proprietary trading divisions. Nor were there any incentives for Wall Street residents to question their collective transformation from quasi-utility to self-serving, risk-taking, profit-maximizing behemoth. Compensation policies across the Street rewarded bankers and traders for turning a blind eye to the needs of the money grid; regulators—agencies charged with ensuring that utilities operate in the public interest—ended up catering to Wall Street rather than trying to rein in its worst excesses.

When utilities come under too much systemic stress, they fail. Think of the electricity system, and what happens when its managers fail to plan for the hottest summer days, when everyone turns on the air conditioner full blast and the demand for power peaks. Like millions of others living in the northeastern United States, I experienced that firsthand one muggy August afternoon in

2003, when the power to everything from elevators in high-rise office buildings to streetlights on Manhattan's busy roadways flickered off—and stayed off for much of the next twenty-four hours. Suddenly, I realized just how important the power grid was to my life. I joined thousands of others who had to walk home along the darkened New York streets, through the heat and humidity. Eight miles and many hours later, there was no cold water to ease the pain from my blistered feet (the lack of electricity had caused a plunge in water pressure) and no food (there was no way to cook anything); I couldn't even find a cold drink to revive me.

Thankfully, the reasons for the blackout were relatively straightforward. Someone had decided to take a power plant offline, meaning that its output wouldn't be available to customers on one of the hottest days of the year. A bad call. When electricity demand spiked, that put a strain on the high-voltage power lines. Since electricity companies know that can happen, causing power lines to sag dangerously low, they make an effort to keep trees and foliage trimmed back. That didn't happen at one utility—another bad call—and the power lines brushed against some overgrown trees, triggering a series of failures that cascaded throughout the region's power grid.[2]

The 2003 blackout was an accidental phenomenon. But imagine if in the years leading up to the blackout, the power companies had been overrun by a new breed of managers, extremely bright and imaginative engineers armed with MBAs. Imagine that they had been given a completely different mandate by shareholders: blackouts don't happen too often (the last big one was in 1965), so if preparing for one consumes too much capital or limits profits too much, don't bother with it. And imagine that those engineers, in order to maximize profits, decided to use all the money they had saved by not investing in backup capacity and maintenance to build and operate a casino, or some other business that would generate a much higher return in the short run. Finally, imagine that regulators were asleep at the switch and let them do it. Happy shareholders would have richly rewarded the engineers for their efforts right up

until the last minute. And even after the blackout (which would have been far more catastrophic and longer-lasting than that of 2003), while all of us were struggling in the dark, those investors and the engineers would have had more than enough money to buy their own generators to provide power to their mansions.

In a nutshell, that's what happened to Wall Street as it morphed from being an intermediary to being a self-serving, risk-taking machine for generating profits. As long as times were good, few participants stopped to ask questions about this transformation, including those who have today become some of the Street's harshest critics. And even now that we've experienced the near blackout of the financial system, the fingers of blame are pointing to individuals—Richard Fuld, at the helm of Lehman Brothers, for instance, or Christopher Cox, the chairman of the SEC, who looked the other way as Bernie Madoff ran his Ponzi scheme and as the investment banks his agency regulated teetered on the edge of disaster. If we ever are going to be able to devise wise policies for Wall Street and ensure the future health of the financial system, we have to take a hard look at more than just the proximate causes of the debacle, such as subprime lending or the activities of pot-smoking, bridge-playing Jimmy Cayne at Bear Stearns. We need to understand how to make the money grid work properly. Maybe just being an intermediary doesn't generate enough in profits to sustain the system anymore—but that doesn't mean that people running the utility should feel free to toss caution to the wind and start speculating on a host of new and risky businesses.

Bankers are trying to clear up the mess they have made, while in Washington, regulators and policy makers are running around in circles trying to analyze what went wrong and to put in place a new set of rules that will prevent the financial system from coming so close to the brink again. But none of these very smart people is either admitting to or acting on the biggest problem of all: the fact that while Wall Street is as important to our economy and society as any other utility, it doesn't work like one. Let's say that Morgan Stanley decided, as a result of the events of the last two or three years, to pare back the amount of risk it is willing to take. It shuts

down its proprietary trading desk, says it won't act as a principal and invest alongside its clients in businesses, and limits its involvement in risky products such as synthetic credit default swaps. It even decides to turn away underwriting assignments if its bankers conclude that the stocks or bonds the firm would be underwriting would add to the level of risk in the system. Instead, Morgan Stanley focuses on wealth management, on building a commercial banking franchise, or on market making (facilitating the two-way flow of trading in stocks or bonds). What would happen next?

Well, none of these is a high-growth business that will lead to big annual jumps in profitability. Before long, the impact of this decision would show up in the bank's quarterly earnings; with each fiscal quarter, the gap between Morgan Stanley and its rivals would widen, in both absolute levels of profitability and the rate of growth in profits. The bonus pool would shrink, and if this risk-conscious move was one that only Morgan Stanley had made on its own initiative (and not part of a government-mandated change affecting the entire industry), the bank's most talented and skilled employees would be lured away to work for competitors. Ultimately, the investors in Morgan Stanley, those who have purchased its stock in hopes of seeing the value appreciate, would stage a rebellion. It wouldn't take long before they'd protest to the bank's management team and demand that the managers do whatever it takes to keep up with the returns being posted by their peers. If those managers stick to their guns, the investors' next stop would be the offices of the company's directors. It's pretty easy for anyone to imagine what would happen next to the executives who had decided that shunning high-risk but profitable businesses was a good idea. "Give us a new management team, with some guts, that's willing to go out and do what it takes to capture whatever profits are going!" shareholder A would demand. Since the board's absolute duty is to maximize value for shareholders, it wouldn't take long for it to capitulate.

Do you think that couldn't happen? Well, it did, over the course of the last two decades. Over that period, Goldman Sachs emerged as the rival to beat, or at least to try to mimic. The firm seemed to

have a Midas touch: in the decade leading up to the financial crisis, it generated an average annual return of 25.4 percent on shareholders' equity, while the four other large investment banks earned an average return on equity (ROE) of 15 percent annually in the same time frame. No wonder Goldman's rivals were furious as they fended off complaints from their own shareholders. It was clear to every other Wall Street CEO that chasing Goldman Sachs was the only way to boost their personal wealth and simultaneously keep their cantankerous shareholders pacified.

What Goldman was doing, however, was something very different from the traditional business of Wall Street. By 2007, the year that it posted record profits of $11.6 billion and distributed a bonus pool that was even larger ($12.1 billion) among its employees, Goldman was getting only about a third of those earnings from serving Main Street clients; the rest came from investing and trading for its own account. It had become commonplace for Goldman's rivals to refer to the firm, scornfully, as a hedge fund disguised as an investment bank, even as they scrambled to mimic the strategy. The problem was that they weren't moving into these businesses because they believed they had a competitive advantage or the most talented bankers and traders. They were doing it just to keep pace with the market leader. And while Goldman Sachs, as we'll see, managed to steer clear of some of the subprime mess, those firms that were just trying to chase Goldman Sachs didn't have the tools or the people to help them properly manage the new risks they were taking.

During those years, when everyone was chasing Goldman Sachs, there was every incentive to just keep doing so and not much encouragement to stop and rethink the strategy. John Costas, former head of investment banking at UBS and one of the Swiss bank's most powerful deal makers, says the system worked in such a way that everyone was under pressure to do whatever it took to grab the extra percentage point of market share or return on equity and to ride roughshod over naysayers. "For a decade, from 1999 through the middle of 2007, anytime you stopped participating, by not adding more risk or by not aggressively pursuing more transactions,

you were wrong." In other words, chasing Goldman Sachs was a strategy that paid off for so long that Wall Street's leaders were ill equipped to recognize that it might not always continue to do so.

Nor was it possible to sit out the dance, to not try to emulate Goldman's golden touch. With the benefit of twenty-twenty hindsight, deciding back in 2003 or 2004 not to get caught up in the business of repackaging subprime mortgages into collateralized debt obligations (CDOs) looks great. At the time, it would have been untenable, says one former senior banker. "What was happening at the bank that did that? The investment analysts are downgrading it, the shareholders are unhappy, and the employees are unhappy because the bonuses aren't as fat as those their friends are earning. The press is all over the bank, saying it's not as well run as the other bank." That, he argues, is the kind of thinking that sealed the doom of some of Wall Street's most venerable names.

That kind of thinking is still alive and well on Wall Street today, even after the near apocalypse. The quest is already under way for the next "new new thing," the next product or strategy that will help firms such as Goldman Sachs and its rivals earn massive profits in the short run while creating new risks for the financial system. Perhaps it will be something that Goldman Sachs pioneers, or something that is launched by one of the new boutique institutions. The one certainty is that Wall Street's mind-set remains unchanged. Left unchecked, every firm will again overlook risk in hopes of gaining a dominant market share in that new product. The financial system has been saved from destruction, but as long as the mind-set of "chasing Goldman Sachs" lingers, it hasn't been reformed.

As the worst of the crisis recedes into the distance and Wall Street battles to return to business as usual, Goldman Sachs is once again the firm that all its rivals want to emulate, at least when it comes to financial performance. As David Viniar, the firm's chief financial officer, told a reporter in 2009, "Our model never really changed"[3]; by the end of 2009, Goldman was again rewarding its employees with one of the biggest bonus pools in its history and had returned to reporting astronomically high earnings. Once again, a relatively small proportion of those profits came from serving Main Street.

Wall Street is still oriented toward serving itself—its shareholders and employees—and as long as that collective mind-set endures, we run the risk of another systemic shock.

There is no point sitting around and waiting for Wall Street to apologize to us, individually or collectively. Nor can we content ourselves with the idea that bankers are twenty-first-century cartoon villains and demand that they get their just deserts. It's not even reasonable for us to indulge in bouts of nostalgia for the banking system of the past. True, in hindsight, the 1960s look like a golden age but we can't just wipe out innovations such as high-speed trading based on computer algorithms that didn't exist then. Nor can we force investment banks to return to the days when they weren't large publicly traded corporations but partnerships that valued long-term relationships over short-term quarterly profits. We can't turn back the clock to a time when hedge funds and private equity funds were a tiny sideshow on Wall Street. What we can and must do is understand the way Wall Street functions today and try to align that more closely with its special role in our economy and society.

This book isn't another anecdotal history of the subprime crisis of 2007 and 2008. Rather, it's the tale of how Wall Street's metamorphosis from a utility serving Main Street to a business that took extraordinary risks to maximize its own profits at the expense of that utility function set the stage for that crisis. It's an analysis of where we stand today and where we need to go next—to a world where, instead of blindly chasing Goldman Sachs in hopes of replicating its success, the players that make up Wall Street identify ways to emulate the strengths and avoid the flaws that lie within the business model of Goldman Sachs and seek out their own paths to success. Above all, those strategies must be based on their own competitive strengths and be pursued in a way that doesn't jeopardize Wall Street's core utility function.

The story is told through the eyes of those who lived it, such as Tom Casson—the bankers, traders, research analysts, and investment managers who have spent the bulk of their professional lives on Wall Street. Some of them can recall firsthand the events of the

1970s, when new technologies and new rules began to reshape the world they inhabited. It's the story of how Wall Street came to be seen, even by one of its devotees, as an "abstraction." With any luck, the next time Bernanke uses that phrase to describe the money grid, he'll be met with howls of outrage.

* Here and throughout the book, a name followed by an asterisk is a pseudonym for a all Street professional. Casson, as is true of many of his colleagues still working on Wall Street, does not have permission to speak openly to the press or book authors about what they see happening around them; while their CEOs do, it's rare to find them frank and forthcoming. In cases such as that—where speaking openly and honestly about what individuals on Wall Street witnessed and experienced would have caused trouble for my sources with their employers or investors, and where simply using an anonymous source would have made following the narrative unnecessarily difficult for the reader—I have chosen instead to gives these sources a pseudonym. In cases where that is done, their name is followed by an asterisk when they first appear. When senior Wall Street officials declined to be quoted on the record for this book, I have not given them pseudonyms, but simply cited them and referred to their roles on the Street, but not their firms. Reporting this book at the height of the crisis in the winter of 2008 and spring and early summer 2009 proved particularly challenging, as many of these individuals were focused on what was going to happen in the next twenty-four hours or the following week, not what happened in past decades or what might happen over the next decade. "How can you ask us to predict that?" said Fred Joseph, former boss of junk-bond king Michael Milken, who went on to cofound a boutique investment bank but who, sadly, died in late 2009. "We can't predict what we'll have to deal with in a month or two, and how that will change our options." This book reflects the views and thoughts of some two hundred individuals whose lives are tied to Wall Street in one way or another and who, like Joseph, made that effort.

PART I

DANCING TO THE MUSIC

The financial markets had begun to feel the first shocks of what would become the worst market earthquake since the Great Depression when, in July 2007, then–Citigroup CEO Charles "Chuck" Prince came up with an unusual metaphor to explain why he and his team were forging ahead with business as usual, making loans to private equity funds to help finance the increasingly gargantuan buyout deals the latter were trying to structure. Sure, the credit markets were rocky, raising fears among some market participants that big banks like Citigroup—those that had been the most aggressive lenders to the LBO community and the biggest participants in the world of structured finance, marketing securitized products and derivatives to clients—would get stuck holding too many of those loans if there were no willing investors to take them off their hands. Prince, too, may have been worried, but he wasn't going to show it. Instead, he told the Financial Times, "as long as the music is playing, you've got to get up and dance." And, he added, Citigroup was "still dancing."[1]

That music came to a sudden and discordant end only months later, by which time Prince himself had been ousted as the giant bank's CEO. Citigroup was still paying the price for his philosophy years later. In order to prevent collapse, the bank had to accept government bailout funds, a portion of which was later converted into stock that gave the federal government an ownership position in Citigroup. Write-downs produced a gargantuan loss—$27.7 billion—in 2008; while the bank's 2009 loss of $1.6 billion was a lot smaller, it stood in stark contrast to the big profits being earned by the likes of JPMorgan Chase and Goldman Sachs.

How and why did one of Wall Street's premier institutions end up in such a pickle? The story of why Prince felt it necessary to keep dancing as long as the music played is one that has its roots back in the late 1960s and early 1970s, long before Citigroup existed or Wall Street had ever heard of collateralized debt obligations, credit default swaps, multibillion-dollar buyout funds, or any of the other instruments or players now often cited as culprits in the meltdown of the financial markets. The story of

Citigroup—both its rise and near collapse—hinges on the changes to Wall Street's very structure. Without those transformations—some of them slow and almost imperceptible; others, like the collapse of the 1933 Glass-Steagall Act mandating a strict separation between investment and commercial banking, grabbing headlines worldwide—Wall Street could not have become as powerful a player in the U.S. economy as it did. Equally, it would not have endangered the entire money grid.

During the opening session of the hearings of the Financial Crisis Inquiry Commission (FCIC), Mike Mayo, a veteran banking analyst and now a managing director at Calyon Securities (USA) Inc., described Wall Street's member firms as being "on the equivalent of steroids. Performance was enhanced by excessive loan growth, loan risk, securities yields, bank leverage and consumer leverage.... Side effects were ignored, and there was little short-term financial incentive to slow down the process despite longer-term risks." But by the time the problems became so big that they began to nag at Mayo and many of his colleagues during the first decade of the new millennium, the trends that had led to those problems had been in place for decades. As I'll explain, the changes to Wall Street forced its financial institutions to rely on the most innovative and most leveraged products it could devise, because those generated the greatest profits. Similarly, the needs of "insiders"—Wall Street players like hedge funds and buyout funds—came to dominate the Wall Street landscape. As long as dancing to the music produced the profits that firms like Citigroup and its investors craved, they would continue to jig, two-step, or even produce a creditable Highland fling, if necessary. The first section of this book is the story of how that ethos became central to the way Wall Street functioned.

CHAPTER 1

From Utility to Casino: The Morphing of Wall Street

Alan "Ace" Greenberg's firm may have collapsed underneath him, but even in the darkest days of 2008, the eighty-one-year-old investment banker's legendary chutzpah was visible on Bloomberg's business television network. "There's no more Wall Street," Greenberg, the former CEO of Bear Stearns, declared, adding that it had vanished "forever" in the rubble.[1]

It's fashionable on Wall Street today to talk wistfully—or in a tone of reverential awe—about investment banking as it was practiced during what is now seen as a kind of golden era. Greenberg's comments, though more hyperbolic than most, are one example.

The changes over the course of 2008 were so dramatic that Greenberg believed the Wall Street he helped forge no longer existed in any kind of recognizable fashion. Some nostalgic Wall Streeters view the investment banking landscape of the 1960s, '70s, and early '80s as a kind of utopia: investment banking as its purest, before the 1987 stock market crash, the collapse of the junk bond market, and Gordon Gekko made Wall Street seem slightly reckless and disreputable. To others, Greenberg among them, the golden era is the more recent past, when investment banks such as Bear Stearns saw their revenues and profits soar as they catered to the emerging powers on the Street, hedge funds and giant buyout funds, and watched their bonus payments and personal wealth climb even more rapidly.

The balance of power has certainly shifted on Wall Street, and new products, players, and technologies have transformed it. But Greenberg's comments were directed at the collapse of specific

institutions: the shotgun wedding of his own firm with JPMorgan Chase, the bankruptcy filing of Lehman Brothers, and, the same weekend, the flight of Merrill Lynch into the arms of Bank of America. Greenberg most likely knew about the behind-the-scenes wheeling and dealing orchestrated by Ben Bernanke and Hank Paulson that involved every conceivable combination of every Wall Street firm with every one of its rivals (J.P. Morgan and Morgan Stanley? Goldman Sachs and Citigroup?). The desperate rush to save the financial system from utter collapse had resulted in the kind of merger negotiations—however short-lived—that would have seemed laughable only weeks earlier. To Greenberg, still reeling at the collapse of his own firm (which had, after all, survived even the 1929 market crash and the Great Depression), that must indeed have felt like the end of Wall Street.

Wall Street, however, is more than just a set of institutions with big brand names, however old and venerable. At its heart, it is a set of functions, and those functions remained intact even in the midst of the crisis. Two days before Greenberg delivered his epitaph for Wall Street, a small Santa Barbara company, RightScale, raised $13 million in venture capital backing from a group of investors led by Silicon Valley's Benchmark Capital.[2] RightScale's secret? It was in the right business—cloud computing, a way for customers to reduce their IT development costs by using Internet-hosted services—at the right time. Despite the dramatic headlines focusing the world's attention on the plunge in the stock market and the deep freeze that hit the credit markets, parts of Wall Street's core business were still functioning, albeit in a more muted fashion. In the final three months of 2008, venture capital firms invested $5.4 billion in 818 different deals, bringing the total for the year to $28.3 billion. That was down a bit from 2007, when venture firms—partnerships that have made fortunes backing companies such as Amazon.com and Google and lost smaller amounts backing stinkers such as Pets.com—put $30.9 billion to work. But it's still more than they invested in any year from 2002 through 2006.[3] By the first anniversary of the collapse of Lehman Brothers, even the high-risk world of junk bonds was back in business. The sign? Beazer Homes, one of the

worst-hit home-building companies in the entire industry, was battling not only the collapse in the real estate market but also a federal fraud investigation. Yet Wall Street found enough investors willing to close their eyes to those risks and invest $250 million in junk bonds issued by the company to help replenish its coffers.[4]

What Does Wall Street Do, and Why Does It Exist?

The reason for the Wall Street bailout—the explanation for Hank Paulson being desperate enough to literally drop to one knee in front of Nancy Pelosi in the White House and plead for her help passing the initial $700 billion rescue package—is that Wall Street's functions are essential to the economy. According to reports that were leaked to the media almost immediately, Paulson begged Pelosi not to "blow it up" (referring both to the bailout package and the financial system itself) by withdrawing the Democratic Party's support for the rescue effort. "I didn't know you were Catholic," Pelosi quipped, referring to Paulson's kneeling before her, in an effort to lighten the atmosphere before blaming the Republicans for the gridlock.[5]

By saving some of Wall Street's institutions—those viewed as the strongest or the most important to the system—the architects of the bailout and many of the subsequent reform packages hoped to preserve intact the system that enables capital to flow more or less smoothly through the economy the way power flows through the electrical grid or water through a municipality's water and sewer system. Regardless of what Main Street was thinking—and communicating to their members of Congress—Wall Street isn't incidental to what happens in the rest of the economy. Without Wall Street to perform its financial grid functions, it would prove almost impossible to raise capital to repair bridges, finance new companies such as RightScale, and keep others—such as Beazer Homes—afloat.

What we tend to think of as Wall Street—the stock market, the investment banks, and the newer entities such as hedge funds—is

really only the visible tip of a much larger iceberg that is the entire financial system. Collectively, these institutions help ensure that capital continues to move throughout the rest of the "money grid." Sometimes they do this by providing a market for participants to undertake basic buy or sell transactions; on other occasions, they negotiate or devise solutions to more complicated capital-related questions, such as helping a company go public or sell debt (a process known as underwriting) or working with it to establish and achieve the best price possible in a merger negotiation.

That intermediary function is alive and well, most visibly at the New York Stock Exchange, which occupies not only the epicenter of Wall Street at the corner of Broad and Wall Streets but the heart of its role as a financial utility. On its sprawling trading floor, traders go about their business in much the same way their earliest predecessors did in the naves of Amsterdam churches, executing the purchases of blocks of shares for their clients, who these days could include an individual trying to sell 100 shares of General Electric or Microsoft inherited from a grandparent or a mutual fund manager trying to reduce his holdings in Amazon.com in order to buy a stake in Alibaba.com, a Chinese counterpart. Exchanges trading stocks, futures, and options contracts as well as commodities remain one of the most heavily regulated parts of Wall Street because of the essential role they play in a large, geographically scattered, and diverse community.

Not convinced of the value of Wall Street's functions and processes? Imagine you are a retiree in your seventies, living off your investment portfolio. The wisdom of your decision to invest in Microsoft in the mid-1980s has become clear; now you're counting on being able to sell some of that stock at its current market value in order to cover your living expenses for the next six months. Wall Street's processes make that relatively simple—all you have to do is place an order to sell the stock at the market price with your broker or custodian (say, Charles Schwab) and ask for the money to be transferred to your bank account when the trade is settled in three days' time.

Now, imagine that there was no Wall Street. For starters, you'd

have a hard time establishing a fair price for that stake in Microsoft without the stock market, with its countless numbers of buyers and sellers meeting in cyberspace to decide each millisecond of the day what value they ascribe to Microsoft's shares and thus what price they are willing to pay for your stock. Even if you thought you knew what your shares were worth, how would you find a buyer and persuade her that your analysis is right? Would you go door-to-door in Miami or Los Angeles? Put up an ad on Craigslist? (In Vietnam's over-the-counter market, that is exactly what happens; you then arrange to meet the buyer on a street corner to swap the shares for cash.) And if you found a buyer, could you be certain that you would be paid in full and on time, so that you could pay your own mortgage and purchase your groceries?

Money has existed for millennia, ever since people recognized that barter was an inadequate method of exchange. The stock exchange, just a few centuries old, was the next logical step as society's financial needs became more complex. The first exchanges were established in wealthy trading cities such as Hamburg, Antwerp, and Amsterdam. Here, by the early sixteenth century, there was a significant concentration of wealth in the hands of merchants and noblemen, all of whom had an interest in putting it to work in new and different kinds of enterprises in the hope of diversifying and making still more money. These communities traditionally were also home to cutting-edge commercial enterprises, ranging from new technologies such as printing to global trading ventures to the East Indies.

Investors willing to back these enterprises—most of which could take years to pay off—needed a secondary market: a place where people who were interested in buying or selling shares in ventures could meet each other or find an intermediary to help them with that transaction. For a while, Amsterdam's church naves served that purpose, along with the open-air wharves on Warmoesstraat near the city's old church, or Oude Kerk. The first formal stock exchange in Amsterdam opened its doors in 1610; between noon and 2:00 p.m. each business day, members were expected to show up and buy and sell on behalf of the general public—in other words, to

provide liquidity to the secondary market.[6] By 1688, the Amsterdam exchange already looked a lot like the trading floor of the New York Stock Exchange in its twentieth-century heyday; seventeenth-century stock jobber Joseph de la Vega, in his dissertation on the financial markets of the time, entitled Confusión de Confusiones, famously described the scene as one in which "handshakes are followed by shouting, insults, impudence, pushing and shoving." (Perhaps it was this atmosphere that led so many former professional football players to pursue second careers in the trading pits of the Chicago Board of Trade and the Chicago Mercantile Exchange.)

There probably has never been a time when people didn't complain about how the financial system worked—or failed to work. Nevertheless, the United States, as Alexander Hamilton, the country's first Treasury secretary, realized, would need a smoothly functioning financial system as part of its struggle to emerge as a viable nation-state.[7] Hamilton's initiatives included creating the country's first national or central bank, the First Bank of the United States, to replace myriad institutions within each of the thirteen original colonies, each of which had its own monetary policy and issued its own currency. Hamilton's goal was financial order and transparency, necessary if the new country was going to be able to repay its war debt and finance its growth by investing in new industries.

Wall Street, the narrow thoroughfare in lower Manhattan that owed its name to its former role as the northern border of the sixteenth-century Dutch colony of New Amsterdam, benefited from many of Hamilton's efforts to create the infrastructure of a national financial system and emerged as the heart of the new country's financial markets. It was here merchants chose to hang out on street corners to swap their ownership interests in government debt or the handful of start-up companies, such as canal construction ventures, that would form the core of the United States' new economy. (If you wanted to trade in the bonds newly issued by Alexander Hamilton's fledgling Treasury Department, you'd have to know which lamppost on Wall Street to stand under.) Eventually, the

introduction of New York state regulations banning curbside haggling as a "pernicious" practice drove these early Wall Streeters indoors. Some two dozen dealers gathered under a buttonwood tree to sign a pact that served as the foundation of the New York Stock Exchange. First housed informally in a Wall Street coffeehouse, the exchange moved to a room at 40 Wall Street in 1817, paying $200 a month in rent, before relocating to the quarters it now occupies, just across Wall Street from Federal Hall. Today, the original Buttonwood Agreement, a tiny sheet of yellowing paper, is on display at the Museum of American Finance a few doors away at 48 Wall Street, the building that once housed the Bank of New York, also founded by Hamilton himself.

"You know, if Hamilton came back to life, I don't think he'd be all that surprised at the way the financial system has evolved," says Dick Sylla, the Henry Kaufman Professor of the History of Financial Institutions and Markets at New York University. A silver-haired, slightly built man, Sylla appears unruffled by the dramatic changes that have taken place on Wall Street, smiling wryly at a display at the museum featuring Citigroup's now-reviled leaders—Robert Rubin, Sandy Weill, and Charles Prince. But then, for him as for Hamilton (about whom he is writing a book), America's financial system was never about a single institution, however large. "It's all about the functions that the various institutions perform, rather than what names they go by or where their headquarters happen to be," Sylla explains. "Hamilton knew that there would be bubbles and periods of chaos. But if over the long run the system as a whole performs its function of allocating capital and allowing us as investors to diversify our portfolio, to not put all our eggs in one basket, it is doing what he wanted it to do."

The Nature of the Money Grid: The Intermediary

Wall Street, in its totality, involves more than what happens on the floor of the New York Stock Exchange or within the walls of any single investment banking institution. It has become a labyrinth of

many different groups and institutions, all of which have one thing in common: they make the whole money grid work more smoothly and more efficiently. Many of them work hundreds or thousands of miles away from Wall Street itself. In Tacoma, Washington, Russell Investments devises stock indexes widely used by mutual funds and other big investors; in Kansas City, a firm called TradeBot uses computer-generated models to exploit tiny differences in the price of different types of securities and trades—in only milliseconds—on that information, making markets more liquid; Chicago's options exchanges make it possible for investors to bet not on the direction of a stock's price but on the rate and magnitude of change in that stock price and the time frame in which the change will occur.

All of these players perform functions that link the "buy side," those who have capital and want to invest it profitably, and the "sell side," those entities in need of capital. "At its heart, when it is doing what it does best, Wall Street is a superb gatekeeper, making matches between investors and businesses, governments, or anyone else who needs to finance something," explains Mike Heffernan*, a former Morgan Stanley banker. The sell-side client could be a regional bank trying to resell portions of some of the loans it has made, a credit card company looking for an investment bank to package up its receivables into asset-backed securities for resale, a town in Indiana trying to find investors for the municipal bonds it must sell in order to finance new hospitals and schools, or a company trying to raise capital for expansion or to acquire a rival.

The sell side wants to get as much capital on the most favorable terms possible from the buy side—investors who range in size and importance from individuals to mutual fund conglomerates such as Fidelity, and include hedge funds, private equity funds, foundations, college endowments, pension funds, venture capital partnerships, and ultrawealthy individual investors such as Microsoft cofounder Paul Allen or financier George Soros. In a perfect world, the sell side would love free money—with no interest payable, no specific term for repayment, and no promises about increasing the value of the investment. It is the myriad institutions that collectively make up Wall Street that—in exchange for a fee—bring together the two

parties and negotiate a compromise: the terms on which the buy side is willing to invest some of its capital and the sell side is willing to agree to in order to get its hands on that capital. Banks have been fulfilling that kind of function in more limited ways for centuries: the Bank of Venice issued government bonds back in 1157 to finance its war with the Byzantine empire in Constantinople, and by 1347, as the Medicis rose to power in Florence, there were no fewer than eighty banks making loans and doing business in that city-state; a few years later, the Florentine authorities started a special credit fund that would give interest-free loans to distressed condottieri, or soldiers of fortune.[8]

But as the sums got larger and the members of interested parties on the buy side (investors) and sell side (individuals or entities in need of capital) expanded in size and number and their needs became more complex, the process of bringing them together got tougher, and Wall Street–like intermediary institutions arose to facilitate the procedure. If you were a former condottiere who had lost an arm fighting for Florence against its neighbor and rival city-state Pisa in the fourteenth century, you knew which bank to approach for your interest-free loan. But what about financing a decade-long voyage to Southeast Asia in hopes of finding the mysterious Spice Islands and returning with a king's ransom in the shape of black pepper, cinnamon, and nutmeg in the sixteenth century, or funding the development of the latest gene-based cancer therapies in the twenty-first century? Both require the right kind of buy-side backer. On its own, the sell-side entity (the merchant adventurer or biotech engineer) would squander weeks or months it could ill afford trying to raise the capital it needed. And it was only logical that these go-betweens—the investment banks and their predecessors, who made it their business to be familiar enough with all the deep-pocketed members of the buy side so as to quickly route the different investment opportunities to those they believed would have the most interest and the right risk appetite—should pocket a fee for that knowledge as well as for their skill in negotiating the terms of any investment.

Wall Street exists to help investors and those in need of capital

find their way through the financing maze. Investment bankers still not only link the two sides but also help them sort out what terms are fair for the kind of capital being sought. Wall Streeters weigh in on the relative merits of different kinds of capital as well, advising corporate chief financial officers when it will be cheaper in the long run to issue debt on which the company will have to pay interest periodically, or when it might be a better idea to sell a stake in itself to investors in a stock deal. If they opt to issue corporate bonds, what kind of debt do investors want to buy, and what interest rate will the buy side demand in exchange for capital? Without the processes that Wall Street collectively oversees, it's hard to see how that vital function in our economy would be filled. The U.S. Treasury could still issue bonds and sell them directly to citizens, and municipalities might be able to raise at least some of the money they need selling muni bonds to their own citizens. But the latter, at least, won't raise all the capital they could at the cheapest possible price without an intermediary to help them identify the maximum number of interested investors.

If we were still back in the early 1900s, the prospect of the collapse of the investment banking system wouldn't be quite as apocalyptic as it is today, at least as long as enough of the commercial banks remained in business. That's because well into the 1920s, corporate finance was largely a matter of bank loans—if you could persuade your local bank manager that your business idea was sound and that you were a good credit risk, then he would lend you what you needed to get going and perhaps introduce you to some other folks who would invest in the fledgling company.

The earliest backers of auto pioneers Henry Ford and William "Billy" Durant (who founded both General Motors and Chevrolet) were local businessmen willing to risk some of their own money on two of the ambitious pioneers trying to build and sell the new horseless carriages. Durant even orchestrated a bidding war between Flint and Jackson, two midsized Michigan towns, to decide which would become the corporate headquarters of Buick, the company that would later become General Motors. Flint won the battle (along with the future tax revenue and jobs for its citizens) when its

four banks and several carriage and wagon businesses, along with hundreds of other corporations and civic boosters, put up nearly $1 million in cash in exchange for stock in the fledgling company, more than double what Jackson's citizens were able to offer.[9]

Financing these entrepreneurs was both risky and nerve-racking: two-thirds of the more than five hundred car companies launched between 1900 and 1908 had either collapsed or changed their business within a few years.[10] Once a bank or a backer had committed its capital to a specific venture, there were few exit strategies—the stock wasn't publicly traded. This early version of the money grid was unsophisticated and underdeveloped. Even Durant—far easier to work with than the mercurial Ford, and a former stock trader to boot—couldn't penetrate Wall Street's establishment and get the money grid working for the benefit of his company. Discussing the possibility of forming a trust made up of the biggest automakers to design and build a car for the mass market with J. P. Morgan's minions, Durant failed to persuade the great man himself of the virtues of the automobile. Much as he loved the idea of an oligopoly, Morgan seemed to love his horse-drawn carriage still more, dismissing automobiles as toys for the rackety younger generation and Durant as an "unstable visionary."[11] Durant was no more enamored of Morgan. "If you think it is an easy matter to get money from New York capitalists to finance a motor car proposition in Michigan, you have another guess coming," he wrote bitterly to his lawyer. Ultimately, Durant relied on local financing to get his new venture, General Motors, off the ground. Henry Ford managed to steer clear of Wall Street until the end of his life, relying on a steady flow of loans from banks such as Old Colony Trust Co.

Today's money grid is altogether a far more sophisticated and effective entity, having expanded geographically and evolved functionally. Wall Street is no longer a small clutch of giant investment banks, but includes a large and diverse network of venture capital funds whose specific function is to underwrite risky start-ups of the kind that Ford and Durant sought financing for a century ago and that a new generation of automotive industry

entrepreneurs are trying to launch today. “This is what we exist to do,” says Dick Kramlich of New Enterprise Associates, one of the venture industry’s veterans. “Until the postwar period, and even for a while after that, if you wanted to start something completely new, your personal network needed to include people who had money or who could vouch for you to the bank. Now all you need is a great business plan that you can get in front of one of us. We’ve become part of the bigger, broader Wall Street system.”

Indeed, during the Internet boom in the 1990s, Sand Hill Road, the long and winding thoroughfare that connects downtown Palo Alto, California, with the campus of Stanford University and other parts of Silicon Valley, became a kind of Wall Street west as the venture capital funds that set up shop there became more important to both the economy and the financial markets, financing start-up companies and generating big paydays for their own backers when some of those—eBay, Amazon.com, Netscape, and Google, to name a few—hit it big. Of course, just as many of the ships that sixteenth-century merchants financed in their voyages to the Spice Islands of Indonesia ended up dashed to pieces against the rocks on the coast of Africa, so many of the start-ups that today’s venture capitalists back never live up to expectations or go belly-up. But the winners have been frequent enough that venture capital investors willing to wait five, six, or even ten years for their bet to pay off in their little corner of Wall Street can make just as much money as top-flight investment bankers or superstar hedge fund managers in theirs.

At the height of the dot-com boom in 1999, commercial real estate on Sand Hill Road was more expensive to rent than anywhere else in the world (including Manhattan and London’s West End), reflecting the triple-digit returns some venture funds were earning. That bubble popped in 2000, making office space in Silicon Valley affordable again. But the venture capital community continues to scour the landscape for the next “new new thing,” whether that is the social networking “industry” or green technology, with businesses built around environmentally friendly twists on the pioneering products of a century ago, such as new

kinds of batteries, power generation technologies, and—yes, you guessed it—new kinds of automobiles. Detroit's executives might have had to grovel for a share of bailout funds after their financial prospects became so bleak that Wall Street east couldn't do anything to help. But on Wall Street west, some of Sand Hill Road's venture investors were eagerly backing companies such as Tesla Motors, founded by Elon Musk, the millionaire creator of the electronic payments system PayPal.

"A few years ago, this was the lunatic fringe of the venture capital industry," explains Ira Ehrenpreis, a general partner at Technology Partners, one of Tesla's financial backers. Today, he estimates, as much as $17 of every $100 that venture funds collectively invest goes into clean-technology companies as a category, while half of all the capital Technology Partners raises is allocated to the industry. Ehrenpreis waxes rhapsodic about Tesla's first car, the $109,000 Roadster, of which 1,200 were on order by the end of 2008; 937 had been sold by December 2009. "It makes a Prius look like a gas-guzzling hog and drives like a Ferrari!" he exults. A couple dozen of the brightly colored sports cars, which can travel 236 miles on a single charge, can sometimes be spotted whizzing silently along Silicon Valley's highways and streets, Musk's among them. The Roadster, says Ehrenpreis, shattered the belief that going green meant abandoning style; the next step is to roll out a more affordable Tesla sedan by 2011, and to raise capital for that through an initial public offering (IPO) of stock in the company, completed in June 2010.

Kleiner Perkins Caufield & Byers is one of Silicon Valley's most venerable venture firms; it has invested in most of the technology industry's landmark deals, now runs a $100 million "iFund" jointly with Apple in addition to its other portfolios, and has the same status in the venture capital universe that Goldman Sachs does on Wall Street east. But despite the motto on its website—"In Search of the Next Big Idea"—the firm passed up the chance to invest in Tesla. "All-electric cars probably aren't practical for a long time," argues Ray Lane, a partner at Kleiner Perkins and former president of Oracle Corp., the world's second-largest software company.

But Lane's resistance to the idea of investing in a next-generation kind of auto company didn't last long. Kleiner Perkins is now backing a more hybrid, less purist company, Fisker Automotive, launched by a designer who briefly worked for Tesla. "The Fisker cars are what I call a 'no-compromise' vehicle—beautiful and with a price point as well as features that will compare to a BMW," boasts Lane, who has a gray Fisker prototype in his garage at home that can run for fifty miles per battery charge. "To back these electric vehicle companies, you have to be as entrepreneurial within the venture world as the entrepreneur is within the corporate world—in other words, very, very willing to embrace risk." But, he quickly adds, Fisker was ready to build some seven thousand electric vehicles in 2010. "GM can't seem to produce one."

By being able to reconceive its role to include venture capital, Wall Street has proven itself, in the long run, more entrepreneurial than the Detroit-based automakers. It's not just venture capitalists that have spotted the potential of this new breed of automaker, however. Even with only a few dozen vehicles on the road, the fledgling green technology banking teams from Goldman Sachs, Morgan Stanley, Credit Suisse, and others were already making the trek to San Jose to check out Tesla and its rivals. So what if they are still guzzling capital faster than an SUV or Hummer can guzzle gasoline? Wall Street today doesn't need to be persuaded that it needs to be present from the very beginning if it is to capture all the business—and profits—it can. Sure enough, early in 2010, Tesla Motors filed to go public, with Goldman Sachs selected to lead four blue-chip underwriters; although the company had yet to generate a profit, it raised $266 million. As of July 2011, the stock hovered near $28 a share, a level the stock hit briefly on its first trading day.

How the Financing Life Cycle Works

There may be no better example of Wall Street's raison d'être than the role that venture capital—itself part of the money grid—plays in making entrepreneurial dreams a reality.

The same week that Lehman Brothers collapsed, the major figures of the venture capital community assembled at Microsoft's campus in Mountain View, California, a stone's throw from Sand Hill Road for the National Venture Capital Association's thirty-fifth anniversary. They listened to presentations by three carefully selected venture-backed companies: Tengion, a firm developing biotechnology to build new human organs from cells; Digital Signal Corp., which is honing 3-D facial recognition software that can be installed anywhere from airports to shopping malls; and Tesla Motors. Formalities over, the crowd escaped to the reception room to quaff Napa Valley wines and buzz excitedly about the meltdown under way on Wall Street east. One of the most visible of those present was former star technology banker Frank Quattrone, who had spent the 1990s steering one promising technology company after another through the financing process, from the first capital infusions to the initial public offering (collecting hefty fees for his firms, which included Morgan Stanley and Credit Suisse, along the way). He became the banker most closely associated with the dot-com boom, but years after it burst, he was back helping start-up technology companies raise capital.

That evening he was talking up his new quasi-banking venture Qatalyst, and debating the impact the turmoil on Wall Street proper would have on start-up businesses in Silicon Valley and his own firm's prospects. "He was very interested, feeling that this might pave the way for a revival of the old West Coast boutique investment bank, like the Four Horsemen," said one venture investor who was on the receiving end of his pitch that evening.

The Four Horsemen were four small to midsized investment banks—Hambrecht & Quist, Montgomery Securities, Robertson Stephens, and Alex. Brown—that individually and collectively carved out both a niche and a reputation for themselves as the go-to guys for entrepreneurs in need of finance, venture capitalists hoping to take their portfolio companies to the next level, and investors hoping to get in on the ground floor of the next great business idea. "We didn't go into this wanting to be Goldman Sachs; we knew we'd end up as a marginal player trying to compete with them on

ground that they owned, and that would be dangerous," recalls Bill Hambrecht, who founded the firm that bore his name and who now runs another boutique, W. R. Hambrecht & Co. "More than many of those larger East Coast firms, our model was very straightforward—we were there to help those companies move up the ladder to the next stage in their financial life cycle."

In 1981, the rest of the investment banking universe woke up to what was happening on the West Coast. "In a sixty-day period, we underwrote [the initial public offerings of stock in] Genentech, People's Express, and Apple," recalls Hambrecht. "I think we had sixty people in the firm; we made about $50 million that year and it changed everything." Hambrecht had attended college with the late Dick Fisher, then chairman of Morgan Stanley, who recognized what was brewing before the rest of the big Wall Street institutions. "He called me, then came to visit me, and told me, 'Okay, I want in on this business.' I asked him what companies interested him, and he mentioned Apple and a few others—he and his team had done their work and identified the best companies, not the biggest ones." Hambrecht & Quist would go on to co-manage multiple deals with Morgan Stanley, the two firms helping each other earn hundreds of millions of dollars more in fees apiece before Fisher retired and Hambrecht & Quist's partners decided to sell their firm to Chase Manhattan in 1999, at the peak of the dot-com market.

The names of the institutions that help Silicon Valley's most promising companies move from one stage of development to the next by providing capital directly or introducing the company to potential backers are likely to continue to change, but the process itself remains intact. The earlier it is in a company's life cycle, the more informal that process, as was the case with Google, now a corporate behemoth. One of the company's earliest supporters was David Cheriton, a Stanford professor who knew its founders, Sergey Brin and Larry Page. Cheriton also knew Andreas "Andy" Bechtolsheim, the cofounder of Sun Microsystems, and introduced him to the two would-be entrepreneurs at a gathering at his Palo Alto home. Bechtolsheim wrote Brin and Page a check for $100,000 on the spot even though the company hadn't yet been formed. He

followed that with another $100,000 when the first formal venture financing round occurred the next month.[12] (One firm that passed on Google was Bessemer Venture Partners; offered the chance to meet the "Google guys," tinkering in the garage of a friend's home, David Cowan asked if there was a way out of the house that would enable him to bypass the garage.)

In the space of those few weeks, the Google guys had rounded up another $760,000 in start-up funding after Bechtolsheim introduced them to John Doerr, one of Sun's earliest investors and at the time the lead investor at Kleiner Perkins. Where Doerr went, others eagerly followed: the imprimatur of Kleiner Perkins was as valuable as that of Good Housekeeping or Goldman Sachs. Doerr roped in Jeff Bezos (he had also provided start-up funding for Bezos's Amazon.com), who in turn brought along Amazon colleague Ram Shriram; all invested in the fledgling company long before it was clear that Google was going to become, well, Google. At the time, it was just another speculative "angel" investment, one of scores that each of these individuals undertook between 1998 and 2000. But by the time the IPO had been sold and Google's stock was trading on the public market, Bechtolsheim's $200,000 was worth $300 million or so.

A typical venture firm, such as Kleiner Perkins, raises and provides capital at the earliest stages of the financing life cycle. That capital comes from other buy-side players, such as college endowments, pension funds, and very wealthy individuals whom the general partners know and trust, often successful entrepreneurs such as Bechtolsheim and Bezos. Venture funds make most of their money from their share of the profits of their funds (usually 20 percent) but also collect a fee from their investor base in exchange for their services bringing together those investors with bleeding-edge investment ideas at their earliest (and most potentially profitable) stage of development. Without venture funds and their vast networks, how would Verizon's pension fund know that two bright young Stanford students were about to put together a company that within a decade would dominate the technology landscape? And how would Brin and Page have navigated the Wall

Street labyrinth in search of financing at such an early stage, while still working out of a friend's garage?

The next stage in the financing life cycle for venture-backed companies such as Google is a process that will allow those early backers to realize the value of their investment. People such as Doerr and Bechtolsheim, like everyone else on the buy side, don't want to keep their capital tied up in the same companies indefinitely; at some stage they want it back, along with a healthy return, in order to put it to work somewhere else and repeat the process. In other words, they want liquidity, just as any of those sixteenth-century merchants wanted to be able to sell part of his stake in the East Indian trading vessel long before it returned home with its hold stuffed with nutmeg, cinnamon, and silks so that he could provide his daughters with dowries.

By the time Google was ready to go public in the spring of 2004, its team didn't need any help from Bechtolsheim or Doerr in finding an investment bank willing to serve as an intermediary between Google and its future stockholders. Every investment bank in the United States, as well as an array of foreign competitors, wanted a piece of the action. Unlike all the dot-coms that had crashed and burned just months earlier, this technology company could point to real revenues, not just an ambitious business plan. It was a jewel, and every bonus-starved banker wanted a place on the list of underwriters—preferably as lead underwriter or, even better, the book runner, the guy in charge of deciding which equally excited mutual fund managers, brokers, and individual investors would win a few Google shares at the IPO price and who would get to pocket the bulk of the underwriting fee in compensation for all the aggravation. This would be a multibillion-dollar offering, and in a typical IPO, the underwriters collectively could pocket as much as 7 percent of the proceeds as their fee.

Every banking team in the world began to chase the deal, and they all took it very seriously indeed. Morgan Stanley opened up a Silicon Valley war room, complete with a team of top bankers and analysts preparing pitch books and rehearsing answers to questions they expected to get from Lise Buyer, then Google's chief financial

officer, and the other Google execs who would select the winners. "It was just like a presidential election campaign," recalls Hambrecht. Two weeks before the "bake-off" was scheduled to take place at the Palo Alto offices of Google's law firm, Wilson, Sonsini, Goodrich, & Rosati, pitting the finalists against each other, Morgan Stanley's team hired the key analyst that Hambrecht had assigned to prepare his own firm's pitch for the deal. "They wanted to find out what we were doing," Hambrecht says, shrugging. "All's fair in love and war."

And this was war, make no mistake about it. On a Saturday afternoon in early April, the finalists were scheduled to appear, one at a time, to make the final pitch to Google executives and board members, each explaining (with the aid of thick pitch books stuffed full of charts, diagrams, and other propaganda) why they were the only guys for the job. The Google folks knew what they were in for. Buyer had helped prepare pitch books herself in a previous life as a top technology analyst. Aware of the other tricks that Wall Streeters liked to play, she instructed the top bankers to stay home, decreeing that only the middle-ranking people who would actually do the grunt work on the deal should show up. (Few abided by that rule.) She also told them to be creative. "We wanted to be sure we'd be working with bankers who got our corporate culture, so I guess we kind of opened the door to a lot of the silliness that followed," she said.

One banking team brought beer, apparently assuming that a freewheeling culture was synonymous with the liberal consumption of alcohol. Another tried to design a PowerPoint pitch incorporating Google's own search engine, which would spit out the firm's name when asked, "What is the best bank to underwrite Google's IPO?" (The technical challenge proved impossible, and the banking team resorted to a paper version of the same pitch.) Citigroup's technology bankers designed laminated place mats that spelled out the bank's achievements and creative strategies for marketing Google to the public, using Google-like design elements and layout. The place mats probably came in useful for the pièce de résistance. The banking team from Goldman Sachs, taking to

heart Buyer's quip that, "given that we're all here on a Saturday afternoon, you can damn well bring me dessert," and learning through their own research that Brin and Page loved chocolate, ordered up a big chocolate cake, emblazoned with the Google logo, to bring to the pitch meeting. Stunts like that have been known to work, as Lisa Carnoy, who is now global capital markets co-head at Bank of America, knows from her days co-managing the same group at Merrill Lynch & Co. Pulling together a pitch book for the investment bank's presentation to Lululemon, a yoga clothing retailer seeking to go public, Carnoy included details of the favorite yoga positions of each member of the banking team in hopes of showing just how much the bankers understood their potential client's business. "They got a kick out of that and we got the deal," she recalled.

Winning an IPO is one matter; completing it to the satisfaction of all parties is something else altogether. However crucial the role played by Wall Street in bringing together and reconciling the competing interests of the buy side and the sell side, there is usually one group that feels it has given up too much in the process. A typical IPO investor, for instance, wants the largest allocation possible of a hot new issue. Many of those investors are also investment bank clients; they execute buy and sell orders and generate trading fees for Wall Street institutions year-round and aren't shy about telling the investment banks what they expect them to deliver in return. Fidelity, back in the days when it routed more than half of its immense trading activity through Wall Street trading desks, routinely threatened to "cut the wire" and trade with a particular investment bank's rivals if it didn't get an allocation twice that of its nearest competitor for an enticing IPO. The investment bank usually obliged.[13]

To make the buy side happy, the new stock should be priced at a level that will allow it to rise in value—preferably by 20 percent or more—in the days immediately following the IPO. That gives any mutual fund manager the chance to sell some of his shares at a quick profit—and can mean a big boost in trading revenues for the investment bank as trading volume in the newly public stock shoots

higher. When Netscape went public in 1995 at $28 a share, it posted its first trade at $71. Those watching the electronic screens were convinced it was a typographical error or that they were hallucinating. An entrepreneur watching that kind of drama, however, is well aware that he may have just lost millions of dollars of new capital for his company and is left wondering whether Wall Street has just ripped him off. "Everyone was angry about that, and very vocal about" what they viewed as giving up that much in potential proceeds, says Buyer.

Google tried to ensure that it would capture as much of the proceeds as possible for itself and its backers. In fact, while the deal itself turned out to be messier and less profitable than anyone had hoped, it did at least leave all three parties—the buy side, the investment bankers, and the company itself—feeling equally dissatisfied. Morgan Stanley and Credit Suisse were told they had won the coveted co-lead-underwriting spots but that they would have to use Hambrecht's new method of capital matchmaking, a kind of auction that forces would-be buyers to bid against each other for the stock, disclosing the maximum price they will pay. That approach was anathema to both bankers and the buy side: it not only involves a much smaller fee for the underwriters (about 2 percent of the proceeds rather than the traditional 6 percent or 7 percent) but also in theory eliminates the possibility of a first-day pop in the price of the newly public company of the kind that investors cherish but that issuers such as Google had learned to loathe. Hambrecht's new firm, W. R. Hambrecht & Co., which had devised the auction methodology, won a co-manager slot due solely to Brin and Page's fascination with the auction idea rather than his four-page stapled pitch, which Buyer rated the worst she'd ever seen.

For their part, potential buyers were disgruntled at being asked to relinquish their traditional instant profit. Hambrecht remained unfazed. The auction process, he says, "means that Wall Street is really fulfilling its role as the intermediary because the proceeds are going to the company, not as instant, nearly risk-free returns to the bankers or investors who've owned the stock less than seventy-two

hours." The rock-bottom fee took a toll on the process, banking analysts would later argue. Merrill Lynch walked away from the underwriting syndicate outright, unwilling to do all the work for what it saw as a skimpy return. The remaining underwriters later confessed to being reluctant to battle as ferociously as they might have done to combat buyer apathy, given the low fees. Buyers lowballed the deal, responding to the process and the deteriorating climate for technology stocks. Google had to settle for a price of $85 a share, instead of the $135 it had hoped to make from the deal.

The Troubled Heart of Wall Street

The process of underwriting an IPO or raising other kinds of capital for companies such as Google and providing exit strategies for their venture backers remains one of the core "utility" functions of Wall Street's big investment banks. "It's really not all that different today from the way it was back in the 1960s, when I wrote my first-ever case study about the IPO process," says Samuel Hayes, professor emeritus at Harvard Business School. Only the names of the issuers and the underwriters are different, while the dollar amounts are larger. But as the Google transaction illustrates, the relationships between Wall Street institutions and the two groups on either end of the capital exchange transaction that develop when a company goes public or otherwise raises new debt or equity capital aren't always smooth and straightforward. On the sell side, corporate clients such as Google don't always feel that their investment bankers are looking out for their best interests. Meanwhile, parts of the buy side—the investors—are just as skeptical.

The first part of the problem—the increasingly bumpy relationship between the investment bank and its corporate clients—Hayes attributes to changes on Wall Street itself. The mergers that have taken place over the last twenty years—all of the Four Horsemen were absorbed by national institutions, most of which in turn became part of still more massive financial behemoths—mean

that doing the kind of smaller deal that is characteristic of what most companies need in the earliest days of their existence isn't cost-effective. Venture capital investors are well aware of this trend, and it worries them. "Unless I have another potential Google, these guys don't want to know," says one Silicon Valley venture capitalist bitterly. "They want the sure thing, the big deal that is going to be able to make a visible difference to their own profits at the end of the quarter. They are more interested in that than in building relationships with corporate clients that might generate a stream of fees over the years. They have betrayed our trust." He points to Goldman Sachs, which shuttered its Sand Hill Road outpost (in a building it had shared with archrival Morgan Stanley) a few years after the tech bubble burst. "They'll fly people in for things they consider important, but there aren't as many people competing to serve this space, which means that all the companies that we are starting to fund today are going to have a much harder time in the later stages of their corporate lives when it comes to getting financing."

This venture investor predicts that a greater number of venture-backed companies will wither on the vine, unable to get financing simply because of their size relative to that of the investment banks. That, he argues, may not augur well for the future of both entrepreneurial energy and Wall Street. Will some prospective entrepreneurs be deterred or some promising companies derailed? And what happens if Wall Street turns its back on its core function of helping promising businesses realize that promise by accessing capital? "We play our role; we want Wall Street to play theirs."

For now, at least, the venture industry is keeping its part of the tacit bargain and continuing to invest billions of dollars a year in start-up companies. Despite the market chaos, venture funds still want to back the companies that they believe have the potential to become next-generation versions of Genentech, Google, or Amazon. These days those companies will range from start-ups offering innovative ideas on managing power grids more efficiently to businesses based on new medical devices. But by 2009, the signals were becoming more mixed. Wall Street's recent aversion to doing

what it saw as small-scale underwriting deals had remained, and had been exacerbated by the general chaos as banks focused on their own internal restructuring. That forced some venture companies to direct as much as 40 percent of their investment funds in 2009 toward existing, relatively mature companies still languishing in their portfolios and unable to find an exit.[14] In a normal year, says Jim Feuille, a general partner at Crosslink Capital, his venture capital firm invests in eight or nine new businesses. By late October 2009, they had selected only three new companies in which to invest, in order to preserve enough capital to be able to continue supporting those older businesses. The National Venture Capital Association reported that the same trend was being seen across the industry: by the third quarter of 2009 only 13 percent of all venture capital investment dollars were directed to first-time companies, the lowest percentage on record. While a surge in IPOs in the first half of 2011 revived confidence somewhat, some still fret about Wall Street's willingness to stick around in bumpier times.

This kind of breakdown in the relationship between Wall Street, as represented by investment bankers, and its corporate clients isn't confined to Silicon Valley—nor, as I'll explain later in the book, is the breakdown restricted to one part of the money grid. The relationship between Wall Street and its partners on both the buy and sell sides has been under threat for more than a decade, as Wall Street drifted further and further away from its core utility function and those clients generated a decreasing proportion of its revenues and profits.

From Gatekeeper to Casino Croupier?

Harvard Business School's Sam Hayes studied the breakdown in the relationship between Wall Street and its corporate clients in real time and knows whereof he speaks. He holds the Jacob H. Schiff Chair in Investment Banking as a professor emeritus and has studied Wall Street from the perspective of a scholar (he has published

seven books and countless research papers and other articles about various aspects of Wall Street), a consultant (to the Justice Department, the Treasury Department, and the Securities and Exchange Commission, as well as many businesses), and even a participant (he chairs the investment committee at his alma mater and is a former chairman of the Eaton Vance family of mutual funds, making him a member of the buy side, while his role as a member of the advisory board of brokerage firm Edward Jones puts him on the sell side). When in 1970 he began scrutinizing the way Wall Street worked, it was performing its intermediary function adeptly; the relationships with clients, he says, were true long-term ties of importance to both parties. When a CEO wanted to sell bonds, raise new capital through a stock issue, or mull over other strategic issues, he'd pick up the phone and call his banker. That banker would be the same person, or at least someone at the same firm, year after year.

But Hayes soon began to detect signs that those relationships were crumbling, as they came under siege from both sides throughout the 1970s. A new breed of CEOs and chief financial officers with MBA degrees felt better equipped to pit one Wall Street firm against another in search of a way to cut financing costs. Wall Street firms were quite eager to poach their rivals' investment banking clients, adding fuel to the fire. To both groups, this breakdown seemed logical and even beneficial—why shouldn't corporations shop around for the best deal and investment banks compete to offer that deal? By 1978, Institutional Investor magazine had stopped publishing the annual "Who's with Whom" list documenting which firms "banked" which corporate clients. "Clients didn't like being labeled as 'belonging' to Kuhn Loeb," Hayes recalls.

The turning point came a year later when IBM wanted to add Salomon Brothers as a co–lead underwriter to a bond sale it was planning. When the company informed its traditional bankers at Morgan Stanley of its wish to include Salomon because of the latter's growing importance in the bond markets, Morgan Stanley refused to share the spotlight. (At the time, Morgan Stanley, in an

attempt to emphasize how exclusive it was in the clients it accepted, even insisted on using a special typeface in the newspaper "tombstone" ads announcing deals it had done.) Instead of backing away from the idea, as Morgan bankers had expected, IBM awarded the whole deal to Salomon Brothers, shutting out Morgan Stanley altogether. It wasn't until 1984, when Morgan Stanley agreed to share the lead underwriting role for Apple with Hambrecht & Quist, that the blue-chip New York firm conceded that it would have to relinquish part of the limelight on occasion in order to participate at all in the deals it wanted to do.

If IBM's decision to put its foot down was the turning point in the relationship between Wall Street and the sell side, the tipping point in ties between the Street and its buy-side clients came in 1995, when Netscape went public with the assistance of several leading investment banks. The transaction certainly was part of Wall Street's core function—the underwriters were raising money for a corporate client—but the company in question had a far riskier and less established business model than those that bankers were accustomed to introducing to the buy side. With Netscape, says Lou Gelman*, a former Morgan Stanley banker involved in the IPO, Wall Street was asking its buy-side clients to adopt a completely different approach to investing. Netscape wasn't earning a profit, and its business model was untested, relying on the then-new phenomenon of the Internet. "Until Netscape came along, Wall Street used to say a company had to have two years of operating profits in order to go public," Gelman says. But Morgan Stanley badly wanted a piece of what promised to be a very hot IPO. "Suddenly our top guys were tossing their own rules out the window in order to get this business."

Above all, the Netscape IPO opened the door to speculation as an investment strategy. It was now in Wall Street's financial interest to encourage its buy-side clients to toss away their concerns about investing in a relatively risky business. "We went from being a gatekeeper to [being] a croupier," says Gelman. Until that time, he argues, Wall Street had served its buy-side clients by helping them preserve and protect their wealth. Now the ethos seemed to have

changed; Wall Street was becoming a casino, a place where people could create wealth rapidly by speculating. "It was with the Netscape IPO that the conviction we have today—that it's actually possible to get rich in a day by owning the right stock—took root," Gelman says. "It's corrupting."

Not only that, but for several years it was also exciting and dramatic; that drama would help swell Wall Street's own coffers as hundreds of Internet companies followed Netscape's lead and paid their 7 percent underwriting fee to go public. It all followed the success of the Netscape underwriting team, which, after overseeing the production of an IPO prospectus containing twenty-plus pages of risk factors, took the fledgling Internet company's management team on the road to drum up buying interest. The target stock price crept slowly higher, to $12 per share and onward, as public awareness grew during that "road show." The battle to acquire stock in the deal ended up bringing Wall Street and Silicon Valley to Main Street's attention; both captured the imagination of ordinary investors who until then had never had a brokerage account. One caller to Netscape's headquarters asked what the IPO signified. "Essentially that means our company will be trading a certain number of shares on the stock market, which will raise capital so we can expand our business," the operator informed him. "What's the stock market?" the caller inquired. Another caller had heard people talking about the deal in the grocery store and wanted more information. A third threatened to report Netscape to the San Jose police for "insider trading" when he wasn't allotted shares at the IPO price of $28 apiece. It's not surprising he was unhappy: the stock soared as high as $75 in its first trading day, before closing at $58 a share.

The external exuberance wasn't always matched inside Morgan Stanley itself, even after the deal turned into a runaway success story. "Some of us pushed back, but the argument came down to the reputation of our franchise against the potential revenue," says Gelman today. "Were we going to be the firm that doesn't do early-stage IPOs, when this is what the public wants to buy? No one, it turned out, was willing to walk away and leave that to our rivals."

By the time the dot-com bubble was fully inflated, Gelman was convinced that the capital-raising process had undergone a fundamental change. “We weren’t there to provide companies with the best long-term sources of capital to grow with; we were doing this to help our investor clients get richer faster.” In his view, Wall Street had abandoned both of its core constituencies in pursuit of its own self-interest.

That approach gained momentum as the years passed, and extended into a variety of products, including higher-risk corporate bonds and collateralized debt obligations (CDOs), the bundles of mortgages (including those issued to subprime borrowers) that had been repackaged in the form of marketable securities. Caveat emptor, Wall Street declared—buyer beware. “Eighteen or twenty years ago, when someone [on Wall Street] showed us a bad product, we went crazy; we’d tell them, ‘Don’t ever show us that again,’ ” recalls Scott Amero, a portfolio manager at BlackRock, a major buy-side asset management firm. “At first we took the time to explain why something was a bad product, why it was risky or poorly designed.” But eventually Amero found it impossible to provide that kind of detailed feedback: either the relationships weren’t strong enough to permit it or the banker wasn’t in a position to do anything about BlackRock’s concerns, especially since there were other willing buyers. All Amero could do was go on a buyer’s strike. In 2009, Larry Fink, one of BlackRock’s founders and its chairman and CEO, gave voice to his fury with Wall Street for abandoning its traditional role as gatekeeper that took care to funnel only valid and viable products to the buy side. In the past, Fink told the Financial Times, firms such as BlackRock “relied on Wall Street to be the safety guards to the capital markets,” winnowing out the poor-quality deals. Now, he added angrily, it seemed as if it was up to his firm and other buy-side institutions to protect the integrity of the parts of the market.[15]

The Core Function Becomes a Sideshow

The IPO market may be one of the best examples of Wall Street's core function at work, funneling capital from those who have it to those who need it. But Wall Street saw underwriting IPOs as less and less attractive with each year that passed. Most transactions were far smaller than either Netscape or Google, and the amount of work the investment bank had to do in order to drum up investor interest in a previously unknown company could be time-consuming. When that company planned to raise only $15 million or so, the fees were small. But being willing to work on an IPO was what a bank had to do in an era where relationships alone were not enough to win business. Some, such as Morgan Stanley's Dick Fisher, realized that technology companies weren't going to generate a lot of banking fees in the future. They didn't need much new equity after an IPO, typically, and almost never raised debt capital, since they didn't have the kind of fixed assets that bond buyers like to see. Unless the company decided to make acquisitions, the IPO fee might be the only banking revenue the underwriter ever earned. "Fisher told me he knew [companies such as Adobe and Apple] weren't going to be good investment banking clients," says Hambrecht. "He was right; Adobe had a $10 million IPO and then never raised another dime on Wall Street."

But Fisher's ultimate goal was to capture a different kind of business and a more secure stream of fee income for Morgan Stanley: he wanted to woo the newly wealthy executives as clients for Morgan Stanley's private banking team. "Sure enough, Morgan Stanley ended up managing about 90 percent of the wealth created in the Apple IPO, while Goldman Sachs did the same for their Microsoft millionaires," says Hambrecht. And when the $4.4 billion initial public offering of stock in UPS closed in November 1996, Morgan Stanley saw its $50.5 million share of the $191.5 million in fees paid by "Big Brown" to the thirty-five-member Wall Street underwriting syndicate as just the tip of the iceberg.[16] That evening, when UPS's top brass sat down to celebrate the first day of trading in their new stock (and its 30 percent pop in value), they were sharing their prime rib not only with the bankers who had sold the stock but also with the Morgan Stanley wealth managers summoned

to woo them as clients for that side of the company's business. Yes, Wall Street was changing.

Some of those who felt as if the new Wall Street was leaving them behind as it drifted further away from its core function came from within the ranks of Wall Street itself. While one group of Wall Street bankers focused on helping companies raise new capital, another specialized in advising corporate clients on making a different kind of match: negotiating a merger with or acquisition of another business. Fees on these transactions may be a smaller percentage (from 1 percent to 3 percent) of the value of the deal, depending on the complexity and the players—but the deal sizes can be large. And a satisfied client can earn a banking team a series of fees year after year, as a business grows through acquisitions. JDS Uniphase, an optical networking company, forked over $30 billion in stock for big-ticket acquisitions in just a few years, each of which generated hefty deal fees—mostly in cash—for the matchmakers who helped orchestrate them.[17]

At any rate, this part of Wall Street tended to see itself as an elite group. Other members of their firms underwrote stock and bond offerings, handled sales and trading, or devised structured products such as CDOs and might generate high fees when their part of the business enjoyed its moment in the sun. But the mergers and acquisitions (M&A) advisory business, in their eyes, was the heart of what Wall Street was really about. "In my mind, the really sharp minds on Wall Street are not doing IPOs or debt financings; they're doing strategic stuff like M&A advisory work," says Mike Donnelly* bluntly. Donnelly, who lost his own job in the wake of the collapse of his firm, hasn't lost his awe for those he considers to be Wall Street artists. "Someone who is really great at this has a knowledge of the business, the industry and the company and the strategic issues that lie ahead. He has the technical knowledge, he knows the latest twists and turns in accounting rules and the law. He has experience and is never taken by surprise because he knows the kind of odd things that can happen," explains Donnelly. "And they can present everything to a board in a lucid and compelling way. I suppose they're a bit like a Pied Piper: people who hear them will

end up following them anywhere. It's incredibly hard to find someone like that, and that's why they are so valuable."

Robert Greenhill, Morgan Stanley's president and Fisher's heir apparent back in 1992, has always been that kind of banker. Flying his own Cessna from one client meeting to the next, he and his team had propelled the firm to the coveted top spot in the league table rankings. (These widely scrutinized lists, published quarterly by data groups such as Dealogic LLC and Thomson Reuters, told the world which investment bank had underwritten the most deals in any specific area imaginable; the battle for league table credit and the bragging rights that went along with a top-three finish was fierce and remains so today.) Alas, merger volumes were down overall that year, and John Mack—whose own background was in sales and trading, the heart of the underwriting function—ended up elbowing Greenhill out of his way. Deposed as president in early 1993, Greenhill resigned shortly after, first joining Sandy Weill as the latter began to construct the behemoth that would become Citigroup and later founding his own boutique advisory firm. He left behind him what became known as the "Greenhill gap"—there was no one who was his equal as a rainmaker for the firm.[18]

To Gelman, the former Morgan Stanley banker, Greenhill's departure symbolized the final transition of power from the long-term strategic thinking characteristic of an M&A advisor to the emphasis on speculation and short-term profit maximization symbolized by the rising power of the trading desks and their chiefs within the power structure of many investment banks. "By the time Netscape came along, serving investors who were speculating and trading like crazy—and trading for our own account—had become what it was all about," he says. "Even in the IPO business, what had been a craft became an assembly line."

But by then, there was no way for Wall Street's investment banks to become purists, even when it came to fulfilling their gatekeeper role. Too much had changed in the world around them, and their responses to those changes had produced a series of unanticipated consequences. Long before the Netscape IPO was a gleam in the eye of the company's venture capital backers, it had become clear to

investment bank CEOs that relying on the basic gatekeeping functions of yore was never going to generate enough profit to keep their ever-expanding empires afloat.

CHAPTER 2

Building Better—and More Profitable—Mousetraps

Long before the dawn of the twenty-first century, it was clear to Wall Street's leading investment banks that while being a superstar at raising capital or negotiating mergers might earn them kudos, it wouldn't keep their shareholders happy in normal or slow market environments. These publicly traded entities needed to deliver reliable, consistent, and ever-increasing profits to their investors, whether or not the cyclical financial markets cooperated. Fees tied to the process of raising capital for clients—which was, in its turn, dependent on those financial market cycles—weren't going to be enough to keep shareholders happy. The future of Wall Street's biggest institutions lay not simply in helping Main Street clients navigate the liquid and transparent stock and bond markets but in generating newer and more exotic proprietary products.

The ugly end to the dot-com boom in early 2000 drove that message home to Wall Street decision makers like nothing else had done. They had spent the waning years of the twentieth century chasing the kind of fees that had been the bread and butter of Wall Street: taking start-up technology companies public, raising both debt and equity for the likes of WorldCom and AT&T Wireless, and pocketing merger advisory fees by helping companies such as Cisco and JDS Uniphase snap up innovative young companies. At least some of those who were part of that boom look back on it now with a degree of wistful nostalgia as the last golden age for the classic investment banker. "It was a period when we did what we were good at, more efficiently than ever before, and made more money for ourselves than ever before," says Larry McInnes*, a veteran technology and telecommunications banker.

Shareholders were happy; the average brokerage firm reported a 27.3 percent return on equity in 1999.[1] Goldman Sachs, which hadn't even had an investment banking office in Silicon Valley itself until that year, nevertheless managed to grab a commanding lead in technology stock underwriting, helping it capture a return on equity of 34.2 percent and making the firm—yet again—the envy of all the other chief financial officers on Wall Street. But that happiness could endure only as long as the market bubble kept inflating. Profitability on that scale came from making Wall Street's core process work overtime. After Netscape changed the game, Wall Street, eager to capture its share of the speculative frenzy in the shape of investment banking fees, was happy to fuel that frenzy by underwriting initial public stock offerings for increasingly risky companies, some of which had been in existence for just months and had no revenues, much less profits, to offer their investors. Goldman Sachs led the offering for Webvan, a grocery delivery service that rapidly closed its doors, while Merrill Lynch brought Pets.com to market; that company shut down ten months after the IPO. But Wall Street's priority was keeping its own shareholders content; as transactions became more speculative and riskier for investors, they became increasingly lucrative for the investment banks.

In 1995, the fee per transaction (equity and debt underwriting as well as advisory fees) on Wall Street hovered around $1.19 million; it hit $1.48 million in 1998, $1.81 million the next year, and a high of $2.03 million in 2000.[2] The average Wall Street bonus nearly doubled between 1998 and 2000, topping $100,000 for the first time.[3] Goldman Sachs alone had pocketed $24.5 billion in fees for underwriting sixty-three IPOs during 2000. By the end of that year, two-thirds of all IPOs were trading below the price at which the stock had first been issued. Investment banks were not going to give back any of their fees, however.

Still, with the classic financing process in a cyclical slump and the average ROE for investment banks and brokerages plunging to between 12 percent and 13 percent in 2001 and 2002, it was time for Wall Street to play the card it had kept stashed up its sleeve for

years. The fact was that Wall Street firms no longer needed to rely purely on the fees they earned for overseeing processes such as underwriting, sales and trading, or advising on mergers. These intermediary functions were profitable only when they could be done in tremendous volumes, as had happened at the height of the dot-com boom. The longer the slump that began in 2000 lasted, the more Wall Street needed to find an alternative source of revenue, preferably one with a higher profit margin.

Wall Street couldn't survive without fees, as veteran banking analyst Mike Mayo pointed out in the first round of hearings convened by the Financial Crisis Inquiry Commission (FCIC). Fees from Wall Street activities, Mayo noted, had generated no more than about 20 percent of bank revenues from the early 1950s right up until the early 1980s. But as other sources of revenue slid and banks found ways to create, package, and sell more exotic securities, that proportion rose—by the late 1990s, banks were earning some 40 percent of their revenues from fees. The answer, it became clear, was to develop structured products: the more complex the better, since the more sophisticated investment and risk management products commanded the highest fees from their clients.

As Federal Reserve monetary policy makers addressed the recession of 2000–2002 by slashing interest rates to the lowest levels most Wall Street bankers had seen in their lives, it made sense that many of these new products would be tied to two markets that are not only the country's largest but also closely linked to interest rates: the debt market and the housing market. Lower interest rates drove borrowing costs down for everyone, from the biggest leveraged buyout fund to the most cash-strapped home buyer. Not surprisingly, the level of borrowing skyrocketed, as did a host of new Wall Street debt products, from the relatively straightforward corporate bonds to leveraged loans and the now-infamous collateralized debt obligations (CDOs).

By 2005, the CDO had steered Wall Street back into extremely profitable territory. The focus on products (in the shape of CDOs) helped profitability per transaction jump back to $1.54 million and

then to $1.91 million in 2006, by which time the CDO market was worth a whopping $2 trillion, according to research firm Celent. (Estimates are that Wall Street investment banks and other participants in the mortgage boom had pocketed the same amount in fees for originating, packaging, and repackaging the mortgage-backed securities in those CDOs during the five years from 2003 to 2008.) Wall Street was hooked, this time on a product—the CDO—rather than on a process such as IPO underwriting.

As profitability zoomed, so did the risk. As one unnamed subprime lender in California recounted, "The sales guys from the Street would come and talk to you and hype you up. They would try to get you to do something. From Monday to Thursday you would make the loans.... By Friday your mistake would be on the marketplace" in the form of a new CDO.[4] The subprime lender (a firm such as Angelo Mozilo's Countrywide, for instance) pocketed an origination fee for making the loans; the Wall Street institution begging for the raw material to turn into CDOs collected the fees for gathering the loans together, repackaging them, and selling them. The quantitative analysts on Wall Street, who used mathematical or statistical markets to analyze the financial markets and develop new trading and investment strategies and tactics (these "quants" would become known as the Street's rocket scientists), began pushing the boundaries of the possible still further. As margins on CDOs began to dip, they first sought to create CDO-squared products (made up not of packages of mortgage-backed bonds but of chunks of CDOs) and even CDO-cubed structures (made up of pieces of a few CDO-squared products in a different combination). These variants weren't even composed of real assets but were "synthetic" securities, built of derivatives designed to mimic what the real assets would do.

Ultimately, Wall Street came to rely on these exotic securities for its profits. At the end of the day, there are a finite number of blue-chip companies that need Wall Street's help to raise capital or complete a merger deal. Persuading any one of those to do one extra deal a year is time-consuming and the odds of success are low, as any Wall Street veteran will admit; corporate deal makers are

well aware of the many studies showing that most mergers don't deliver the promised operational or financial benefits. Without a clutch of blockbuster deals—a few IPOs like that of Google, a series of multibillion-dollar takeovers on which to earn advisory fees—it was going to be hard to earn the kind of profit margins investors wanted. Wall Street needed help, and one of the places it found it was in the development of a new kind of deal machine, based on proprietary products. If the deal machine faltered, investment bankers knew, so would profit margins—and that just wasn't acceptable.

For all its fascination with correlations—market relationships, such as that between the price of crude oil and the value of oil and gas drilling companies, for instance—Wall Street seemed oblivious to one of the most significant correlations of all. Whenever its own fee income spiked to unusually high levels and its ROE levels surged well above average levels (by some calculations, around 15 percent), disaster seemed to follow. That had happened in 1999 and 2000. In 2006, the average ROE of the investment banks hit an average 23.3 percent, with Goldman Sachs again leading the pack with 33.3 percent. But Larry Sonsini, the Silicon Valley lawyer whose firm advises about four hundred public companies and thirty-five hundred privately held businesses, was watching with growing anxiety. "Month by month, year by year, I saw one investment bank after another drifting further and further away from their knitting, investing more and more in products rather than services," he says. Even the rhetoric changed, he observes. Instead of talking about Wall Street's role in the economy, the bankers he knew began to emphasize their role as profit-making businesses with no overarching economic mission. "They didn't even realize that they were moving outside the boundaries of what they had traditionally done; much less ask if it was a good idea for themselves, let alone the broader system. And as it turned out, they screwed up; Wall Street didn't understand what they were doing well enough to manage the risk associated with it. They felt they needed this business, and now we're all paying the price."

Even those who served as the earliest architects of this new Wall

Street didn't fully recognize the transformation they were helping to orchestrate. At Salomon Brothers, Lewis Ranieri knew that securitizing mortgages just made good sense for all concerned, from homeowners to investors—and certainly for Wall Street. He didn't envision the advent of collateralized debt obligations (also known as CDOs), much less CDOs squared or synthetic CDOs based on credit derivatives. He certainly didn't conceive of how those later innovations would transform an idea that made sense for all parties and that served a need for Wall Street's client base, into little more than a casino. As he later admitted in an interview with Fortune magazine, "I wasn't out to invent the biggest floating craps game of all time, but that's what happened."

Certainly, no one recognized the implications of the changes within Wall Street institutions that accompanied the shift in focus. The emphasis on products, rather than services, meant that relationships with clients became slightly less important with every month that passed. It took years, but by the end of the transition, few people were surprised when Goldman Sachs's CEO Lloyd Blankfein implied during his testimony on the Hill and to FCIC panelists that the firm's clients needed to do their own due diligence. Clients were on their way to becoming little more than counterparties. The inflection point had come and gone.

Mayday, Mayday, Mayday!

Wall Street's obsession with products and product innovation as a recipe for profits has roots more than thirty years old. May 1, 1975, has gone down in the history of the Street as "Mayday," the date the Securities and Exchange Commission had dictated would mark the end of fixed trading commissions in the stock market. Overnight, Wall Street's comfortable existence was shaken; its long-standing business model was turned upside down.

Until then, investors had been forking over 40 or 50 cents a share to place a buy or sell order for stock through their broker. "I was a big producer, because I'd do one trade in connection with a deal."

recalled the late Fred Joseph, former CEO of Drexel Burnham (itself a victim of product-related risk-taking in the form of junk bonds), who went on to cofound a boutique investment bank, Morgan Joseph. "I could make a $500,000 fee without discussing it with the client" simply because the commission was fixed. Those fees, many paid by big institutional investors such as Fidelity and Capital Research and Management, earned massive profits for those who did nothing but execute the trades. Jimmy Cayne, then a rising broker at Bear Stearns (and later its CEO and chairman), pocketed up to $900,000 a year at a time when Bear's partners earned only $20,000 plus a share in whatever profits the firm made each year.[5] "Oh, that was a wonderful cushion," recalled Joseph. Those profits, he explained, helped subsidize all kinds of other businesses that were vital to Wall Street's core function but that didn't make much money in their own right, such as research.

When regulators dismantled the fixed commission structure, they weren't thinking much about the unexpected consequences that might follow. Their focus instead was on the rebound in trading volumes that took place as the bear market of the early and mid-1970s loosened its grip. A pricing system that seemed reasonable when the average daily trading volume in a stock might be a few hundred shares looked like Wall Street getting rich at the investor's expense when volumes climbed. After all, it didn't cost a brokerage firm ten times as much to trade a thousand shares as it did to buy or sell a hundred shares of stock, in terms of the salaries paid to staff on the New York Stock Exchange, telecommunications costs, and other forms of overhead. Commissions of 40 cents a share were simply too costly for Wall Street's buy-side clients—the investors—to sustain, and the SEC decided that the intermediaries should have to negotiate their fees with their clients, competing against each other to offer the best deal. At Goldman Sachs, bankers recall they expected those transaction fees to fall 10 percent or so during the first few months of the new pricing regime. It was one of the few occasions when Goldman Sachs would be proven dead wrong. By the end of Mayday itself, the first day of the new trading fee regime, Wall Street's largest and (until now) most profitable customers had

used their clout to negotiate trading costs that were half what they had been the previous day. The trend continued. By the 1990s, trades that had once cost dollars to execute could be done for pennies; even the smallest individual investors were benefiting as discount online brokerages offered rock-bottom trading fees to win their business.

Initially, the end of fixed commissions won the moniker Mayday simply because of the date the new system began—the traditional May Day, celebrated for centuries as the beginning of spring. But perhaps the selection of a word that doubles as a radio communications signal for a life-threatening emergency wasn't all that coincidental. Michael LaBranche, now head of one of the New York Stock Exchange's firms of specialists, recalls people walking around the trading floor lamenting the changes and proclaiming it was the end of their business.[6] In a way, it would prove to be just that. Even those firms who had supported it, such as Merrill Lynch (which hoped to use negotiated commissions as a way to nab a larger share of the trading business), couldn't have anticipated the long-term consequences, in particular the scramble to replace the now-vanished cushion of earnings.

Wall Street's Mayday "changed the whole nature of Wall Street; what we did and who we were," argues Wilbur Ross, a financier and private equity investor who at the time worked in an institutional brokerage that specialized in research. No longer did the large and lucrative trades by big institutions help investment banks and brokerages subsidize less profitable but systemically important businesses, such as executing trades for individual investors and providing investment research. "Research suddenly had no value in its own right and wasn't being subsidized," Ross contends. "So the clever people on the Street said, 'Okay, we'll use these smart and well-paid people to bring in investment banking business.' " That led directly to one of the Wall Street scandals of the last decade, the one that pointed out just how wide the gulf had grown between the Street and the investors who had previously relied on firms such as Merrill Lynch not only to execute their trades but to give them advice.

Henry Blodget, the former hotshot Internet analyst, had done a very good job picking winners for Oppenheimer's investment clients, suggesting that they snap up shares in Amazon.com when the online retailer was trading at about half of his price target of $400; it breezed through that level only weeks later. That forecast grabbed the attention of Merrill Lynch, which recruited him to make research calls that would be just as lucrative for their clients. But if Blodget was good (in the short term) at picking dot-com winners, he proved great at raking in investment banking fees and being a cheerleader for the speculative Internet stocks. Even when their prospects soured, Blodget remained publicly upbeat. After the bubble burst, regulators began to question just why supposedly smart people had advocated that the rest of us do stupid things. They discovered that Blodget had sent internal e-mails to Merrill Lynch colleagues, griping about having to talk bullishly about overvalued and risky stocks just to help Merrill land investment banking deals. Blodget later forked over $2 million in fines (Merrill itself paid $100 million) and was barred from the industry for life, but he was far from the worst offender. And to this day, no one has figured out how to make independent and substantive investment research a paying proposition for a Wall Street firm.

For his part, Wilbur Ross simply shifted gears, forging a career first as a turnaround specialist and investor in distressed assets at Rothschild Investments, then launching his own specialized buyout firm in 2000. In his new position, Ross rarely had to worry about dealing with the pressures that Mayday had unleashed—particularly the push to produce a constant stream of high-margin new products that could help (temporarily, at least) fill the void left by the disappearance of fixed commissions. But he was aware of them nonetheless. "I was performing a specialized function and collecting a fee for it," he says of his work restructuring bankrupt companies. "But elsewhere on Wall Street, people were substituting balance sheet strength for brains" whenever the new product pipeline slowed.

Even before Mayday struck, the world had begun to change for Wall Street's investment banks and brokerages. The old-style partnership structure limited the amount of capital available and was increasingly proving inadequate for the new environment that was emerging. The capital belonged to the partners: they brought it with them and invested it when they joined the firm, and they contributed to it as the deals they did generated profits that caused the firms' profits to swell. And when partners retired, they could take it with them. Even the biggest partnerships chafed at the limits that this structure imposed on their ability to compete for big underwriting deals.

There were tremendous upsides to the partnership structure as well, especially when it came to managing risk. The partners all had a say in how to deploy the investment bank's assets—what deals to underwrite, what back office investments to make, whom to invite to join the partnership. The thinking was that no partner in his right mind (and they were all men) would take outsized risks that might jeopardize the health of the financial system, because in doing so he would destroy not only his professional reputation and his firm but also his financial security and that of his family. "When a partner put his capital on the line, he knew it was his right and responsibility to ask questions," says investment banking veteran John Costas, a former head of UBS's investment banking operations who launched his own boutique, PrinceRidge, in 2009. "If I'm involved in mortgage-backed securities, and someone else wants to do a big oil trade that I'm not comfortable with or don't understand, I'm going to raise my hand and say so, and tell them they need to explain it to me, because it's my money that's at stake."

Peter Solomon, chairman of his own boutique investment bank, Peter J. Solomon Co., recalled the scene at his former firm, Lehman Brothers, for the benefit of FCIC commissioners during the latter's first round of hearings in January 2010. "The important partners of Lehman Brothers sat in one large room on the third floor of … the

firm's headquarters," reminisced Solomon, who later became vice chairman of Lehman as well as co-head of its investment bank and head of its merchant banking operations. "The partners congregated there [but] not because they were eager to socialize. An open room enabled the partners to overhear, interact, and monitor the activities and particularly the commitments of their partners." There was a reason for any eavesdropping and snooping that took place, Solomon pointed out. "Each partner could commit the entire assets of the partnership" to a transaction.

The cons began to outweigh the pros of this system during the 1960s. That is when the capital constraints of the traditional partnership structure collided headlong with a surge in investor interest in stocks and a corresponding explosion in the trading volume on the New York Stock Exchange, which doubled between 1960 and 1965 and then more than doubled again by 1968. Drowning in the paperwork associated with each trade, Wall Street firms couldn't keep up. For a while, the stock exchange had to shut down every Wednesday, just to give its member firms a chance to balance their books. Even that didn't help; scores of brokerage houses simply collapsed, running afoul of net capital rules when they couldn't prove they had enough capital to support the trading positions that they had taken on behalf of clients. Technology was part of the answer, and so was hiring additional staff to deal with the flood of paperwork—but both would require large, long-term infusions of capital. And as Don Regan, then CEO of Merrill Lynch & Co., pointed out, with the partnership structure "you were never really sure what your capital was going to be."[7]

Dan Lufkin and his two partners, who had cofounded Donaldson, Lufkin & Jenrette (DLJ) in 1959, were determined that their fledgling firm wasn't going to be among the casualties. Although the NYSE's rules at the time required that its member firms be private partnerships, Lufkin believed that survival required major change. So in early 1970 he showed up at a meeting of the New York Stock Exchange Board of Governors, to which he had just been elected, and calmly informed his peers that his firm would file to go public the next day, in order to raise a permanent capital base and put the

business on a firmer footing. The reaction, Lufkin later recalled, "was pretty nasty, old men screaming."[8]

Chief among the opponents was Felix Rohatyn, one of Wall Street's most revered deal makers and managing partner of Lazard Frères, who snarled at Lufkin, "You are Judas."[9] Despite furious opposition from Rohatyn and others (Lazard itself wouldn't go public until 2005, after Rohatyn had left the firm to become U.S. ambassador to France), Lufkin and his partners prevailed, completing their IPO in April 1970, at a price of $15 a share. Although they raised less than they had hoped in the IPO, and although the stock's price languished well below that level during the bear market of the early and mid-1970s, the firm and its partners had pointed the way to an entirely new business model—the publicly traded investment bank, whose executives deployed investors' capital (aka other people's money) in search of the highest possible return.

The pressures on other banks to follow suit increased over the coming years. During the 1970s, new computer technology made markets faster-moving and more efficient, which in turn caused the spread between the bid and ask prices on any given stock (the difference between the price at which investors were willing to buy or to sell) to contract. Mayday knocked one prop out from underneath the old model of investment banking profitability; the computer would do the same to another, since those spreads represented another big chunk of Wall Street's earnings. To stay profitable, investment banks would have to become more active traders, making up in the number of trades what they could no longer capture in profit margin per trade. But that would require capital investment, and one by one, the other Wall Street powerhouses followed DLJ's lead and filed to go public in the 1970s. Some moved rapidly—Merrill Lynch in 1971—and others dragged their heels, worried by how the transformation might affect their culture. The results of this shift from partnerships to public ownership—and the wave of mergers that would follow—would prove dramatic. In 1955, the ten largest investment banks had about $821 million in equity (and subordinated debt) on their balance

sheets; by 2000, that had ballooned to about $194 billion.[10]

Goldman Sachs was the last of the major Wall Street players to make the transition, finally going public in 1999. There, too, partners-turned-shareholders saw the firm's culture shift, slowly but inexorably. Once, partners had been able to describe themselves—with a straight face—as being "long-term greedy." Now, things were different. "There was an awareness that we had a new constituency, and that all of our traditional ways about thinking about the business didn't necessarily tie in to what those guys wanted from us—which was profits and returns," says one former Goldman partner. "At some point along the way, we forgot to ask the question that had always been at the top of the list: is this piece of business worth having?"

Donaldson, Lufkin & Jenrette's open challenge to the Wall Street status quo was just the tip of the iceberg. There were other factors at work that would reshape the way Wall Street worked, notably the bear market of the early 1970s. Why do business at all? Wall Street's largest clients asked themselves. Why not just sit on the sidelines and wait it out until the extreme market volatility became a more manageable environment? Individual investors, who had flocked to Wall Street, savings in hand, during the 1960s, promptly pulled back. Wall Street's fee income from its traditional businesses—buying and selling stock on behalf of its clients and underwriting their debt and equity businesses—was threatened once more.

The solution? New products that would address new concerns, such as how to hedge against market slumps or volatility. Options were one possibility; these gave their purchasers a way to bet on the future price of an underlying stock (and, later, on the movement in indexes and other assets) for a fraction of the cost of buying the stock and with less risk than selling it short. (A short sale, in which investors borrow the stock from a broker and sell it in the hope of repurchasing it at a lower price to return to the lender and pocketing the price difference as their profit, has potentially unlimited risk. If a stock sold short at $10 soars to $100 a share instead of falling to $5, an investor is out $90 a share rather than making a $5-a-share profit.)

Until 1973, options had been used mostly by speculators, but that year a new mathematical model offered a seemingly perfect solution to the problem of how to understand the volatility and risk of a stock and therefore determine the correct price of an option. Devised by MIT professors Fischer Black and Myron Scholes (and immortalized as the Black-Scholes model), the formula gave dealers in the new and rapidly proliferating options products on the fledgling Chicago Board Options Exchange a relatively straightforward way to make a profitable market in options and helped investors use the products with greater comfort. (The model's limitations would become apparent only with the passage of time and in periods of market stress, as I'll show when it comes time to discuss risk management.) Black-Scholes opened the door for Wall Street to begin selling options-based strategies to their clients: investors could, for instance, own a stock but use options to hedge the risk that its price would slump in a bear market. Best of all, in addition to proving that they were paying attention to their clients' needs and wants in a time of stress, brokers could actually earn higher fees from options transactions than they could by executing more plain-vanilla stock and bond trades. It was a win-win situation—at least for the time being.

Globalization also created new market opportunities. In 1971, the United States abandoned the Bretton Woods system of fixed exchange rates, creating a thriving market for options and futures contracts on foreign currencies, such as the British pound, Japanese yen, and Swiss franc. The Eurobond market was another attractive new opportunity. Born in London's financial markets in the 1960s, it involved issuing dollar-denominated debt outside the United States, meaning that the issues didn't need to be registered with the SEC and that the companies selling debt didn't need to abide by U.S. accounting rules.

The Eurobond market was one of the fastest-growing capital markets around—and, like options, it was a lucrative alternative to plain-vanilla bond deals, rewarding underwriters with higher fees. But trying to build a Eurobond business drove home, yet again, the need for a large and stable base of capital. Not only did trying to

grab market share in Eurobonds mean establishing a presence in London, but players such as Morgan Stanley and Goldman Sachs (among the early arrivals) would need to compete with giant commercial banks such as Deutsche Bank and Credit Suisse, institutions that, unlike their U.S. counterparts, faced no domestic rules against using their giant commercial banking balance sheets to help them muscle in and grab investment banking business. (The 1933 Glass-Steagall Act, passed in the wake of the 1929 crash and mandating the separation of commercial and investment banking, was based on the belief that this kind of risk taking on the part of commercial banks had led to the collapse of the U.S. banking system during the 1930s.)

Long before the 1987 crash, all the ingredients required for Wall Street to become a higher-risk environment were solidly in place. "When we went from private partnerships that were the bread and butter of Wall Street's success for many years to publicly traded entities, we may have gained financial capital, but we lost one of those important checks and balances" that stops participants in the financial system from piling on risk, says John Costas. Moreover, publicly traded investment banks found that their new shareholders had a slightly different view of what the institutions' priorities should be than the former partners had had. Both wanted to maximize market share, but one of the trade-offs for access to capital was the demand by new shareholders that the firms also maximize profitability. If Goldman Sachs could earn an ROE of 20 percent or more, why couldn't Merrill Lynch, Citigroup, or Morgan Stanley? That's the kind of question that Wall Street's chief financial officers found themselves being asked year after year, with increasing heat, indignation, and exasperation. Soon they began to share that perspective. "Look, if we're going to be honest with ourselves, we need to admit that we wanted it all," says Lou Gelman, the former Morgan Stanley banker. "We wanted to keep making fat fees, posting high profit margins on relatively straightforward kinds of business. And after 1975, the writing was on the wall: that was never going to happen again." Wall Street, as it had functioned for decades, had undergone an irrevocable change.

one that made its core utility function take a backseat to its ability to devise new and exotic products.

From Cornflakes to Raisin Bran

In Marty Fridson's view of the world, today's Wall Street has drifted far afield from its roots as a utility, driven there by the winds of change blowing through the financial system and originating outside it. He sees clearly through the rhetoric that the investment banks still put forward when describing their role, to the heart of the matter: Wall Street's real focus is profits, not its utility function. And after a quarter of a century spent warning investors when one of Wall Street's cherished junk bond deals is nothing more than a pig dolled up in lipstick, Fridson is willing to speak his mind. It is no longer about the process, he insists; it's about the products. "I tell anyone I meet who's starting out in banking or research today, Wall Street is really in the breakfast cereal business," Fridson says bluntly. "Forget the idea of having a big mission. They're selling stuff to people, and after a while, that stuff becomes a commodity, like cornflakes. And then it's time to come up with a new, better idea, something that will become the financial equivalent of peanut-butter-flavored Cap'n Crunch."

How did fees earned from selling "stuff"—whether it's junk bonds, CDOs, or exotic derivatives—come to replace the fees captured as a result of the process of bringing together investors with those in need of capital? It all dates back to the changes that began in the 1970s. Wall Street's investment banks had always battled ferociously for the top spot in the league tables, the monthly, quarterly, and annual rankings that show which firms dominated the underwriting of what kinds of securities for what kinds of companies. The turmoil caused by Mayday introduced a new, cutthroat element of price competition to that already feverish competition. Most institutions that survived the 1960s and 1970s, whether through some kind of strategic planning or through trial and error, ended up devising several different ways to try to boost

their bottom line in a world of perpetual downward pressure on profit margins. A failure to replace trading revenues lost to technological innovation and deregulation could mean the institution's collapse, they were all well aware.

Sallie Krawcheck, who studied the investment banking business first as a research analyst and head of research at Sanford C. Bernstein and later as chief financial officer at Citigroup, notes that every year for thirty years after Mayday, the revenue that Wall Street collected in the form of trading fees declined. Every year, investment banks needed to generate more—not less—income and profit. The only solution? "You had to start running faster and innovating," says Krawcheck. "The best way to increase profits in that environment was, firstly, through innovation or by increasing the amount of leverage on your balance sheet."

The need for product innovation was made more pressing by the breakdown in long-term client relationships. The House of Morgan had ties to AT&T that dated back to a 1906 bond underwriting; Morgan Stanley inherited the investment-banking portion of those ties after the passage of the Glass-Steagall Act forced the venerable banking institution to separate its commercial bank from its investment banking operations. Between 1936 and 1968, AT&T steered $4.68 billion of underwriting business to Morgan Stanley, yielding lucrative fees.[11] And AT&T was just one of the forty-one major corporate clients that used Morgan Stanley as their sole lead manager on deals like this; 80 percent of their top clients would deal with no one but Morgan Stanley. So when one loyal client, IBM, turned to Salomon Brothers to handle its 1979 bond deal, the writing was on the wall: client loyalty was becoming a matter of the question "What have you done for me lately?"

Sure enough, clients began shopping around for the best deals. That, in turn, put more pressure on investment banks to go public, since part of offering a client the best deal increasingly required the investment bank to put its own capital on the line first, by doing "bought deals" (buying the securities for resale to investors), and later, by providing bridge financing. But clients weren't only shopping for the best deals; they also wanted the brightest ideas. To

return to Fridson's breakfast cereal analogy, Main Street was no longer content with being served cornflakes every day of the week. If a company needed capital, it wanted the right kind of capital, and if the increasingly sophisticated capital markets meant that was a highly structured customized transaction, well, so much the better for both the company and the investment bank, which could pocket a larger fee on the deal.

The cornflakes era had survived as long as it did not just because it worked (it had helped the government finance wars from the Revolutionary War right through to Vietnam, assisted states in building canals for transportation, and created extraordinary wealth for the railroad barons and others) but because Wall Street's clients didn't realize that there were—or could be—alternatives to cornflakes that would meet their needs or cater to their tastes more precisely. To stretch the analogy further, as long as consumers can rely on cornflakes to be readily available at a reasonable price and to get them fueled up for the day, they may not actively hunger for alternatives. But as soon as a smart researcher discovers that a significant minority of those cornflakes consumers love eating raisins atop their cereal, and realizes that that group might pay much more for a specialized product that satisfies their craving for raisins, bingo—Kellogg's Raisin Bran is born, and the world changes. Consumers flock to the exciting new product; to keep their market share, cornflakes producers slash prices and profit margins.

On Wall Street, Salomon Brothers was one of the firms playing the role of the manufacturer of Kellogg's Raisin Bran. As a firm that had specialized in bond trading, it watched its profit margins shrink and plotted ways to escape its allotted role in the Wall Street scheme of things. Through a combination of price cutting and innovation, Salomon parlayed its bond market trading prowess into more underwriting mandates from firms such as IBM, chipping away at the market share of their white-shoe rivals in a process that Pete Peterson, a financier and onetime secretary of commerce who became chairman and CEO of Lehman Brothers in 1973, referred to as "de-clienting."[12] The firm, whose dominance of the bond market was matched only by its ambition to capture an ever larger share of

Wall Street fees, became an expert innovator. Developing successful new products—even entirely new markets—would, Salomon's leaders calculated, be one surefire way to escape the "muddle in the middle" in investment banking and catapult a second- or third-tier financial institution to the top of the heap, alongside the likes of Goldman Sachs.

One of Salomon's chief bond gurus, Lewis Ranieri, originally had dreamed of becoming a chef in an Italian restaurant. When his asthma made it impossible for him to survive long days in smoky, steamy kitchens, he went to work in the mailroom at Salomon Brothers. It was the first step on his way to being anointed by BusinessWeek in 2004 as one of the greatest innovators of the last seventy-five years—and, later, to being referred to as one of the chief architects of the 2008 market meltdown. Unable to craft mouthwatering confections in a kitchen, Ranieri set about designing equally appetizing products for investors' portfolios: mortgage-backed securities.

The idea of taking homeowner mortgages, bundling them together, and selling them had been introduced in 1970, with the launch of the first Ginnie Mae (formally known as the Government National Mortgage Association) securities. The concept was very simple: the financial institution (or issuer) trying to sell the securities rounds up enough mortgages, pools them in a special-purpose vehicle (such as a trust), and then underwrites bonds issued by that special-purpose entity. To all intents and purposes, it was like any other underwriting, except that the issuer wasn't a real company, and the investors were getting a stake in a portfolio of some bondlike securities rather than a corporation. The cash from the sale goes right through the trust and back to the originator(s) of the mortgages, typically a bank or savings and loan institution. The way the bonds were priced and traded would depend on the kind of assets they contained—what kind of mortgages (commercial or residential) and the credit quality of all the home buyers taken in aggregate.

"No new product succeeds unless it's in the interest of investors," argues Michael Lipper, president of Lipper Advisory Services. In the

more than thirty-five years since Lipper first created a series of indexes to track the performance of mutual funds, he has watched the Wall Street innovation juggernaut produce a seemingly endless series of new products, or new twists on older products, all in hopes of gaining at least a momentary edge in the constant battle for market share and fee income. "Chuck Prince's comment about keeping dancing as long as the music was playing got him a lot of hostile feedback, but what people often overlook is that it takes two parties willing to dance together," says Lipper, referring to the former Citigroup CEO's comment. Any product that succeeds, such as mortgage-backed securities, Lipper believes, does so because it meets a need for both the issuer (the banks and savings and loan institutions) as well as the investor. "Wall Street doesn't go around trying to invent things just for fun, and they couldn't sell them if the product didn't meet some kind of need on the part of the investor. Wall Street institutions don't go around holding guns to the heads of investors or their other clients, and insisting that they buy this structured note or the other derivative contract."

Indeed, it's pretty much impossible for Wall Street to do anything like that in the earliest stages of a new product's development. When Ranieri began to turn the fringe business of mortgage securitization into a money spinner for Salomon and for Wall Street as a whole in 1977 (at its zenith, Ranieri's mortgage finance group would generate half of Salomon's profits), mortgage-backed securities were legal investments in only fifteen states; even where legal, they weren't necessarily respectable. But it became clear, as Ranieri fought a two-front war to win investor understanding and legal recognition of asset-backed bonds, that the new products filled needs on both sides. The 1970s were the era of market volatility, but also the decade in which the first baby boomers began purchasing homes. Banks were overwhelmed; every loan they made was a fresh inroad into their capital base, and demand was such that they couldn't cope. But if they could originate the mortgage loan and then sell it to another nonbank investor—well, that instantly removed any artificial constraints to issuing a mortgage. A home buyer in Boise, Idaho, wouldn't be turned down for a loan

simply because that city's financial institutions—the only lenders directly available to him or her—had already made too many home loans.

The advent of the mortgage-backed securities market meant that home buyers indirectly had access to the entire money grid known as Wall Street. The banks were happy—they could keep collecting their fees for originating mortgages and maintain their other relationships with their clients. Home buyers were happy—they got their mortgages, often at a lower cost. (Ranieri figured that the evolution of the mortgage-backed securities market helped shave two percentage points off the cost of a typical mortgage simply by creating a more efficient market.) Investors eager for bondlike investments with higher returns than Treasury securities began snapping up the securities once they became more familiar with the structure itself. And the issuers—the Wall Street institutions such as Salomon Brothers—were happiest of all. With an investment of time, money, and brainpower, they had created a viable new product, one that would become central to the financial system, earning them lots of fees. And while it wasn't as venerable a business as underwriting or trading on behalf of corporate clients, it was just another way of fulfilling the same core function of Wall Street, bringing together those who needed capital with those who had it—in this case, home buyers and their banks with outside investors such as pension funds and mutual funds. It was just doing so with an emphasis on a proprietary product that happened to generate heftier fees than the traditional process had done.

Innovate or Die

At a lavish dinner celebrating the fortieth anniversary of Institutional Investor magazine in 2007, Henry Kravis, a cofounder of the giant buyout firm KKR, was one of the evening's honorees—the forty "Legends of Wall Street." (That group also included John Gutfreund of Salomon Brothers.) In his speech, Kravis chose to laud Michael Milken, the investment banker who had popularized the

"junk bond" during the 1980s. Without Milken, Kravis told the audience, KKR couldn't have done the gargantuan deals that made it famous, and the entire buyout business (which had generated $357 billion in deals in the United States alone the previous year, each of which produced massive fees for Wall Street investment banks) would have been stillborn. Kravis called for Milken to stand up and be acknowledged. With the Wall Street audience applauding and even whooping and cheering, Milken, sitting at a table in the midst of the crowd, rose to acknowledge the acclaim.

By the 1980s, innovation became the way for every investment bank aspiring to be ranked alongside Goldman Sachs and Morgan Stanley to achieve that dream. The smaller the firm, the more ambitious and aggressive it had to be in order to grab market share; the more willing to bet the house on a completely new idea. That is what Ranieri had shown with securitization at Salomon Brothers and Michael Milken would demonstrate at the firm that became known as Drexel Burnham Lambert. The venerable Philadelphia-based firm was still Drexel Firestone when Milken arrived there as a bond salesman in 1970. It had been in partnership with the House of Morgan until the passage of the Glass-Steagall Act in 1933, but like many of its peers had since undergone a long, slow slide. Three years after Milken joined Drexel, I. W. "Tubby" Burnham, head of a smaller but profitable investment bank, purchased the firm; when he learned that Milken, one of the smartest of Drexel's traders, was on the point of leaving because his bosses wouldn't give him any capital to use to trade, Burnham promptly handed over $2 million. In a single year Milken doubled it, and Burnham raised the capital available to him to $4 million.[13] The two men then struck what would become one of Wall Street's most infamous compensation agreements: Milken would collect 35 percent of his group's revenues, after the costs of running the business were deducted. "It was a good deal for us, and a good deal for him," recalled Fred Joseph, who later became Milken's boss. "Yes, it led to one year where he ended up doing so much business that he made $550 million personally, but he made even more for the company."

Milken's coup wasn't the invention of junk bonds; in one form or another they had been around since at least 1909, when Moody's began rating bonds issued by railroad companies and found that the credit quality of some wasn't high enough for them to be described as "investment grade," in the Wall Street jargon of today.[14] Milken transformed the market, realizing that to sell these lower-quality bonds, an investment banker needed to woo investors with the company's story, in the same way that a stock salesman would pitch the potential for future growth of a business. On the surface, the bonds were indeed junk—their credit ratings signaled that the company carried a heavy debt load or its business was troubled. But Milken could see that on a risk-adjusted basis, the prices for these bonds were too low, partly because there wasn't an active secondary market (there's no equivalent of the stock market for bonds) and partly because investors weren't evaluating them the right way.

Milken persuaded investors to look past the ugly credit rating to the underlying potential of the business. It was only natural, he argued, for some companies to have a lower credit rating, but the risk that they'd default on that debt, given the underlying business story, was far lower than the market price of the debt suggested. Milken succeeded so brilliantly that by the late 1970s, a host of companies that previously had been shut out from selling bonds because of their less-than-pristine credit rating were now able to issue debt—through Drexel Burnham, of course—to a growing coterie of investors that Milken had cultivated. "The first year that new issuance hit $1 billion was 1977," recalls Marty Fridson, who in a few years' time would decide to specialize in analyzing junk bonds. When Fridson made that move, his colleagues thought he was a bit nuts; the products were new and the move was risky. "But it was a great career maker, because too few people were really studying these products, and the lack of understanding" created opportunities that Fridson believed trumped the risks.

Junk bonds, like mortgage-backed securities, were, in their earliest and simplest form, great for both investors and issuers. Investors able to do their credit homework got access to a whole

new pool of higher-yielding bonds, while the availability of the capital in this new market helped jump-start a host of new businesses in the gaming, telecommunications, and media businesses. Multibillionaire Steve Wynn relied on junk bonds to build his casino empire, as did Ted Turner in expanding his broadcasting business (including CNN). As these and other moguls caught on to this new type of financing, the early days of the junk bond revolution were good for everyone. The sheer newness of the junk bond market and the fact that no one but Milken and his team of specialists seemed to understand it meant that Drexel could charge an astonishing 4 percent of the proceeds of a junk bond issue in fees, compared to 1 percent for an investment-grade corporate bond issue. And there were more junk issues coming every year, as a new breed of financiers such as Henry Kravis used junk bonds to finance their buyouts.

That meant hefty profits. In 1977, Drexel reported about $150 million in revenue; by 1985, that had soared to about $2.5 billion, and the book value of its stock (which didn't trade publicly) had increased more than tenfold. By 1986, when its revenue hit $4 billion, Drexel's estimated net earnings were $545.5 million, making it the single most profitable investment bank in the country. None of its rivals could sell a billion-dollar deal in hours, as Milken boasted he could; the network of investors he had carefully cultivated was the ace in the hole that allowed his group (known as "the Department") to dominate Drexel, and Drexel to dominate Wall Street. Meanwhile, Salomon, the other upstart firm, had parlayed its dominance in other parts of the market (including the burgeoning world of securitization) into the position of Wall Street's second-most-profitable firm, earning about $516 million (although it took twice as much capital to generate that kind of profit, making for a much lower return on capital).[15]

But every successful innovation carries within it the seeds of its own potential destruction, and Drexel's junk bond empire would be no exception. First, the product itself became less cutting-edge with every year that passed, and, as competitors became more adept (or hired some of Drexel's pros), the firm slowly but steadily lost

market share. Profit margins also shrank; in the case of junk bonds, the average fee an investment bank could demand for underwriting a junk bond issue fell steadily, to 2.1 percent by 2003 and a low of 1.5 percent in 2006. As with any hot new product, from the pocket calculator to the DVD player, on Wall Street the passage of time and greater sophistication makes it easier for rival manufacturers to offer the same product profitably at a lower cost. "The increasing complexity of products is a direct result of the fact that you can't get a patent or copyright for your innovations on Wall Street," explains Sallie Krawcheck. "So if you make something so complicated it will take your competitors a long time to figure out and replicate, well, that's great. The longer it takes, the longer your advantage lasts."

The awareness that fees are falling (or about to fall) puts the pressure on an investment bank to compensate for lost revenue. If the margins are shrinking, then, as Krawcheck points out, it's up to the investment bank to somehow replace that revenue, whether by boosting volumes or adding complexity. In the case of products such as junk bonds (or CDOs), the logical first option is to ramp up the number of transactions. And that's exactly what happened at Drexel. Fred Joseph, named president of the firm in 1984 and CEO in 1985, had promised Tubby Burnham that within the next decade he would use Drexel's junk bond prowess to transform it into a firm that was even more powerful than Goldman Sachs, already considered the gold standard on Wall Street. "If we'd been asked publicly if we wanted to be Goldman Sachs, we'd probably have denied it, but secretly a lot of people coveted what they saw as Goldman's cachet," said Joseph, comparing this "Goldman envy" to the same feeling that hits a bright kid with a blue-collar background who makes it to Harvard or Yale only to find himself among privileged prep school grads who take their advantages for granted. "It wasn't that we had a chip on our shoulder; just that many people figured they were just as bright as anyone at Goldman, but even then they and Morgan Stanley were the firms that got the automatic respect of every potential client. All they had to do was show up, some people would complain, to knock us out of the running for a deal." That's what Drexel's junk bond prowess helped

change.

But Joseph couldn't reshape Drexel's culture, which was now dominated by Milken's group. And that group, it seemed, was playing fast and loose with the rules to drum up deals and profits. No one could figure out all that they were doing or get them to toe the line. Milken and others created a number of limited partnerships of dubious legality that allowed them to make even more money than Drexel itself and of which even Drexel's top executives and board members weren't aware. Ultimately, Milken refused to cooperate with Drexel's own internal investigation into the possible involvement of the department with insider traders Ivan Boesky and Dennis Levine. To settle the case, the firm forked over what was then the largest securities industry fine in history—$650 million. Milken, indicted on a variety of securities offenses, ended up serving nearly two years of a ten-year sentence after pleading guilty to six felonies. By the time that Milken emerged from jail in early 1993, Drexel had been gone for years. Joseph himself was barred from actively running the new investment boutique he co-founded; until the day of his death in November 2009, he remained restricted to the role of co-head of corporate finance.

The roots of the problem, of course, were Milken's excesses and the risk management and governance failures those revealed. "Frankly, while I feel bad for people who worked at Drexel and had nothing to do with the high-yield bonds and lost their jobs and life savings, I don't feel bad that the firm collapsed," says Fridson today. "Any other firm could have done the same thing that Drexel did by committing almost all its capital to that one ultrasuccessful product line, but they didn't—and they were right, because that's too risky." And that's another reason it is perilous for any investment bank to rely on any single new product as a steady source of profits. In the case of junk bonds, by the time that Milken ran afoul of regulators, the junk bond cycle was coming to an end—a prospect to which he and others at Drexel seem to have blinded themselves. "Well, we only realized it in theory," Joseph admitted only a few months before his death. Interest rates jumped, the

economy slumped, and suddenly companies that had issued junk bonds began to default, at a rate of one in ten. The buyout kings, including Kravis, put their deal making on hiatus, cutting off the flow of fees to Drexel. Even if Drexel hadn't run afoul of the securities laws, its heavy dependence on a single product that was about to hit a cyclical slump, coupled with the fact that it was using its own capital to buy back some of those distressed bonds from unhappy investors, likely would have wreaked havoc on its profits and balance sheet. In 1990, Drexel filed for bankruptcy.

As Drexel's experience with junk bonds illustrates all too clearly, success requires more than one brilliant idea. To succeed at the innovation game, an investment bank needs a string of them, carefully developed so that as one is flagging or hitting a cyclical low, the next is appearing on the horizon. But how many "new new things" are there on Wall Street, really? In practice, Wall Street ended up turning to other, more dangerous ways to artificially prolong the profitable life span of its innovations, such as leverage and doing lower-quality deals. As Mike Mayo told the FCIC, the world of banking and investment banking became "an industry on steroids," whose loan volumes grew at about twice the rate of the underlying economy. "[Banks] pushed for loans that should never have been made," Mayo said. Ranieri's brainchild fell victim to this, as investment banks took the mortgage-backed securities he had pioneered and turned them first into CDOs, then into subprime CDOs, then into more complex CDO-squared or CDO-cubed structures. Ranieri began warning investors publicly about the problems with these later, high-risk incarnations of his creation around 2006. (In a 2008 interview, he would describe the increasingly exotic features of CDOs, conceived as a way to keep the fees flowing and the profits climbing, as "loans [that] need the tooth fairy to keep up their values.")[16] The more successful a new product or strategy is, the harder it becomes for an investment bank to stay disciplined, and Salomon (which would be caught up in a Treasury-bond trading scandal in 1991) and Drexel were no exception to that rule. Salomon would survive, although not as an independent firm (it became part of what is today Citigroup);

Drexel's deal makers moved on to try to work their magic at other investment banks and its alumni can still be found scattered across the Street.

Chasing Goldman Sachs

One of the reasons most of Wall Street's investment banks have spent the last two decades chasing Goldman Sachs—or at least lusting after and trying to replicate its profitability—is the fact that Goldman is one of the few firms that has managed repeatedly to get the innovation process right. Part of the reason, rivals say now, is that the firm didn't place all its bets on a single product or even a single strategy. "They were about the only firm on the Street that saw the kinds of changes that were coming and planned for them strategically," says one former senior figure from another investment bank. "Of all the firms on the Street, Goldman Sachs is the one that behaves most strategically, nearly all of the time. When it doesn't know what kind of new business model will emerge, it puts a bet on everything, in order to be sure it will be part of whatever emerges the winner." That's what happened in the late 1990s, when the SEC ordered some of the most sweeping changes to the way stock trading took place on Wall Street. The New York Stock Exchange lost its control of trading in the stocks listed on its own exchange to rival start-up electronic networks. Goldman had taken a stake in a number of these; ultimately it used its clout to arrange a merger between one of the winners, Archipelago, and the venerable stock exchange. Today the combined entity is run by a former Goldman Sachs managing director. "That's just what they do," says the former rival with a shrug. "Their approach to innovation is opportunistic."

That approach dates back to the 1980s, when two of Goldman's former leaders, Robert Rubin (who would go on to become Treasury secretary for the Clinton administration before returning to work on Wall Street, this time at Citigroup) and Stephen Friedman, realized that they had two options if their white-shoe investment

bank was to retain its elite status. Midsized firms were doomed, they concluded; either they would collapse or become acquisition targets. That left Goldman with the choice of either being a great boutique investment bank or making the leap and becoming a giant global financial institution. Rubin and Friedman decided on the second course of action.[17] (In the 1990s, faced with the same dilemma and reaching exactly the same conclusions that being stuck in the middle was a recipe for disaster, Bill Hambrecht's successor at the head of Hambrecht & Quist, Dan Case, decided that even survival as a boutique was doubtful in a world now dominated by giants; he decided to sell the firm to what was then Chase Manhattan Bank, a predecessor of today's JPMorgan Chase.)

Goldman recruited quantitative analysts—known as quants—such as Fischer Black to help them come up with new products and fresh approaches to trading, and tried to identify new business opportunities wherever they could. The firm needed to devise new products and business lines—and it needed to be the first to launch them, Friedman believed. "If we're not leaders in innovation, we won't be fast enough to reap the really good profits that the innovators get—and deserve."[18] The 1970s bear market had left many companies with depressed stock prices and discontented shareholders, making them vulnerable to hostile takeovers by a growing array of corporate raiders who were beginning to make their names on Wall Street. Goldman's bankers began offering what they labeled "tender-defense" services to actual and potential targets. The first few times their bankers called on a target company, their offer of help was politely declined. They persisted, and beleaguered executives quickly realized how useful it could be to have Goldman's financial markets know-how on their side in a battle for control of their companies. Ultimately Goldman managed to parlay this into a business that generated a steady stream of income each year. CEOs, reassured by the fact that Goldman refused to work for any of the raiders, were apparently quite happy to fork over annual retainers to the investment bank in exchange for the right to summon its team of defense specialists should a raider come calling. (In contrast, many of Goldman's rivals seemed more

like mercenaries, working on an ad hoc basis for either raiders or targeted companies, depending on who was willing to pay a fatter fee.)

In addition to creating its tender-defense business and its push into overseas markets, Goldman Sachs acquired J. Aron, a veteran commodity and futures trading business. As Rubin and Friedman had recognized earlier, and as Dan Case would later, Herb Coyne of J. Aron saw Wall Street was changing; his firm wasn't likely to survive if it remained a stand-alone business. Coyne's willingness to sell gave Goldman a toehold in these high-margin businesses (J. Aron's business lines generated a third of Goldman's profits with only about 5 percent of the staff) and helped the company prepare for a still more significant change, one that the next chapter will explore in greater detail—the transformation of Goldman from a firm that simply executed transactions for its clients to one that used its own base of capital to take risks, investing or trading on its own behalf.

Collectively, those innovations resulted in the creation of a business model that increasingly appeared to the rest of Wall Street like an unbeatable juggernaut. Between 1996 and 2008, Goldman Sachs's return on equity averaged 24.4 percent, dwarfing those of its rivals. Lehman, its nearest rival for most of that period, managed to earn 19.2 percent, while Morgan Stanley came in third, with an ROE averaging 18.6 percent. That was a wide gap, and one the outside investors in the now publicly traded investment banks badly wanted to close. It was now that the IPOs of the investment banks proved to be a double-edged sword. They provided Wall Street investment banks the capital base they needed to expand globally and to innovate as well as giving partners the ability to lock in their profits and reduce their risk. (The Goldman Sachs IPO alone created hundreds of instant paper millionaires out of all its partners.) "It was very, very tempting to sell to the public," says Sam Hayes of the Harvard Business School. "The claim was that they needed the capital, but to this day I think it was just as much about greed. An IPO gave partners in an investment bank the opportunity to sell, or at least value, their ownership of the firm at a multiple of book

value."

The IPOs had made bankers richer and helped them expand their business, but they had also made that business more accountable to outsiders, whose definition of success involved generating the biggest return on equity within the industry and boosting profits quarter after quarter, year after year. Large shareholders, including mutual fund managers, would meet with the CEOs of large publicly traded investment banks and challenge them—not always politely—to do whatever it took to boost the firm's return on equity to match that of Goldman Sachs. How would they get the extra 5 or 10 cents in earnings per share that investors wanted this year? What business could it come from? What product could be created and sold, rapidly and profitably? And what could they do to maintain those profits over the long haul, when the newness wore off and rivals started to imitate them?

The pressure filtered its way down the food chain. "Every quarter, we'd get some kind of note about how this would be the biggest or most important quarter in the firm's history, asking us to keep focused and deliver the results," recalls Peter Blanton, whose career as an investment banker has taken him to Citigroup, Credit Suisse and Lehman Brothers, among other firms, and who now works for a boutique firm. Bankers found it harder to say no to a piece of new business, even if it looked a bit risky or otherwise unappealing. The scramble for market share and a bigger ROE came to look almost like the cold war arms race, with Wall Street firms rolling out one innovation after another—the block trade, zero-coupon convertibles, PIPE (private investments in public companies) deals. Then, as the financial markets struggled to recover from the aftermath of the dot-com collapse of 2000, came the CDO revolution. Not only were these new products part of the largest and most liquid markets out there—the bond market and the real estate market—but financial wizards could make them even more profitable and strip out the risk as well (or so they claimed).

Innovation, says Tom Caldwell, had finally gone too far. Caldwell runs a Toronto-based investment firm and owns stakes in stock exchanges globally; his career as a trader and investor dates back to

the early 1970s, just as Wall Street began its metamorphosis. "I watched this happen, but I didn't get alarmed until banking started becoming exotic," he says. "Banking should be boring." To Caldwell, Wall Street's role remains all about providing capital to growing companies—and withholding it from others, as it has done recently in the case of the automakers or companies such as Kodak, when their leaders showed an inability to manage or to innovate. "The business of Wall Street isn't innovating, or creating some flashy new product to boost its own profits; it's providing the wherewithal for corporate innovation," he argues. Whenever financial innovation—the kind Wall Street indulges in—ends by making capital less available to corporate innovators, that is when Caldwell knows Wall Street has drifted too far from its mission. "That's what happened when the credit markets froze; it was the last sign of that trend."

Indeed, at the height of the exotic product innovation craze in 2005 and 2006, fueled by the need of Wall Street to keep dancing while the music played, few products were being developed to help improve access to capital for companies. "It goes in cycles," says Rob Kapito, president of BlackRock. "When we started out in this business, oh, 150 or so years ago, if we developed a new security, it had to have a purpose and it had to work the way we thought it would. It had to be something that was good enough for your mother to buy. But over time, there's a tendency for things to go crazy, for innovation for innovation's sake to take over." Kapito agrees with Caldwell that Wall Street lost its way. From his years working at an investment bank before moving to the sell side (joining the ranks of those who invest in the products Wall Street creates or underwrites) at BlackRock, he figures he can identify a bond-based security that serves a purpose for the investor, as did the first mortgage-backed securities or junk bonds. The innovative products being pitched to buy-side firms such as BlackRock by 2006 didn't qualify, he says. "If we had created a security like some of those [that are collapsing and causing large losses], we would have been fired, and the firm would have done whatever it took to make reparations to their clients," Kapito insists.

Ultimately, innovation for innovation's sake put Wall Street in peril when investment banks began packaging lower-quality, higher-risk deals into these complex mortgage-based securities, and then using leverage to make the transactions more profitable still. As Lloyd Blankfein told the FCIC inquiry in early 2010, the average annual growth in new mortgage loans was about 6.3 percent between 1985 and 2000, but between 2001 and 2006, it had jumped to 10 percent. And subprime loans were making up a greater and greater portion of all the new lending: from 2 percent in 2002, new subprime loans soared to make up 14 percent of all new mortgages in 2008, Blankfein testified.

But then, to keep the deal machine whirring, Wall Street and its mortgage suppliers—firms such as Angelo Mozilo's Countrywide—simply overlooked the fact that they had lent all that it was prudent to lend to creditworthy buyers and moved further down the quality spectrum. They began lending more than was prudent, offering loans for 100 percent of the purchase price of a home, and reaching out to buyers with limited incomes or poor credit ratings. About 7 percent of all the mortgages repackaged into asset-backed mortgage securities in 2000 were subprime loans, or about $74 billion. By 2004, subprime lending made up 22 percent of the market, or about $608 billion by some estimates. True, Wall Street CEOs such as Chuck Prince, Stan O'Neal, or Richard Fuld weren't personally signing off on subprime loans or undertaking risky, highly leveraged buyouts. But their willingness to embrace that risk and their reluctance to adopt a cautious attitude toward the products on which so much of their revenues and profits now depended ensured that firms such as Countrywide pushed their own sales forces to generate more and riskier home loans.

That kind of reckless competition should have made it clear that a balance sheet blowup was looming, says financier Wilbur Ross. "When Salomon Brothers started out, they made their money trading [Treasury bonds]. Well, there's a risk in trading them, [but] it's a market timing risk, not a credit risk." When Wall Street branched out and began to rely on junk bonds and securitization to generate profits, that meant new risks, Ross adds. Every innovation

brought new risks to Wall Street. “The whole thing was getting bigger and bigger and bigger, but the basis on which people were competing wasn’t innovation anymore, because that didn’t go far enough. But you can be the biggest deal maker in the world if you don’t care, if you go far enough down the food chain.” By the autumn of 2008, Wall Street had only a handful of very large and highly innovative firms, most of which seemed to the best-informed insiders to be teetering on the verge of bankruptcy and could only be saved by an unprecedented government-organized bailout.

Wall Street, at its best, had proved to be a very good innovator, spotting opportunities and turning them into creative products that its clients needed and wanted and that generated lucrative enough fees for firms to not only survive the dog days of the 1970s but grow dramatically during the 1980s and 1990s. But chasing after fees, it was becoming increasingly clear, could be a dangerous pastime. Indeed, the more that Wall Street managed to collect in fees, the more risk lurked in the system. The wizards of Wall Street may have been very adept at devising ever more exotic and profitable twists on all kinds of classic products, but like the sorcerer’s apprentice in Goethe’s poem, they failed to realize the risk and danger associated with that financial alchemy.

Later, Wall Street observers would begin to focus on the role that innovation played in the cataclysm. Paul Volcker, the former Federal Reserve chairman, was among those who spoke out; describing the biggest useful financial machine as the automated teller machine, or ATM, he told a conference of bankers at a luxurious country house hotel in England that he wished “someone would give me one shred of neutral evidence that financial innovation has led to economic growth—one shred of evidence.”[19] Testifying to the FCIC a few weeks later, Mike Mayo was even more blunt. “Wall Street has done an incredible job at pulling the wool over the eyes of government and others,” he declared. Not only did the economy work just as well without CDOs, the risk “was more obvious and easy to see.” Certainly, as financial market innovation ran amok in the early years of the new millennium, the risks only increased, as new Wall Street players displaced those on Main

Street as principal clients of the investment banks, causing the Street to drift further still from its traditional role in the economy.

CHAPTER 3

What's Good for Wall Street Is Good for … Wall Street

How Wall Street Became Its Own Best Client

Over the years that Mark Vaselkiv and Dave Giroux had worked on Wall Street's buy side as portfolio managers at T. Rowe Price, selecting investments for an array of bond mutual funds, they had become accustomed to having Wall Street bankers call or show up on their doorstep to pitch the latest structured product or market a hot new deal. So it was with a sense of something being slightly askew that the two men boarded the high-speed Acela train in Baltimore one morning in the early spring of 2005. Their destination: the New York head office of JPMorgan Chase, where they would meet with Nils, the salesman the bank had assigned to cover their account.

Vaselkiv and Giroux wanted to talk to Nils about the leveraged loans that investment banks such as JPMorgan Chase were issuing at an ever more rapid clip to help private equity funds finance their ever-growing string of buyout transactions. Loans of this type are the least risky investment to own since they rank above bonds or stocks in a company's capital structure; in the event of a bankruptcy, lenders have first claim on assets. But the Federal Reserve's commitment to fighting a recession in the wake of the dot-com bust and the 9/11 terrorist attacks meant that interest rates had remained at rock-bottom levels for so long that the world was awash in money. With every day that passed, it was becoming harder for investors such as Vaselkiv and Giroux to find bonds to

buy that offered a yield high enough to offset the potential risk of the investment. Vaselkiv thought that leveraged loans just might be part of the answer to this conundrum.

The T. Rowe Price managers were hardly minnows in the fixed-income world. Together, the two men managed about $25 billion of investor funds; Vaselkiv figured that that should help them win a share of some of the leveraged loans. Even better, he calculated, was the fact that T. Rowe Price bought bonds and other products and held on to them for longer-term returns; the firm's investment managers didn't try to capture profits by trading them rapidly, as hedge funds tended to do. Historically, being an owner rather than a trader has been a desirable trait in the eyes of Wall Street when it has been trying to match up companies in need of capital with the right kind of investor. Still, Vaselkiv couldn't quite shake a sense that all was not quite right with the picture. What was he doing, boarding a train to visit a salesman to ask for access to a product that in prior years the same salesman would have been pleading with him to purchase?

It was odd, especially since Vaselkiv calculated that JPMorgan Chase probably could use some new buyers for these loans. The recent buyout boom had left companies carrying outsized amounts of debt on their balance sheets, and the economic environment was starting to wobble amid sky-high energy prices and rising interest rates. "The buyouts were getting larger, the loans were getting bigger, and we all anticipated that at some point defaults would rise," Vaselkiv says. "No question, the cycle would come to an end." That was just why he was interested in owning the loans, rather than the more readily available junk bonds: in that kind of scenario they would hold their value better. "By the same token, we figured that the investment bank would be interested in us as a new client."

On their arrival in New York, Vaselkiv and Giroux traveled across town from Pennsylvania Station to JPMorgan Chase's Park Avenue offices. They sat with Nils, their salesman, and made their pitch: T. Rowe Price, one of the largest mutual fund investment groups in the country, was eager to become an investor in leveraged loans. It should have been the answer to a Wall Street salesman's prayer.

Vaselkiv, however, was left dumbstruck by the response. "I'll never forget this, to my dying day; he looked at me and said, 'We don't need you,' " Vaselkiv recalls. This was no pleading Wall Street salesman: The shoe was now on the other foot. Vaselkiv realized now what had been bugging him about the idea of the trip to New York in the first place: He and his firm, which managed hundreds of billions of dollars of assets, had had to bang on the bank's door and ask humbly to be considered as a worthy buyer. Not only had he done so, but he and T. Rowe Price had been rejected out of hand.

Wall Street had changed: Giant investment firms such as Fidelity and T. Rowe Price were now less important to an investment bank than were smaller but more profitable hedge funds, which generated more trading fees and made buy decisions faster than the old-style mutual funds. Nils explained to Vaselkiv that JPMorgan Chase had about twenty-seven collateralized loan obligation (CLO) products in various stages of development. "Each and every one of those [leveraged] loans would go into those products, which in turn would be resold," Vaselkiv recalls. "He said there wasn't going to be any product for people who asked as many questions about a deal as we did." T. Rowe Price, the seventy-year-old $400 billion behemoth, had just been royally dissed by a mere salesman.

But Nils was right. JPMorgan Chase didn't need the traditional buy-side clients nearly as much as it had a few years earlier; neither did the other Wall Street institutions. Nor did these investment banks rely nearly as much on their classic corporate finance clients, companies such as Coca-Cola or Verizon that were on the other side of the money grid from investors like T. Rowe Price. These Main Street clients still called on Wall Street firms to help them raise capital or advise on merger transactions, but their significance paled when compared to that of the giant buyout funds. In the 1980s, making the plain-vanilla loans to those big Main Street clients had still generated the vast majority of JPMorgan's profits; but by the mid-1990s, that picture had changed irrevocably with fees from trading and investment banking—and increasingly, from derivatives—generating $3 out of every $4 in profits. In 1997, only about 2.3 percent of the IPOs Wall Street firms underwrote were done on

behalf of a buyout firm. A decade later, in 2007, nearly 30 percent of the IPOs completed were done for companies held in the portfolios of buyout funds such as KKR that were using the IPO as a way to begin to sell their holdings in the company. KKR, the Blackstone Group, and other such firms also turned to Wall Street to raise capital to finance their leveraged buyouts; as the buyout industry's deal making exploded, so did junk bond issuance. In 2000, the average junk bond deal brought in a mere $881,300 in fees for its underwriter; by 2007, the average deal was worth $2.45 million to bankers. In 2005, the year that Vaselkiv and Giroux made their pilgrimage to JPMorgan Chase in search of leveraged loans, those transactions—nearly a thousand of them across Wall Street as a whole—generated an average of $3.5 million in fees.[1]

Only later, in revisiting the events of the decade while testifying to the FCIC, would Nils's ultimate boss, Jamie Dimon, concede that the bank got carried away. "We should have been more diligent when negotiating and structuring" leveraged financing commitments for clients, Dimon said, referring to those loans themselves. "We allowed the lending terms to create too much leverage and assumed too stable a market appetite for these types of loans." Or perhaps they were simply targeting those leveraged loans at the wrong part of that market? But then, back in 2005 and 2006, the buyout funds seeking the leveraged financing, and the hedge funds that bought the CLOs containing the loans, were the bank's biggest clients. Why would that change?

"Let's face it, if you asked J.P. Morgan or Goldman Sachs who their best and most profitable clients were in 2006 or 2007, well, the answer you'd get wouldn't be Lockheed Martin or General Electric," says the manager of one large hedge fund. "The names you'd hear would be KKR or Citadel. Because how many deals or different kinds of deals is a Lockheed going to do in a year? Whereas KKR, well, they do a deal and they'll be back in a few weeks to do another one." And underwriting the junk bond and leveraged loan issuance to finance those deals was just the tip of the iceberg by that point. In addition to those fees, a private equity fund could generate bridge financing fees, deal advisory fees, and,

down the road, IPO fees when the buyout firms exited their portfolio companies (at a profit). In between, there was plenty of opportunity for an investment bank to step in and grab a few million more in fees here and there, in exchange for advising a buyout portfolio company on how to pay out a special dividend to its new owners (a quick way for the latter to book a return on their acquisition) and then for executing that transaction.[2]

Hedge funds, it was also clear by the beginning of the new millennium, could generate similarly lucrative fees for Wall Street in exchange for different products and services. These "go anywhere, buy anything" investment vehicles had become increasingly popular during the 2000–2002 market slump, and their assets under management exploded from the late 1990s onward, despite the collapse of hedge fund Long-Term Capital Management. By 2007, a study by Greenwich Associates, a consulting firm, showed just how important they had become to Wall Street. Hedge funds, unlike mutual funds, usually weren't long-term investors looking for steady sources of return; rather, with hedge fund managers pocketing their fees (20 percent of every dollar of profit earned goes straight to the fund's managers) at the end of every year, they preferred short-term gains and didn't care how many trades it took to earn those returns, as long as the turnover didn't erode returns.

Although hedge funds made up only about 20 percent of all buy-side assets under management (other players included pension funds, college endowments, and mutual funds such as T. Rowe Price), Cambridge Associates calculated that the group was responsible for nearly a third of all trading in the bond markets by early 2007, double the level of only a year earlier. That meant that hedge funds were generating a disproportionate amount of the fees Wall Street trading desks were earning. (Vaselkiv's pledge to be a buy-and-hold investor of leveraged loans was probably the last thing that any Wall Street firm involved in trading wanted to hear.) They were even more important to Wall Street in the smaller parts of the bond market, areas where the market is less liquid and trading harder to do, meaning that investment bank trading desks

could command higher fees for facilitating those trades. Cambridge Associates reported hedge funds accounted for 55 percent of the trading in both investment-grade derivative products and bonds issued in emerging markets.[3] When it came to distressed debt and derivatives with low credit quality and high yields, hedge funds ruled the roost, accounting for 80 percent to 85 percent of the trading volume.

No wonder, as Greenwich Associates pointed out, that Wall Street was now trying to devise products that would appeal directly to hedge funds. The leveraged loans that Vaselkiv had been eyeing were the result of the Street's efforts to attract not one but two important new constituencies: the buyout firms, who needed to issue them to finance their deals, and the hedge funds, who found the loans interesting and profitable to buy and trade. Nobody really needed Mark Vaselkiv.

Turning Wall Street on Its Head

At times, it almost seemed to some bankers that private equity funds and hedge funds had been sent to them by the gods of finance to meet their insatiable need for fee income. Why would anyone be at all surprised that hedge funds were getting red carpet treatment? wonders Leon Cooperman, a former Goldman Sachs partner who set up his hedge fund business, Omega Advisors, back in 1991. "It's like Willie Sutton said when he was asked why he robbed banks—that's where the money was. Why did Wall Street get all excited about this business? That's where the money was!"

Certainly, Cooperman wasn't surprised to see Wall Street begin to tweak its business model to better accommodate these new and very lucrative clients. Investment banks, led by Bear Stearns and Goldman Sachs, packaged up all the services that hedge funds needed under the umbrella of new, dedicated teams that were known as prime brokerage groups. (The name of these groups came from the idea that it made sense for a hedge fund to have one "primary" banking relationship: to rely on one bank for services

such as tracking its positions, monitoring its collateral, clearing, and other services.) Most of the largest investment banks, led by Goldman, JPMorgan Chase, Citigroup, and Morgan Stanley, also created sponsor groups. These teams of generalist bankers were dedicated to serving buyout funds with whatever they needed to put a deal together, coordinating all the specialist bankers and financial wizards who could structure deal terms.

In the early 1990s, very few investment banks had prime brokerages; by 2000, they were ubiquitous and nearly as many had sponsor groups working with their buyout fund clients. Now that the banks didn't make these big private equity clients run from one industry banking team to another, depending on whether their next deal involved an industrial conglomerate or a new computing venture, they could vie for the loyalty of this attractive group of clients more effectively. "There was a need," explains Tom McNamara*, who works as a midlevel banker at one large bank's sponsor group. "The day-to-day business of these guys was doing deals. Serving them is going to be different from serving a widget maker who is only going to do a deal once a decade. There's a big difference between a widget maker's strategic deals and the opportunistic ones that a sponsor will do."

Ever since the 1980s, Wall Street had been in the habit of paying more heed to the needs and wishes of investors than to those of the widget makers on the other side of the transactions that it helped to execute. "It was, has always been, and always will be a case of he who pays the piper the most gets to call all the tunes," says former Morgan Stanley banker Lou Gelman. The pattern was set when Michael Milken priced junk bond deals in a way that rewarded his group of dedicated investors rather than the companies that needed to raise capital; companies were just pleased to have been able to complete the financing. The logic behind this buy-side power was solid: there were relatively few specific deals that a mutual fund manager or pension fund manager had to buy; companies such as Netscape or Google were the exceptions that proved that rule. So while companies trying to raise capital needed their Wall Street underwriter slightly more than the latter needed them, the same

wasn't always true of money managers. Wall Street couldn't annoy a Fidelity, or even a T. Rowe Price, without feeling some pain down the road. "It was very critical to have a very high market share in those institutions, because 80 percent of your business was being done with 20 percent of your clients," says Rob Kapito, president of BlackRock.

Right up into the 1990s, it was firms such as T. Rowe Price that were still paying the piper and calling the tune. That's one reason so many of the IPOs of that decade were priced with plenty of room for the price to pop a few dollars on the first day of trading. When that happened, it was an instant winner for the investors who had just paid $15 a share to acquire the stock in the IPO, and who could now sell it for $18 or so the next day, a strategy referred to as a flip. That was great for buy-side clients, but, as noted earlier, at the height of the dot-com boom it left more than a few of the companies feeling as if they had accidentally handed a cabbie $50 on a $10 fare, and not been offered any change.

The buy-side client—the investor—was the Wall Street client who was there day in and day out, generating fees for investment banks through their trading. Even before the days of hedge funds, the buy side knew how to throw its weight around: a company such as Fidelity wouldn't even promise to hold on to newly issued stock for any length of time, reserving the right to flip some of their shares in a particularly successful IPO for a quick profit. So when Wall Street investment banks began bending over backward to keep the new group of power players—hedge funds and private equity funds—happy, no one was too surprised. But these power players were different. Often run by former bankers and traders, they were really part of Wall Street itself, and had developed business models that relied on deal making alone to generate profits. Buyout firms were consuming capital not to make cars or finance biotechnology research but to acquire companies that they would try to resell for a profit later on. Hedge funds weren't investing the retirement savings of the average American citizen for the long haul but instead were trying to make as many quick bucks as possible. These were more than just new names: they were an entirely new breed of client who

knew how to extract every ounce of value from Wall Street. "You knew when you were sitting across the table from a [buyout firm executive] that you are about to negotiate with someone who used to be a banker," says McNamara. "And you know that his repeat business is going to be so valuable to the next guy on his list that you'll do whatever it takes to accommodate him."

Jeff Arricale, a T. Rowe Price portfolio manager who invests in financial stocks such as insurance companies and investment banks for the firm's mutual funds, understands this trend intellectually. But that doesn't mean it's easy to cope with. "The investment banks know very well that we're never going to call them up and say, 'Thanks, you did a great trade for me, here's a check for $50,000,' " he says, laughing at the very idea. "But a hedge fund manager will do just that—and be back the next day for more. And to get hold of that guy, the dude on the trading desk at Goldman or Morgan Stanley or wherever just has to make a single phone call." In contrast, getting a T. Rowe Price portfolio manager to act on a trading idea might require multiple phone calls and a lot of patience and effort on the part of the Wall Street trader. "Realistically, what we might pay him months later would never be enough to get this guy promoted," Arricale acknowledges. "We keep a close eye on those expenses." In contrast to hedge funds, firms such as T. Rowe Price are doing all they can to reduce their reliance on Wall Street and its endless demands for fees, building their own trading desks and research divisions.

So the fact that with each year that passed Wall Street was paying more and more attention to its hedge fund and private equity fund clients was little more than the financial markets version of Henry Kissinger's realpolitik, akin to the former secretary of state's decision to open diplomatic relations with Mao's China. That kind of pragmatism is what Wall Street is all about, and T. Rowe Price's managers understand and accept the logic that led Nils at JPMorgan Chase to reject them out of hand as potential investors for the leveraged loans. What did worry them was the combination of the nearly monomaniacal focus by Wall Street investment banks on their Wall Street clients and the investment banking industry's

constant need to boost revenues and profit margins. If carried to extremes, this could mean that Wall Street's role as the money grid would take a backseat to the pursuit of profits for their own sake.

Increasingly, Wall Street's newest products fit the needs of the banks issuing them or the Wall Street players, such as the hedge funds, that bought most of them. Many mutual funds didn't want to touch some of the securities that Wall Street was devising; unlike classic bonds, the new products didn't have terms that required the issuer to maintain certain minimum credit standards. In some cases, the company issuing the bonds had the option to finance its regular interest on that debt by issuing more debt, a feature known as a pay-in-kind option and about as appetizing to a mutual fund manager as a dose of cod liver oil. (Indeed, by mid-2008, rating agency Standard & Poor's was already predicting that investors in these securities were likely to recoup only 10 cents on the dollar.) And how, critics wondered, could ordinary individuals saving for retirement be considered logical buyers of highly structured CDOs? By 2007, however, Wall Street firms such as Bear Stearns and their hedge fund partners—firms such as Highland Capital Management—had begun spinning off some of the least attractive CDO structures in products aimed at just those mom-and-pop investors, hoping that they would overlook the warning signals contained in the prospectuses.[4]

Meanwhile, mutual fund managers such as Arricale could see deals in which they did want to invest going to other, more favored Wall Street clients. "There was a company whose stock we had owned for four or five years; we were the third-largest shareholder," Arricale recalls. "They came back and raised more equity through a follow-on stock offering, and obviously we wanted to participate. Then we get the call from the underwriters telling us, 'Congratulations, you got 6 percent of the shares you requested.' And you know in your heart that wasn't a good deal for anyone except the bankers."

Arricale insists that he doesn't feel entitled to stock in deals he likes. "But when I saw the list of where the new stock went, and saw that nearly all of the top ten accounts on that list were the

names of hedge funds, well, there's no way that's in the issuer's interest, either," he says, thumping his desk with his fist. "Come on! This is a hedge fund! What are the odds they'll be around in four weeks, much less four months or four years? They're looking for a quick flip! But they're also the guys waving the big stick. Not only do they generate the trading fees, but if they don't get what they want, they'll move all their prime brokerage business over to Lehman Brothers."

Working on stock underwritings and other corporate finance transactions at a series of investment banks, Peter Blanton found that his corporate clients weren't any happier about this trend. Often he'd have to break the news to clients that even if they didn't want hedge funds to end up as their biggest shareholders, there wasn't much that he or they could do about it. "The clients would tell me, 'I just want the [buy-and-hold] guys, like the mutual fund managers or the pension funds,' " says Blanton. "But the hedge funds were making their way into the new issue market as buyers, and that was just reality." Hedge funds came to completely dominate the market for convertible securities, in particular, thanks to the special characteristics of these "converts." A convertible security is faster and easier to sell to investors than stock; it looks like a bond (because it offers regular interest payments), but down the road investors can exchange it for shares at a set ratio of so many shares per $100 convertible security. Those features—the income and the ability to swap it (convert it) for stock—make convertible securities particularly intriguing to hedge funds. With their trading expertise, hedge fund managers could place complex but profitable bets involving both the convertible security and the stock; the most common of these arbitrage strategies involved selling the stock short. Owning the convertible securities gave them an indirect stake in the company's stock; selling the stock short outright was simply a way for the hedge fund to manage its risk and maybe capture a bit more profit.

But companies that had issued convertible securities in order to raise new capital weren't happy about the unintended consequences. They didn't want hedge funds to buy these securities

if it meant that the funds' next move would be to sell the company's stock short. After all, an increase in short selling not only put downward pressure on the stock price but was tantamount to a public declaration of lack of faith in the company's business or prospects; only very well-informed or sophisticated investors would figure out that the short selling had nothing to do with a lack of confidence and that the hedge funds were merely hedging the exposure associated with owning the convertible security. "There was a period where we'd have to soft-talk the issuer, point out that they'd need hedge funds" to make the deal a success, Blanton says. It took time for the companies to accept the inevitable, although the fact that hedge funds were willing to accept lower interest payments and to quickly commit their capital to a deal helped; companies could now raise capital more rapidly and cheaply.

In the eyes of Wall Street, classic buy-side managers such as Arricale, Vaselkiv, and Giroux were small fry compared to buyout and hedge funds, nitpicking over trading fees and increasingly trying to squeeze already razor-thin trading margins even more. These mutual fund buyers that companies claimed to want as investors could take days or weeks to commit to a deal. Wooing them also meant taking the underwriting client on a four-day road show to visit key investors in cities such as Boston, Baltimore, and Los Angeles in person, an expensive and time-consuming proposition. Why bother, irritated investment bankers wondered, when the hedge funds were willing to just sign on the dotted line?

"Wall Street got to the point, eventually, where it figured it didn't need Main Street, except for the firms like Merrill Lynch, which could use their retail networks as a way to get products out the other end," muses Harvard Business School's Sam Hayes. Although his students have included some of the biggest architects of the buyout and hedge fund universe—including the late Bruce Wasserstein, Joseph Perella, and the Blackstone Group's Stephen Schwarzman—Hayes isn't blind to Wall Street's errors of judgment in catering too slavishly to this group. "There's a kind of social contract that is implicit in the relationship between Main Street and Wall Street," he argues. "Wall Street has to produce a sense of

financial well-being in the shape of a rising stock market, or it will generate a terrible sense of envy [on Main Street] of what will be seen as the obscene profits and compensation that Wall Street is earning for catering to these other groups who aren't seen as part of Main Street."

Dealogic data show that by 2005, when Vaselkiv and Giroux called on Nils, about a quarter of Wall Street's investment banking fees were coming from private equity deals, while 40 percent of the trading fees Wall Street institutions were earning came from executing trades for hedge fund clients. By some estimates, there were now more than eight thousand hedge funds in existence, double the number of only five years earlier, and their managers were in charge of more than $1 trillion in assets, more than three times the level estimated five years previously. Both hedge funds and buyout funds had been important Wall Street clients since the 1980s—firms such as KKR and Blackstone on the private equity side and hedge funds run by veterans with impressive long-term track records, such as George Soros and Julian Robertson. But by the dawn of the twenty-first century, these players were not only more numerous but more significant. Wall Street, in the form of these entities (most run by former bankers and traders), had become its own most important customer, generating the lion's share of investment banking fees and using that influence to even dictate the shape and nature of the transactions that were done.

"In 2003, when I started my MBA program, everyone in the class wanted to be in mergers and acquisitions when they graduated," McNamara says. "By the time we finished, everyone was eager to work for a sponsor group or, as a second best, the prime brokerage group." Today, thanks in part to the havoc wreaked by the toxic combination of cheap capital, innovation run amok, and overaggressive deal making by a Wall Street that had forgotten its traditional client base, McNamara admits that he and other bankers just want a job—any job at all.

Leaving Goldman Sachs?

With the benefit of twenty-twenty hindsight, one can identify the first sign that a fundamental change was in the making. That was the year that thirty-six-year-old Kevin Conway turned down the offer to become a partner at Goldman Sachs, becoming only the second person to do so in the firm's 125-year history. Goldman had been confident enough that Conway would join the partnership to include his name in the list of all the new partners in a newspaper ad. But two days later, Conway left egg on the face of Goldman's management when he announced that, rather than take up the partnership, he planned to leave the investment bank and join the ranks of buyout firm Clayton, Dubilier & Rice.

The gossip spread like wildfire. Turn down a partnership at Goldman Sachs? That was akin to deciding that you'd rather stay in the minor leagues than take a job as a starting pitcher for the New York Yankees. Who in his right mind would do such a thing? Contemporary newspaper accounts explained the move as a result of Conway's concern about the personal risk he would be assuming in becoming a partner at any investment bank: joining the partnership at Goldman, which wouldn't go public for another five years, meant that Conway, like his peers, personally would take on a share of the firm's liabilities. But that had never frightened anyone away before; after all, partnership had almost invariably proven to be a ticket to the top of the investment banking world, and to wealth.

But 1994 was a bumpy time in the financial markets, one of those years that proved life on Wall Street wasn't always a bed of roses. A series of surprising and surprisingly large interest rate hikes in the early spring and summer had wreaked havoc on financial markets; later in the year came a crisis in emerging markets that culminated in the devaluation of the Mexican peso. Goldman Sachs partners were defecting at a record rate—by the end of the year, about a third had left for greener pastures. But Conway's decision still astonished Wall Street. It was one thing to leave Goldman and go off to do something else—politics, say, as Bob Rubin had done and Jon Corzine would do later, or philanthropy. It was also

understandable and acceptable to move on to start a new business, as Leon Cooperman had when he launched Omega after retiring as chairman and CEO of Goldman Sachs Asset Management. But to curtail a career at Goldman so early on, voluntarily, in favor of moving to a private equity firm? Wall Street gave an almost visible shudder of alarm.

For most of the Street's existence, investment banks had been admired and respected institutions; the young bankers who got a toehold on the bottom rungs of the ladders at the top-flight firms were envied by their peers who had to settle for a regional or second-tier firm such as Jefferies & Co. Premier institutions such as Goldman Sachs had become career destinations in their own right. But Kevin Conway's decision to bolt from an elite firm and go to a private equity firm, of all things, would signal the beginning of the end of Wall Street's ultra-elite status. Increasingly, for the Kevin Conways of Wall Street, working for a top investment bank was no longer an end in itself but simply a stepping-stone to something still better. And what was better? In the eyes of aggressive young bankers and traders, more and more that was defined as working for an elite private equity firm (KKR, say, or Blackstone, or even Clayton, Dubilier) or joining a top-flight hedge fund.

By the new millennium, the goal was to be the next Eric Mindich. Mindich was Wall Street's version of Doogie Howser, the lead character in a television comedy whose plot revolved around Howser being both a normal teenager and a genius who, before he gets his driver's license, has already become a surgeon. After becoming the youngest partner at Goldman Sachs in that firm's history (at the tender age of twenty-seven) in the same year that Kevin Conway departed for the world of private equity, Mindich stuck around at Goldman for another nine years before leaving to start his own hedge fund based on the risk arbitrage tactics that he had learned at Goldman (in the group formerly headed by Bob Rubin). Mindich raised what was then a record of $3 billion for a start-up fund, despite his insistence on relatively onerous terms: to get access to the fund, his limited partners had to be willing to tie up at least $5 million of their capital for nearly five years (at a time

when investors in most funds could get their capital back on a few weeks' or months' notice).

Mindich became what all savvy young traders want to be—a multimillionaire who hangs his hat in a Park Avenue co-op building with neighbors such as newsman Mike Wallace. Certainly Mindich couldn't have done that well that quickly toiling away in the (relatively) bureaucratic world of Wall Street. In 2007, his personal share of his new hedge fund's profits was nearly three times what his former boss, Goldman Sachs CEO Lloyd Blankfein, took home—about $200 million, compared to Blankfein's $68 million in salary and bonus. And Blankfein was Wall Street's most richly paid CEO ever that year.

As the years passed, former Morgan Stanley banker Lou Gelman observes, "The best people tended increasingly to see Wall Street as a great place to learn and to forge relationships, and then to leave." (Gelman himself bolted for the hedge fund world in the late 1990s.) "Wall Street, instead of being the folks cracking the whip in the relationship with everyone else, would become more and more under the control of these new Wall Street clients. You just couldn't afford to say no to them." Perhaps not coincidentally, it was also in 1994 that Goldman set up its own dedicated sponsor group to serve the buyout funds.[5]

The increasing prominence and, ultimately, dominance of both hedge funds and private equity funds can be traced to the concept of alpha. In finance, the Greek letter becomes a word that signifies an investment return that is due only to the manager's skill rather than to what the broader market is doing. A portfolio manager who earns 11 percent in a year when the major stock indexes are up from 10 percent to 12 percent is said to earn a return that is mostly beta; she is benefiting from the rising tide of the markets lifting all the portfolio managers' boats. But in a year where an index is up only 5 percent and a manager succeeds in posting a 15 percent return—or whenever the broader markets post losses but an investor generates a positive return—that is alpha. And by the end of the 1990s, the pursuit of alpha made the quest for the holy grail look like child's play.

Investors of all stripes, it turned out, were in dire need of alpha. The biggest among them—pension funds such as CalPERS, the behemoth that oversees the retirement savings of California's state employees, or Yale University's endowment—were run by managers whose all-encompassing goal was finding a stable, steady source of investment returns not tied to what stocks and bonds were doing in any given calendar year. In search of investments that would zig when the U.S. stock market zagged, these powerful players had begun investing in emerging-market bonds, timberland, Chinese stocks, oil well partnerships, real estate in Dubai, and commodities: they were all in quest of alpha returns. Every stock market slump—in 1987, in 1989 and 1990, again in 1994, and briefly but violently in 1997 and 1998—reinforced the importance of having exposure to assets that didn't behave the way the broad market did. The larger and longer-lasting three-year bear market of 2000 to 2002 was when hedge funds, for instance, really caught fire: during that period, their number jumped more than 25 percent, while their assets under management surged 42 percent. While mutual fund managers struggled, many hedge fund managers continued to post positive returns. Hedge funds had an edge over many other "uncorrelated" investments—in contrast to, say, five hundred acres of farmland, the investment in the hedge fund was liquid (at least initially) and relatively easy to value. If an investor wanted to leave, all he had to do was request his money back at the prevailing market value. (As hedge funds became more powerful, however, managers followed Mindich's lead by imposing more onerous lockup periods that meant that liquidity proved more illusory in practice.)

For investors, the allure of hedge funds lay in their go-anywhere approach to financial markets. Their name implies that these managers spent their time hedging, or finding ways to limit the risk of one investment by taking another market position. (One example

of a hedge might be investing in the stock of a company that makes most of its money producing crude oil; to address the risk that a slump in crude oil prices will hurt the stock, an investor might sell crude oil futures short. If crude falls, he would hope to make up in profit on the oil futures what he would lose on the stock bet.) In practice, the thousands of hedge fund managers today pursue far more varied and complex strategies than simply hedging. Some structure complex positions revolving around actual or potential merger transactions involving public companies, shorting one company involved in a deal while owning the stock in another, a strategy known as merger arbitrage or event-driven investing. Others use convertible securities, which combine elements of stocks and bonds, and employ different strategies to capture any difference in value between these and the stock of the company that had issued them. Increasingly, a hedge fund manager was simply an investor who acknowledged no restrictions on where he could invest, how much he could borrow to try to magnify his returns, the extent to which he could use derivatives, or how much he could put to work in a particular stock or industry.

This go-anywhere, do-anything approach was appealing to investors, who felt that skilled managers able to anticipate twists and turns in financial markets should be able to use whatever products and strategies were available to make money regardless of what asset class was winning. Relative outperformance was appealing only in a bull market. Who wanted to own the best large-cap mutual fund in a year when stocks as a whole were in the doldrums? As the Wall Street saying has it, you can't eat relative returns. While mutual funds were restricted to buying, owning, and later selling a specific kind of stock (say, small-cap value shares), a hedge fund manager could do anything he wanted with his investors' money, as long as he spelled out his general strategy in advance. He could invest at home or abroad; he could focus on stocks, bonds, or more exotic instruments; he could buy and hold or sell short; he could borrow to buy and generate leveraged returns; in short, he could be a real master of the financial universe.

"The first time you saw this pattern develop was in the

commodity trading advisor [CTA] world during the eighties," says Glenn Dubin, cofounder of Highbridge Capital, a hedge fund empire that he and childhood friend Henry Swieca built and later sold to JPMorgan Chase. (Dubin and Swieca still run the show.) In the mid-1980s the two partners teamed up to create a series of portfolios combining CTA multistrategy funds with funds that invested in stocks and bonds. "The first big eye-opener for investors probably came during the 1987 crash," Dubin muses. "Soros, [Bruce] Kovner, and all the other guys who were short stocks and long bonds when that happened made a killing, while the long-only guys got pummeled."

Then in 1990 came the first Gulf War; that and the recession that followed seemed to prove that hedge fund managers could make money from anything, in any environment. "You could [own] crude oil futures in the months leading up to the Gulf War, as the supply fear drove prices higher, then short it when the guns started going off, for instance," says Dubin. "Suddenly stocks are plunging and traditional asset managers are losing their shirts, but the global macro hedge fund guys like Soros and Paul Tudor Jones and Kovner are all up enormously as a result of their positions."

The "lost decade" for stock and bond market investors in the first part of the new millennium just confirmed that hedge funds provided alpha, in the eyes of some data providers. The Hennessee Group, one of those market analysis groups, proclaimed that while the S&P 500 Index had plunged 23.33 percent over the course of the ten years between January 2000 and December 2009, the Dow Jones Industrial Average had lost 9.3 percent, and the NASDAQ Composite Index had nosedived 44.24 percent, its proprietary hedge fund index had gained 88.3 percent in the same period. Skeptics may point to the flaws associated with performance tracking in the hedge fund industry, such as survivor bias, but to advocates of alternative investments, results like that spelled one thing: seeking alpha in the form of alternatives, like hedge funds, is the way to go.

By the time hedge fund managers were attracting widespread attention, private equity funds were already well established. One

of the first firms into this new business was KKR. As a corporate banker at Bear Stearns in the 1960s and 1970s, Jerome Kohlberg devised debt-financed exit strategies for small to midsized family-owned companies, deals he referred to as "bootstraps." When Bear Stearns was reluctant to give Kohlberg and his protégés Henry Kravis and George Roberts the capital to establish an in-house fund dedicated to these new transactions, the trio bolted to form KKR in 1976.

The rest is history. KKR landed its first institutional investor (an Oregon state employee pension fund) in 1978, and by the mid-1980s the partners were conducting multibillion-dollar management buyouts of companies such as Safeway and Beatrice. The battle royal for ownership of RJR Nabisco in 1988 proved to Wall Street just how attractive private equity clients could be; the $31.1 billion deal, the outcome of a titanic battle between KKR and a rival group led by RJR Nabisco's CEO along with an investment bank, earned the numerous Wall Street firms involved an estimated $1 billion in fees.

Both private equity funds and hedge funds raised funds privately, from what regulators like to call "accredited investors" and what the rest of us tend to refer to as rich people and sophisticated institutional investors. In other words, unless you have at least a million or two in investable assets (realistically, much more, since even the smallest of these funds likely won't even take your phone call unless you're worth $15 million or more and can spare at least $1 million for their fund), don't bother trying to get inside the golden circle. Investors, referred to as limited partners, tie up their capital in a private equity fund for a decade or so. In the early years of a fund's life, its general partners (the managers at funds such as KKR) spend their time hunting for deals and investing and then find ways to exit at a profit. (As of this writing, KKR has raised about fourteen different private equity funds over its life span.)

The long-term secular decline in interest rates throughout most of the 1980s and 1990s fueled a boom in the leveraged buyout business, making financing relatively cheap and helping private equity funds reward their investors with outsized returns. By mid-

2008, KKR estimated it had invested about $43.9 billion and earned $60.1 billion in profits from those fourteen funds; another $27.5 billion of profits were still on paper because the investments hadn't yet been sold. It also revealed that its average annual internal rate of return (IRR, the most commonly used measure of investment returns used by private equity investors) was a whopping 26.2 percent during a period when investing in the Standard & Poor's 500 index would have earned the same investors about 8.8 percent a year.[6] With that kind of track record, it was little wonder that investors didn't balk at the fact that it could take years before KKR and other buyout funds would achieve those returns and pay them their share of the profits. In fact, while once investment managers who had run portfolios stuffed with illiquid assets that couldn't be quickly sold for a price close to their fair value—like those of a private equity fund—charged their investors lower fees to compensate for the lack of liquidity, now the magnitude of those returns (all that alpha!) meant that firms such as KKR could command premium fees. While a mutual fund might charge a flat 1.25 percent management fee, KKR could levy a 2 percent fee—and collect 20 percent of any profits, to boot. In the eyes of investors, illiquidity was no longer a risk, but simply the price one paid for alpha.

Hedge funds adopted a similar compensation scheme. But while private equity investors didn't get their 20 percent share of the profits until after the investments in their portfolios were sold, hedge fund managers could become very wealthy very quickly through what is known as mark-to-market accounting. At the end of every fiscal year, the assets in the hedge fund are valued, and the manager typically pockets a fee equivalent to 20 percent of those paper gains without having to liquidate the portfolio. (That compensation scheme is, in the eyes of some private equity investors, responsible for some of the aggressive risk taking on the part of hedge funds; as long as the transaction worked in the short run, hedge fund managers could become wealthy regardless of what happened to their investors over the longer haul.) By the mid-1990s, the prospect of easy riches enticed a steadily growing

procession of bored, frustrated, or fed-up traders to walk away from their investment banks and set up shop on their own.

At first, explains Patrick Adelsbach, a principal at Aksia, a hedge fund advisory group, who has studied hedge funds since the early 1990s, these traders invested their own money, the fruits of years of big bonuses, and brought in some family and friends as fellow investors. Those who were successful quickly earned a reputation as stars and went on to establish a more formal structure. By 2000 or so, skilled traders with an idea for a new niche strategy were leaving investment banks at a rapid clip to set up their own shop; Goldman's IPO in 1999 spawned a particularly large batch of new hedge fund managers, including, ultimately, Eric Mindich. "It seemed almost as if these guys were afraid of being left out of the biggest party around if they didn't leave and start a hedge fund," says Anna Pinedo, a partner specializing in securities law at Morrison & Foerster, a national law firm. With each year that passed, the new funds became larger; in the late 1990s, a significant debut fund could have $100 million to $200 million in assets, but by 2002 or so, a manager needed to have $300 million to even get the attention of Wall Street's traders and the burgeoning prime brokerage industry.[7]

Wall Street had long recognized the potential for hedge funds to become a big new source of fees. Bear Stearns was one of the first, using its expertise in the relatively unglamorous business of clearing trades (making sure that they are properly executed and documented) to move up the food chain and provide other services to hedge funds, including record keeping and lending them the stocks they needed in order to sell short. Other firms caught on quickly; by the early 1980s, Morgan Stanley was providing one-stop shopping for Julian Robertson's Tiger Fund as well as for George Soros, while Goldman Sachs dealt with the needs of another top hedge fund manager, Michael Steinhardt, within what was known as their personal client services division. These ad hoc services formed the basis of the prime brokerage groups.

The earnings power and clout of Goldman's new prime brokerage business, Global Securities Service (GSS), grew in tandem

with the hedge fund industry itself. The business was so profitable that soon employees in GSS without MBA degrees were outearning those who did possess the coveted degree but who toiled away in higher-profile but less profitable parts of the firm.[8] The good times only got better in the coming years as the hedge fund industry's explosive growth continued, peaking at 9,550 funds managing a cool $1.535 trillion in assets by mid-2007. Best of all, because hedge funds needed the services so much—and were raking in so much money in management and incentive fees—they didn't balk at paying the bill for prime brokerage services. Finally, it seemed, Wall Street had found a product that couldn't be easily commoditized and that maintained its profit margins. Despite the growing competition from the mid-1990s onward, Goldman Sachs, at least, found that its prime brokerage fees slid a relatively modest 20 percent, an amount it could easily recoup from the massive growth in volume.[9]

Using these new prime brokerage businesses, investment banks set out to do everything they could to smooth the path for traders hoping to launch a hedge fund, facilitating the industry's explosive growth. "The average bank had a turnkey solution for any manager who wanted it; he'd show up at one of the more sophisticated prime brokers like Goldman or Morgan Stanley, and the guys there would find him office space, help him set up his computer technology, even help him order his office furniture," says Adelsbach. They'd also introduce the fledgling manager to potential investors, offering what they dubbed "capital introduction services." (Among the beneficiaries was Galleon, the now-defunct hedge fund group whose CEO was convicted on insider-trading charges in mid-2011: Goldman offered its assistance in meeting potential investors.) The pitches walked a narrow line between what was legal and ethical and what wasn't; funds would be invited to attend high-profile conferences where they could set up booths in the exhibit halls or brokers would help a new manager arrange a series of meetings with potential investors. The very fact that Goldman or Morgan Stanley was willing to stamp the Wall Street equivalent of a Good Housekeeping seal of approval on a start-up hedge fund was

enough to set the new manager apart from the crowd. The tacit quid pro quo was that the manager would direct all his trading and other prime brokerage business to the firm that employed his capital introduction team.

The stock market slump and the economic recession that followed the collapse of the dot-com bubble in 2000 rang the death knell for old Wall Street relationships. As they had in past slumps, hedge funds outperformed the stock market during its three-year slide (in their worst year, 2002, the average fund fell only 2.89 percent).[10] Unhappy investors pulled money out of the stock market and directed it to the portfolios run by the go-anywhere gurus. Pension funds, facing future payout obligations to retirees and blindsided by large losses, found the allure of alternative asset classes and alpha to be almost magnetic; they hoped hedge fund gains could help them recover their losses as rapidly as possible. The stock market's malaise meant that stock underwriting was difficult and far from lucrative for investment banks; after raising $300 billion in equity for companies in 2000, Wall Street institutions collected fees on a measly $97 billion of deals in 2003.[11] Nor were there many M&A advisory fees to be earned: few corporations were interested in making strategic acquisitions in the midst of economic uncertainty when they couldn't compute the value of what they planned to buy. While the private equity funds weren't immune to the market slump of 2000 to 2002, they still had funds to invest and a big incentive to do deals. KKR alone raised another $6 billion in capital in 2002, a sum that could finance $35 billion or more in buyouts, given how low interest rates had fallen and how easy it had become to obtain debt financing even for risky transactions. But if Kravis and his colleagues didn't put that money to work, they wouldn't even earn the 2 percent management fee.

The "Saviors" of Wall Street

By 2002, it was clear the balance of power had tipped away from

Main Street institutions—investors such as T. Rowe Price and corporations that relied on Wall Street to meet their capital needs—in favor of these new players. "New prime brokers were calling us every day," says Nick Harris*, manager of a large hedge fund. "They were offering us access to their balance sheet—if we needed to borrow to trade or otherwise generate fees for them, well, they were going to do whatever it took to make sure that happened." His fund's average leverage level was around 1.5, meaning that for every $1 billion he invested of the firm's own capital, he would borrow another $500 million from one of those eager prime brokerages and invest it, too. But Harris's prime brokers were urging him to go further, to raise that borrowing to $1 billion. "When I started in the business in the early 1990s, you could lever up three or four times what you had on your balance sheet," Harris recalls, meaning that for every dollar of capital, a maximum of $3 or $4 could be borrowed. "At its most extreme level, leverage of 20 times became at least theoretically possible."

On the surface, borrowing was tempting; it was certainly cheap, since interest rates had fallen and so had the cost to hedge fund managers to borrow. At the end of 2001, Harris says, his interest costs were 170 basis points above the international interest rate benchmark, known as the London Interbank Offered Rate (LIBOR). That meant that if institutions borrowing money on London's interbank market paid 2.5 percent, he would be forking over 4.2 percent. By 2005 or 2006, he says, those costs had plunged to 30 basis points above LIBOR; a 2.5 percent LIBOR rate would have meant he was now paying a mere 2.8 percent to borrow the same amount of money. Had Harris increased his borrowing, he would have had a lot more firepower to put behind his trading strategies and investment ideas, making it possible for him to earn exponentially higher returns. But he was also aware that if a trade went sour, the borrowing could backfire.

The Wall Street prime brokers didn't seem worried about that risk and even downplayed it, he says. Of course, the more leverage they could persuade Harris and his fellow hedge fund managers to take on, the higher the fees they could generate for their firm. And

even the ultralow borrowing costs weren't set in stone, Harris says. The prime brokers' original role was handling back office functions for the thinly staffed hedge funds, keeping track of trades, clearing them, and keeping custody of the assets, carefully segregated from those of its other clients. The profit margins on this business might be low, but it was a consistent earner for the prime brokerage. "Our firm alone was large enough that we could generate $10 million to $20 million just in custody and back office fees these prime brokers charged" every year, Harris says. The prime broker also tended to handle a lot of trades for its hedge fund clients, collecting fees on those as well. Those fee streams were important enough in their own right that hedge funds could use them as a way to negotiate even lower financing costs. The more Wall Street firms jumped into the prime brokerage business, "the more we had carte blanche," he adds.

If Wall Street's prime brokerages were helping to drive up the level of risk taking in the financial markets by making ultracheap financing available to hedge funds, its investment banking operations were about to play their own part in making the financial system riskier. Once it had seemed at least possible for an investment bank to take the moral high road and not participate in a deal that might jeopardize the firm's reputation or long-term profits simply in order to capture a fee. That's what Goldman Sachs had done when it chose not to advise corporate raiders and others making hostile takeover bids. But as competition to woo the notoriously fickle private equity firms became fiercer and as clients grew more cutthroat by the day, the investment banks themselves rejected the mere idea of leaving anything behind on the table that a rival might be able to parlay into a penny of profit. By 2006, private equity firms, encouraged by the availability of cheap capital and their ability to raise larger and larger funds from alpha-hungry investors, were doing new deals at such a rapid clip that at any given time, a bank's sponsor team could be working on four or five multibillion-dollar takeovers simultaneously, recalls Tom McNamara.

The deals were sometimes happening so quickly that it was

nearly impossible to conduct proper due diligence. “On a Friday afternoon at 5:00 p.m., Blackstone or someone would call and want a commitment from us to finance a deal that would require $15 billion in debt—and they would want it by Monday,” McNamara says. Credit research was being conducted by associates, the junior members of the team fresh out of business school, because there weren’t enough experienced credit analysts to go around. When something struck one of them as not making sense or being too risky, McNamara says, “the response was that if we didn’t do this, someone else was going to—one of our rival institutions. Then whoever had asked the question would be told, ‘Are you going to be the guy that didn’t get the commitment okayed, and the guy who let that business and all its fees go to a competitor?’ ” Naturally, nobody wanted to be that guy.

The business of financing buyouts proved nearly as addictive as crack cocaine. Banks could collect a series of fees from these private equity funds and didn’t have to spend millions of dollars wooing them or presenting them with deal ideas that would never be acted on, as they did with corporate clients who didn’t do deals for a living. The first revenue might come in the shape of an advisory fee, or in exchange for a financing commitment. Another fee could be levied on providing interim financing or bridge loans. More fees could then be charged for selling the junk bonds and leveraged loans that replaced that interim financing. And then there was the 7 percent fee that the bank could collect on the IPO of the company in a year or two.

Lloyd Blankfein, CEO of Goldman Sachs, admitted that his institution, like others, “rationalized” pushing the risk envelope during the credit bubble years. But he also insists that these rationalizations for the relaxation of lending and credit standards were completely justified. In his January 2010 testimony to the FCIC commissioners, Blankfein says bankers would cite reasons such as the power of the emerging markets and the ample liquidity in the financial system to justify the risk taking. But he undermined his own argument when he concluded that the rationalizations were the result of the fact that “a firm’s interest in preserving and

growing its market share, as a competitor, is sometimes blinding—especially when exuberance is at its peak."[12] In other words, while every other firm on Wall Street may have been chasing Goldman Sachs, Goldman itself was afflicted with just the same kind of hypercompetitive urge, and feared losing even a fraction of a percentage point of market share to its own rivals.

These sponsor-backed IPOs weren't the tiny, $100 million or $200 million deals that came from taking start-up companies public. The IPO of private-equity-backed Hertz, the large car rental company, was a $1.32 billion affair that raised an estimated $90 million in fees for its underwriters—Merrill Lynch, Goldman Sachs, and JPMorgan Chase. Anyone who wanted a piece of those fees down the road had to be prepared to play ball with the private equity funds when the latter first structured and sought to finance those takeovers, says Peter Blanton. Blanton himself wasn't involved in putting together the packages of bridge and longer-term buyout financing, involving multiple layers of loans and bond issues, but he'd hear about them when it came time for the bankers to try to win the lead underwriting job on the IPO. "Writing the pitch books, we'd always note that we put up some of the original money, so we should be part of the deal." That turned into a vicious circle; the next time the same private equity team needed financing for a deal, they'd use the same argument to the bankers: they had just paid out millions of dollars in underwriting fees and so had earned some generous terms on the next financing. "A lot of sponsors looked at Wall Street and saw a honeypot full of money and felt that was their money, because it had come out of their pockets when they paid the IPO fee," Blanton says. "Now they wanted some of that back in concessions on the cost of the deal financing. The Wall Street firms had no backbone; all anyone could say was yes. The answer was never no." Wall Street institutions knew they might be getting squeezed on the terms of any single deal by their ultra-aggressive clients. But they could make up for that on volume, they reasoned.

Some bankers chose not to stick around. Gelman, the Morgan Stanley banker who had helped bring Netscape public even as he

saw it as an example of Wall Street's transformation into a casino that encouraged short-term speculation rather than long-term investing, left early, before the market reached its most extreme levels. He didn't want to go through the whole dot-com experience again, this time with junk-bond-financed buyouts. "Over and over again, I'd find that the client whose stock issues I worked on wasn't a corporation raising capital for a new plant, but an IPO that would get a buyout firm a fast profit," he says.

Private equity funds argued that the way they earned their hefty returns was by taking a poorly managed company private, restructuring and overhauling its operations, and then selling the new and improved version, either back to public shareholders in an IPO or to another private buyer. But the time frame that elapsed between when the buyout was done and the IPO that marked the buyout fund's exit shrank steadily. Often, the private equity managers might have bought the company less than a year before the IPO, not enough time to make any fundamental operational changes, much less for those improvements to pay off in higher earnings or a higher valuation. A transaction like that "was a classic flip," Gelman says. The stock underwriting business, once a craft, had become an assembly line, he laments. "It was all about 'How many deals can we price this week?' " Gelman left, he says, "when it became impossible to be an effective conscientious objector to these deals."

Others stayed but became increasingly worried by the deals that were being done. Some voiced concern about the pattern of one buyout company selling portfolio companies on to another one, a phenomenon that became known as secondary buyouts. Why, they wondered, would a company that supposedly had already been through the private equity wringer—costs slashed, business revamped and refocused—be attractive to another buyout firm, one that presumably would try to make money by doing exactly the same things? If there was any fat left to be trimmed, that meant that the first firm hadn't done its job properly, which meant it wouldn't be able to extract the maximum sale price and thus the maximum return for its investors. On the other hand. if the first firm had done

its job properly, then the second buyer was making a foolish investment; there would be no way for its managers to generate a return for their own investors. Private equity investors were openly skeptical, but the deals got done: by the end of 2004, the Simmons mattress company had been acquired by no fewer than five different buyout firms—the fifth, Thomas H. Lee Partners, had paid $1.1 billion for the company.

Deals, Deals, Deals!

Secondary buyouts were just the tip of the iceberg, bankers and private equity funds agree today. By 2005, dividend recapitalizations had arrived on the scene as a way for buyout firms to generate quick profits on deals they had done only a few months earlier. Think of these as being a bit like refinancing a mortgage: the homeowner takes advantage of the increase in her home's value (or at least the increase in its paper value) and increases the size of the mortgage. While homeowners were doing just that in the mid-2000s, private equity firms did the same with the companies in their portfolio in order to lock in profits for themselves and be able to provide returns to their investors more rapidly.

"What I think happened was that bankers weren't gatekeepers, thinking about the quality of the transactions they were financing for their buyout clients," says Jake Martin*, a partner at one large buyout firm. Investment banks were shuffling the assets they underwrote off their own books as rapidly as possible and into the portfolios of other investors. "The question became not whether it was an attractive deal for buyers so much as 'Is it structured right, so that I can push this stuff out the door?' " A lot of lipstick was being applied to make a lot of pigs look more appealing to buyers, he figures. With interest rates at such low levels, buyout firms had an incentive to put smaller amounts of capital into each deal they did —perhaps 10 percent or even 5 percent of the total value—and finance the rest. That was great news for all concerned. The buyout firms could put more money to work in more deals, and have less

cash at risk in each one; the greater the number of deals done, the more fees the Wall Street bankers could collect. Because investors were starved for securities that offered even slightly higher yields than those on Treasury notes, they held their noses and bought.

Martin admits that his firm was probably one of the beneficiaries of this phenomenon, able to finance its transactions more cheaply than otherwise would have been the case. But he adds that the new dynamics of the market—particularly the fact that increasingly the only investors who would buy the relatively low-yielding and higher-risk debt used to finance the later-stage buyouts were hedge funds—ultimately made his life more difficult. "We would rather know who is going to own our paper," Martin says. "In the old days, you'd know who your lenders were and you'd have a relationship with them, and if something went wrong, you'd go and you'd sit down with them and work it out. Now I go and look at the list of people who hold my paper and it's like alphabet soup. It's XYZ hedge fund, or JJB, or GBX, all weirdly named hedge funds that I've never heard of before. If I have a problem with a company and try to talk to them, they basically look at me as if I'm a criminal, and I can see them wondering, 'What kind of pound of flesh can I get out of you? What extra return from your misfortunes can I get?' That is just the reality of today's Wall Street."

Wall Street Joins the Party

Watching their clients rake in profits hand over fist beginning in the late 1990s, Wall Street firms found themselves envying the apparent ease with which they made money. Serving these clients was great; working with hedge funds meant that they not only earned big fees but also picked up valuable market intelligence that helped in other parts of their business. But across Wall Street, investment banks as well as banking giants such as Citigroup began to wonder how they could capture a bigger slice of the pie for themselves. Wouldn't the best way to maximize profits for their own restless shareholders be to just become their own clients?

A growing number of firms took stakes in hedge fund businesses; JPMorgan Chase's acquisition of Highbridge was the biggest deal, but Morgan Stanley spent $1 billion to purchase pieces of Avenue Capital, FrontPoint Partners, and Lansdowne. Citigroup paid $800 million for Old Lane Partners, a hedge fund founded by former Morgan Stanley banker Vikram Pandit, as part of a bid to convince Pandit to join the company's team of top executives. (That turned out to be a particularly controversial deal when, less than a year later, Citi shut down Old Lane.) Lehman Brothers acquired stakes in firms such as Ospraie Management, run by high-flyer Dwight Anderson, an alumnus of Julian Robertson's Tiger fund. It also backed former employees who decamped to start hedge funds; after all, one of them might become the next star, like SAC Capital's Steve Cohen. Among its other investments, Lehman acquired a 45 percent stake in R3 Capital Partners, started by a former proprietary trader at Lehman, Richard Rieder, as late in the game as the spring of 2008. (By the time that interest was sold in October as part of Lehman's bankruptcy proceedings, it had lost half its value.)

Still, Wall Street CEOs wondered whether it wouldn't be even better if their firms could just go and make money for themselves in the financial markets, using their capital to do deals and place bets in the markets through proprietary trading desks. Why not become

deal makers in their own right? The logic was impeccable: turning themselves into their own client would be so much simpler … and it wouldn't require that much of a leap. Ever since Wall Street had begun its transformation back in the 1970s, investment banks had been looking for ways to put their balance sheets to work profitably. "All Wall Street CEOs have two traits in common," says Marsh Carter, deputy chairman of NYSE Euronext and former chairman of State Street Bank and Trust Corp., who has worked closely with most of the current crop of these individuals. "They are very, very, very optimistic. And they all have an undying, unquenchable thirst to do something unique."

To Pete Peterson, who headed Lehman Brothers from the early 1970s until the early 1980s, unique meant looking back in time to the days when banking meant merchant banking, buying and owning businesses rather than just serving as an intermediary for others. Financing other people's deals was inherently perilous, Peterson worried, since blips in the market or the economy could cause a stream of fees to vanish overnight. Why not use Lehman's capital to do its own leveraged buyouts or invest in other businesses, such as real estate, where no one else put a limit on how much they could earn by telling them what kind of fee was acceptable?[13] Lew Glucksman, Peterson's co-CEO, had a different vision for the firm, however. A street-smart trader, Glucksman was aware that trading the growing array of products available—options, futures, and commodities, as well as stocks and bonds—generated two-thirds of Lehman's profits by the early 1980s.[14] Why shouldn't the firm build on those strengths and put its capital to work accommodating its trading clients and taking proprietary positions?

Both co-CEOs had a vision of the future that went well beyond Wall Street's classic role as an intermediary and involved Lehman using its own capital and becoming its own client. The difference in the nature of their vision, however—Glucksman believed Lehman should become more like a hedge fund, while Peterson preferred a private equity model—resulted in an epic battle for control of the firm in 1983. Glucksman triumphed briefly, ousting Peterson and

ruling the company for another ten months before the partnership collapsed under the weight of the internecine battling. It is perhaps not surprising that Peterson went on to cofound the Blackstone Group with fellow Lehman alum Stephen Schwarzman in 1985, a company that the two men turned into one of the largest buyout firms in the world. (Glucksman went on to work with Sandy Weill as the latter began building what became Citigroup; he died in 2006.)

At Goldman Sachs, partners were also debating how best to make use of their own balance sheet. As Wall Street's transformation got under way in the 1970s and 1980s, a growing number believed that the recipe for long-term survival and success involved more than simply acting as an agent for its clients: Goldman Sachs should do business as a principal, to take risks with its own capital and pocket 100 percent of any return. Steve Friedman and Bob Rubin battled to get their partners' assent to a $5 million investment in one of KKR's first funds over the objections of colleagues who griped that they didn't want their profits going to support the business launched by Jerome Kohlberg, Henry Kravis, and George Roberts. But the investment was made, clearing the way for more direct investments in operating businesses by Goldman itself. Goldman veterans still fretted that this time KKR would see them as rivals instead of bankers. ("Yes, but they'll get used to it," Friedman retorted.) Finally, in 1991, Goldman opened what would become the first in a series of private equity funds carrying the Goldman Sachs brand name.[15] The $1 billion GS Capital Partners I, with $300 million of Goldman's capital invested in it, set out to compete directly with the big guys. In less than two decades, Goldman Sachs was the big guy, raising a $20 billion fund that even dedicated buyout firms such as KKR and Blackstone would find hard to match in size.

Goldman was slower to set up its own hedge fund, although Leon Cooperman had proposed doing so at a partners' meeting in the same year that GS Capital Opportunities made its debut. "The other partners were reluctant, because the hedge fund might short stocks of companies who were also investment banking clients of the

firm," Cooperman recalls. "They worried that if that happened and the clients found out, there would be hell to pay. They just weren't progressive enough to see that in a few years this would become mainstream" and that even though those corporate underwriting clients didn't like it, they didn't have enough clout to punish the increasingly powerful Wall Street institutions. Cooperman left to set up his own hedge fund, to which other Goldman alumni have flocked. Meanwhile, Goldman quickly overcame its qualms and rolled out proprietary hedge funds. It also allocated a steadily increasing stream of capital to its proprietary traders, who were charged with using that money to generate profits for the firm in much the same way that the hedge funds would.

Both the hedge fund and proprietary trading businesses exploded in the 2000s. "Within ten years after I failed to convince them, suddenly hedge funds were all they were selling to their [investment] clients—these premium products," says Cooperman. Indeed, so great was Goldman's dependence on these principal activities—private equity investing, its hedge funds, and its proprietary trading business—that among the cognoscenti it had become almost a cliché to refer to Goldman Sachs as a hedge fund disguised as an investment bank. That's a description still guaranteed to cause Goldman Sachs executives to sputter in outraged indignation. Gary Cohn, the company's president, insisted in a 2009 interview that "the vast, vast majority of our revenue and income comes from our client facilitation" activities.[16] Many see that as posturing; others nod knowingly at the almost Clintonesque precision of Cohn's choice of words in describing Goldman's activities.

Ultimately, it became hard to figure out whether a Wall Street investment bank was operating as an intermediary, helping clients finance transactions; as a partner, investing alongside them; or as their rival, competing with them for trading ideas or access to deal flow. "It became very situational," says Jim Tanenbaum, a partner at Morrison & Foerster, who has worked closely with Wall Street clients of all stripes; the answer would vary depending on what day of the week it was or even the time of dav. If Goldman Sachs met

with the board of directors of a company thinking of going public, there was no guarantee that the investment bank would agree to underwrite the deal, for reasons Tanenbaum says had less to do with the IPO candidate's appeal to public investors than with Goldman's own interests. "What would have happened? Goldman's bankers would have gone to the first meeting, said, 'That's very interesting. Let us introduce you to some of our colleagues,' " he observes. "And then at the next meeting, they'd be there with managers of their proprietary funds, because they had decided that rather than be the conduit for you to raise capital and earn a fee, they'd rather compete with their peers by buying you outright or investing in you." Instead of acting as an agent, the banks had themselves become principals in the financing transactions.

Is that better or worse for the hypothetical company looking for new capital? It's impossible to know if the company would have been better off following the traditional path of going public and selling stock to a number of mutual funds rather than selling itself to a private equity firm. Blanton is forthright in assessing the kind of analysis that was being made by his bosses. "Who is to say that this is wrong? You're a public company; your duty is to make money for your shareholders. And if everyone else is doing it too, why would you be the one firm to become holier than thou? It's just inconceivable." What was significant was that, increasingly, it was harder than ever for midsized or start-up companies with respectable revenue and profit track records to go public. Meanwhile, venture investors and bankers note that the same investment banks who turned them away as underwriting clients would often return with acquisition offers, sometimes emanating from themselves, on other occasions on behalf of buyout funds. Wall Street firms, which once saw their role as facilitating access to public markets, increasingly seemed inclined to block it, say a number of corporate lawyers and venture capital investors.

Part of this shift, Wall Street veterans agree, stemmed from the fact that investment banks and the growing numbers of commercial banks vying with them for capital markets transactions were almost all publicly traded businesses by 2000. Only a handful of firms

remained partnerships, including Lazard, Greenhill & Co. (the boutique launched by former Morgan Stanley rainmaker Bob Greenhill) and Evercore Partners, another boutique launched by a group of veteran bankers (many of them Blackstone alumni) including Roger Altman, who had also worked at Lehman Brothers. (By 2008, all of these firms would also be publicly traded, following an IPO.) "When I started practicing on Wall Street, none of this could have happened, because people owned their own firms," remarks Tanenbaum. "The idea of using capital to pay traders based on the volume of the business they did would have been viewed as an absurdity."

Now that they were publicly traded, investment banks faced two conundrums: the perennial challenge of finding new and profitable business lines in order to deliver a stream of steadily rising profits to shareholders; and finding ways to deploy their constantly expanding balance sheets to generate those profits. "When any company raises new capital, they need to invest it in a business that will make even more money than what they are already doing," says Jimmy Dunne, CEO of one of Wall Street's boutique investment banks, Sandler O'Neill. "It's no good raising capital if it goes into a business at which they aren't as good as they were at the core business. That's a bad use of capital." Not coincidentally, Sandler O'Neill remains a private partnership.

The consequences of the business decisions made by the likes of Stan O'Neal and Lloyd Blankfein—CEOs of investment banks that were now accountable to outside shareholders—were reflected not only in the rate of growth in their profits but also in the kinds of business that were now generating those profits. At Merrill Lynch, revenue from trading and principal investments—the kinds of activities in which the firm used its capital to generate profits for itself, becoming its own client—was 47 percent in 1997, rising to 55 percent in 2007, according to data cited in the Financial Crisis Inquiry Commission's final report. At Lehman Brothers, 32 percent of pretax earnings flowed from these transactions in 1997, compared to 80 percent a decade later; in some years, Bear Stearns generated more than 100 percent of pretax earnings from those

businesses, thanks to losses in other divisions. And at Goldman Sachs—which remained the envy of all its rivals for its ability to steer its way effortlessly through any controversy while turning everything it touched to gold—the proportion of revenues attributable to proprietary trading and investing jumped from 39 percent in 1997 to 68 percent a decade later. As a result, profits for the financial sector, which had made up about 15 percent of all corporate profits in 1980, ranged between 27 percent and 33 percent of total corporate profits in the years immediately preceding the meltdown.

By early 2006, some of Wall Street's more thoughtful insiders were questioning what was happening. How much of the record earnings that investment banks were posting could be attributed to their wisdom and deal-making prowess, and how much to the fact that they were benefiting from record low interest rates and investors' seemingly insatiable appetite for risky investments? What was unquestioned was that by 2006, the definition of success for Wall Street had changed. Once, the masters of the universe were those who could navigate the money grid most adeptly, generating the biggest benefit for their corporate clients while earning hefty fees for their firms. Now success was about not only serving a new breed of clients but trying to emulate them. Financial alchemy was the magic ingredient; if they could find the right ways to structure and hedge their financial innovations, the world, they were sure, could be their oyster.

And killjoys? Well, they didn't last long on the new Wall Street. No one had to look further than Phil Purcell, the Dean Witter executive who had risen to the top spot at Morgan Stanley in the wake of the two firms' merger in the late 1990s, only to be ousted in 2005 in a bloody battle for control of the investment bank. "In a lot of ways, the smartest guy out there was Phil Purcell," comments Nick Harris, the hedge fund manager. "He took few balance sheet risks, he said no to that special bottle of Château Leverage 2003. And he got fired for it."

That was only part of the story, of course. Purcell was widely disliked within Morgan Stanley, and during his time at the helm a

number of top bankers had fled the elite investment bank. Still, under Purcell, Morgan Stanley hadn't taken the same kind of big balance sheet bets as its competitors—and that showed up in the company's profit margins and return on equity, which compared unfavorably with those of rivals. Shareholders were already concerned by news of the defections, and, backed by bankers inside the firm eager to delve further into the world of principal investing and proprietary trading, they ended up ousting Purcell. "He just didn't get what it meant to be a banker in the twenty-first century," says Gelman, the former Morgan Stanley banker. "I don't know why he seemed to be surprised that people weren't happy." Purcell's replacement was John Mack, who promptly went where Purcell had feared to tread. When Morgan Stanley reported its first-quarter earnings in 2007, the company announced a $1 billion profit made by shorting subprime securities in the first stage of their slump; investors beamed with delight at one-upping Goldman Sachs.

The lesson of Purcell's ouster wasn't lost on anyone. It wasn't that people lamented his absence as a person or even as a leader. But to many Purcell stood for an old-fashioned way of thinking about what Wall Street did and how it worked. "His Wall Street was a customer-focused place, not a place where people chased after business as a principal," Gelman notes. So Purcell's departure was symbolic; if he could be driven out of Morgan Stanley for failing to maximize profits at all costs, the thinking went, then consciously walking away from business opportunities just because they might involve a bit of risk was likely to be a career-limiting move for anyone else on Wall Street. "We watched, we listened, and we all learned from that," says another Wall Street veteran. "The message was clear: the question we were supposed to be asking ourselves wasn't whether a piece of business was prudent, it was whether it would help us beat Goldman Sachs."

CHAPTER 4

To the Edge of the Abyss—and Beyond

Flying Too Close to the Sun

Richard Fuld didn't like naysayers or killjoys any better than anyone else on Wall Street, especially when they came from inside the ranks of Lehman Brothers, the firm that had been his home his entire professional life. As CEO, he struggled daily to win the respect he felt Lehman deserved after clawing its way to the position of Wall Street's fourth-largest investment bank. Occasionally Lehman even managed to earn a larger return on equity than Goldman Sachs did, as happened in 2000 and again in 2003. Fuld, say some former Lehman bankers, was obsessively competitive and focused on beating Goldman Sachs on a consistent basis, and that meant emulating Goldman's risk-taking culture and taking on even more leverage. While Goldman Sachs borrowed about $25 for every dollar it put to work in proprietary deals or other high-margin undertakings, Lehman, by some calculations, borrowed more than $30. To continue earning those returns, Lehman devoted a lot of that capital to buying mortgages and repackaging them into CDOs as fast as it could, billions of dollars at a time. The 1 percent fee on creating and selling CDOs was a windfall that flowed straight to Lehman's bottom line.

When Mike Gelband, Lehman's new co-head of fixed income, began questioning the health of the real estate market in the summer of 2005, he was directly challenging the resolute optimism of Fuld and his closest allies at the top of the firm about one of the most profitable parts of their business. According to Lawrence

McDonald, a Lehman banker who went on to chronicle the collapse of the investment bank in a book entitled A Colossal Failure of Common Sense, Gelband was a studious kind of person, as bankers go. But, McDonald added, "to this day I've never met anyone who could grab and comprehend a difficult new idea faster than Mike Gelband."[1] The "difficult new idea" that Gelband was focusing on in June 2005 certainly wasn't a welcome one for many at Lehman. It had nothing to do with the invention of a new way to make money but instead questioned the rationale for the profits the firm was already earning. Gelband prepared a thirty-page report spelling out just why he thought the real estate market was a bubble about to pop and do far more harm to Wall Street and the economy than the Internet bubble had done only a few years previously.

Gelband presented his evidence to McDonald's group early one morning at the beginning of June 2005. To the tense group of bankers and traders assembled in a conference room at Lehman's mid-town Manhattan headquarters, he argued that the real estate industry "was pumped up like an athlete on steroids, rippling with a set of muscles that did not naturally belong there," McDonald later recalled. "Those muscles gave a false impression of strength and in the end would not be sustained."[2] With almost oracular ability, Gelman identified everything that would go wrong and ultimately cost Fuld his post and Lehman its very existence—the rise of the shadow banking system of which Lehman was a part, the leverage, the poor quality of the mortgage loans that Wall Street was churning into CDOs. He even predicted the timing of the debacle: the chickens would come home to roost in 2007 and 2008, he said.

Not surprisingly, this kind of analysis was unwelcome to those toiling within Lehman's mortgage banking and trading division. Gelband just didn't get it, they argued; he was too conservative. And Fuld tended to agree with them. Why did Gelband want to kill the proverbial goose that was laying golden eggs at a very rapid rate? The buzz, McDonald said later, "was that Mike Gelband had developed some kind of an attitude problem, and it needed to be changed real fast."[3] As Gelband's anxiety grew about Lehman's

exposure to what he saw as a catastrophe in the making, so did the worry among Lehman's top brass about Gelband and his inability to be a cheerleader for the business that was generating big profits for the firm.

In 2006, the volume and value of CDO deals hit another record, $552 billion—generating about $5 billion in profits for the Wall Street firms packaging the securities. But Gelband's anxiety grew just as significantly. That spring, some four million homes were for sale across the United States, double the number at the same time of year in 2000; CDO issuance was now more than three times the level of 2003. Gelband tried on several occasions to communicate those worries to Fuld and his chief lieutenant, Joe Gregory. At a year-end review in late 2006, Fuld openly told Gelband he was being too conservative. Ultimately, the naysayer had to go: by March, Gelband had been forced out of Lehman Brothers.[4] Only weeks after his departure, however, Gelband's predictions began to come true. Fuld may have won the battle, but Lehman would lose the war.

In the life cycle of every bubble, there is a point where it becomes clear that what looked like a boom is really a bubble—one, moreover, doomed to explode violently in the near future. By the early summer of 2007, that point had been reached. True, regulators such as Fed chairman Ben Bernanke could burble reassuringly about the problems associated with the subprime mortgage crisis being "contained," while Wall Street investment bankers remained publicly upbeat. But if the summer of 2007 was a tipping point, it is by studying the eighteen months that led up to it that we can begin to appreciate the extent to which Wall Street was afflicted with a kind of willful blindness or magical thinking. Each of the Street's five large investment banks, together with the investment banking divisions of giant global banks such as Citigroup and UBS, was fixated on doing whatever it took to maximize short-term profits. If one risky deal was highly profitable and thus good, then doing ten such deals had to be even better, they reasoned. With their gaze focused on their own bottom line, they neglected to consider the implications for the entire financial

system of each step they took. “We talked ourselves into complacency,” Blankfein later admitted during his FCIC testimony.

By the time Gelband began to warn his colleagues at Lehman Brothers about the impending storm, it was already on its way. At first it looked like nothing more than a single, distant cloud marring an otherwise perfect sky, or a small snowball rolling down an Alpine slope. But as the months passed throughout 2006 and early 2007, the number of clouds grew in number and became darker and more ominous; the snowball became a giant boulder and, moving faster and faster, threatened to trigger an avalanche that would crush everything in its path. At the time, few seemed to realize just what was brewing, yet the signs were everywhere. Nine of the ten largest leveraged buyouts proposed in the industry’s history were negotiated in 2006; subprime lending reached a peak along with CDO creation and leverage levels. Wall Street was drunk on cheap money and oblivious to the inevitable hangover.

The period that elapsed between two IPOs that, in different ways, signaled just how greatly Wall Street had changed over the last few decades proved to be the period in which that avalanche became unstoppable. The first of those transactions was the decision in the final days of 2005 by the New York Stock Exchange to merge with electronic trading network Archipelago and become, in the process, a publicly traded, for-profit entity. The second was the June 2007 initial public offering of stock in the Blackstone Group. The private equity group hoped to leverage its own decades-old brand name and its status as one of the linchpins of the “new” Wall Street into another successful nontraditional IPO. By now, however, the cracks in that new financial system were beginning to show up, and only days after the Blackstone IPO was completed, the financial apocalypse had begun. The fifteen months that followed would prove to be just as ugly and traumatic as the fifteen months that lay between the two IPOs had been filled with euphoria. Wall Street would never be the same again, the pundits proclaimed.

The Big Board Goes Public

In the final weeks of 2005, the New York Stock Exchange's 1,366 members prepared to vote on the most dramatic change to the centuries-old institution they ever expected to witness. Enough yes votes, and the Big Board would end 215 years as a member-owned nonprofit utility. Merging with electronic trading firm Archipelago Holdings Inc., the exchange would become a publicly traded for-profit entity whose activities revolved not around the venerable trading floor but around increasingly sophisticated computer networks.

To the exchange's new leadership—Goldman Sachs banker John Thain had just replaced Big Board veteran Dick Grasso at the helm in the wake of a scandal surrounding Grasso's lavish compensation package—the deal was a slam dunk. The exchange may still have been a symbol of American capitalism and the financial markets themselves, visited by every head of state that flew into New York to attend United Nations events. But, they argued, it was stuck in the twentieth century at a time when all of its major competitors at home and abroad had thrown themselves into the world of electronic trading. Its best clients—hedge funds and the trading desks of buy-side and sell-side firms alike—demanded execution in milliseconds, not seconds, especially for the vast majority of trades that simply involved buying or selling blocks of stock. The NYSE had taken a relatively slow and haphazard approach to computerized trading, and its ability to execute client trades cheaply and rapidly was in question even as the SEC forged ahead with plans to level the playing field still further. Supporters of the Archipelago merger argued that the deal wouldn't just make members rich—they would get, collectively, $400 million in cash and 70 percent of the shares in the new company—but also would save the centuries-old institution from becoming about as irrelevant as, say, a quill pen in the computer era.

Few Wall Street culture clashes are as visible as the one between the old and new Wall Streets that surfaced in the months after the transaction was sprung upon the world in the spring of 2005. The proposed merger had been negotiated in a matter of weeks, after

Archipelago was rebuffed in its attempt to acquire the Big Board's largest competitor, Nasdaq. Not a word of the negotiations—in which both sides were advised by Goldman Sachs—leaked out. On the day of the announcement, Archipelago executives attending the press conference snuck in a side door of the NYSE and up a back staircase to reach the room where the media was assembled in order to keep the news secret until the last possible second. "Rarely do you get to completely shock the Wall Street world, and we did," recalls one of the participants in the negotiations, gleefully.

Shock was the appropriate word. One NYSE member loyal to ousted exchange CEO Dick Grasso and angry about Goldman Sachs's increasing clout at the exchange (Goldman also owned a stake in Archipelago) tried to launch a rival offer. He argued that the deal didn't compensate seat holders for the value of the exchange's real estate at the corner of Wall and Broad Streets, much less its brand. On the floor of the exchange itself, a coterie of traders quietly mourned what they believed was the end of a long tradition. "I had always taken great comfort in the idea that the Big Board was above the fray, a kind of disinterested, nonprofit thing where our focus [as an institution] was to keep the wheels turning rather than only making money," one trader mused. "Obviously, we all wanted to make money for ourselves, but we also thought that the system within which we were making money was one that thought first about that system and only then about profiting for itself. I suppose we felt as if we had a kind of trust to discharge."

But the future lay with a new breed of player, such as Tom Caldwell, a Toronto financier who thirty-five years earlier had stood beside George Washington's statue outside Federal Hall, just across Wall Street from the exchange, and vowed to himself that one day he would own a seat on (and thus a stake in) the NYSE. By the time of the vote, Caldwell, now head of a multibillion-dollar investment empire, owned forty-nine seats on the NYSE and cast his own ballots in favor of the merger and the IPO. "When an exchange is public, when people are willing to own it, it's a sign of a stable financial system," argues Caldwell, who also owns shares of publicly traded stock exchanges worldwide, from Europe to Latin

America. “By having a publicly traded exchange, you give investors a way to participate in the growth of the economy and the region, and you give the exchange a currency that it can use to invest in itself to make sure it remains a competitive force.” The kind of push that comes from shareholder-investors to become more competitive and efficient is the best way to make sure an organization is as effective as possible, he adds. The NYSE just couldn’t afford to cling to its nonprofit status in a new world of intensive competition among stock exchanges for market share. It was this “new” Wall Street, with its emphasis on technology, innovation, and maximizing fees and revenues, that triumphed in the December vote. At least 85 percent of the exchange’s members (95 percent of those who cast their ballots) voted in favor of the transaction, Caldwell among them.

Three months later, shares of the new New York Stock Exchange Group began trading on its own exchange. Tiny ceremonial bells were handed out to all who showed up for the traditional party accompanying the first day of trading in any new listed company, and as the moment approached when exchange officials would ring the opening bell, members-turned-shareholders and hundreds of assembled guests began ringing them in celebration. The celebration was even louder at the end of the first day of trading, after the exchange’s shares rose from $67 to $80 apiece.

Nonetheless, everyone was well aware that this was an entirely different kind of IPO. For two centuries, the exchange had been a member-owned organization that wasn’t just a part of the financial system but one of its hubs. Even its location, at the corner of Broad and Wall, had given its name to that financial system—Wall Street. The reason for its existence was to give everyone a chance to access the secondary market for stocks. Unanswerable questions were everywhere. Some wondered what effect the fact that the exchange’s single largest holder was now a private equity firm—General Atlantic LLC—would have on governance.

It was early days for the merger, but even as the bells rang out joyfully, a chorus of boos was also heard on the trading floor. Some came from disgruntled floor traders who hadn’t had seats to sell and

who thus hadn't been made rich in the transaction, but who knew that significant upheaval lay ahead. Others, on and off the exchange floor, were wary for different reasons, and continued to voice their unease at the idea of a for-profit exchange. "Look, I think it's great that the NYSE is competitive and innovative, but I don't know how much thought has gone into finding a way to be both a utility that has to serve all of us who are market participants and a for-profit company that has to maximize shareholder returns," says one investment manager who has served on exchange committees in the past. "They had struggled with these conflicts even before they were public, earning profits for the exchange by selling the right to trade in certain stocks [specialist listings], even though they acknowledged those listings belonged to everybody who participated in the markets, not the exchange itself. I don't know how they'll cope with this over the long haul."

Cultural clashes such as these likely will recur for many years to come. Exchange insiders, on the other hand, point out that a separate regulatory company reports to an independent board of directors, while the exchange as a whole is still overseen by the SEC. And the risk is worth running, they argue. "If the exchange was a public utility, which implies being a kind of monopoly, then there would be no incentive for it to become better, faster, or more efficient; the competitiveness of our markets would suffer," says one former senior executive at the exchange. In other words, the profit motive was necessary; without it the exchange couldn't discharge its responsibilities to the system properly. Certainly, without the public listing the NYSE never could have taken its next step. Only a few months later, it signed a deal to merge with Paris-based Euronext, forming the first transatlantic stock exchange company and setting the NYSE on course to having a global footprint. The only way the NYSE could outbid Deutsche Boerse, its rival to acquire Euronext, was its ability to use its stock as the "currency" in the €8 billion offer.

Blackstone Cashes In

Little more than a year after the NYSE's debut as a public company, in June 2007, armies of television cameras showed up again at the New York Stock Exchange for another unusual kind of IPO. This time the company going public wasn't an exchange but an entity from another part of the Wall Street labyrinth: private equity giant Blackstone. Only a month before the IPO plan was announced, Blackstone's CEO, Stephen Schwarzman, had called the public markets overrated and not really worth it when it came to raising capital.[5] Now, it seemed, Schwarzman was willing to eat his words (which had been directed at hedge fund firms and rival private equity companies that had filed for IPOs) if it meant that he could raise nearly $700 million by selling part of his interest in the company he cofounded to other investors, and put a $7.7 billion valuation on the rest of it. It would quantify the magnitude of his achievement in the eyes of everyone—and make him even wealthier to boot.

On the surface, the deal looked appealing; it was pitched to potential investors as a way for them to get a piece of the private equity action that was usually confined to the deal makers themselves, their closest (very wealthy) allies in the finance and business worlds, and blue-chip institutional investors. The only problem was that owning Blackstone's stock wouldn't give ordinary investors access to the same riches they might have enjoyed as real partners in the private equity firm's deals. What Blackstone was offering to the public were shares in its management company, not participation in its deals. Moreover, investors would have limited voting rights, giving them little to no say over the way Schwarzman and his board decided to run the business. In the eyes of some potential investors, the Blackstone folks were hanging on to their cake even as they ate it.

The success of the NYSE's debut as a public company hinged on the ability of a centuries-old brand name to overcome worries that the newly merged company might not be able to reinvent its business model and compete successfully in the twenty-first-century era of computerized trading. Blackstone now faced its own set of

obstacles. Despite its status as a different kind of icon—a symbol of the riches that came from being a success on the "new" Wall Street—Blackstone's IPO bid raised eyebrows. After all, the firm had made that money for its partners and investors in its funds from private equity. Indeed, Blackstone's entire business model relied on the premise that the public markets it now sought to tap for its own benefit were inefficient. Only by taking publicly traded companies private (using debt to finance the deals) and overhauling and streamlining them could the true value of a corporation be unlocked, private equity investors argued. Of course, the public markets would come in handy eventually, when Blackstone needed an exit strategy to turn its investors' paper profits into cold hard cash. But an IPO wouldn't take place until Blackstone's partners had extracted as much value as possible from the company, leaving little on the table for subsequent investors. In other words, for Blackstone, the stock market had served traditionally as a dumping ground for its leftovers.

Nonetheless, Citigroup's Michael Klein, co-head of investment banking, felt the time had come for Blackstone itself to go public; the fascination with private equity as a source of fees for Wall Street had reached its logical extreme. It was time to turn those private equity profits into cash for the buyout firm's owners—and into fees for Citigroup. Klein, one of a small handful of bankers who pioneered the concept of sponsor groups within the investment banking world, had helped Blackstone finance so many of the firm's buyouts that Citigroup became known as Blackstone's bankers in much the same way that midtown Manhattan's Four Seasons restaurant, around the corner from the private equity shop's offices, was referred to as the Blackstone cafeteria. Klein broached the idea of an IPO for Blackstone itself not in Manhattan but over lunch at Schwarzman's recently acquired $34 million estate in the tony Hamptons.[6]

It was obvious that Blackstone had a better track record than many conventional companies that seek to raise new capital through an IPO. In the nearly twenty years that had passed since it launched its first fund, Blackstone's assets under management had

grown at an average rate of 34 percent. Even after paying Blackstone's fees, clients of its core private equity funds had pocketed an average annual return of 22.8 percent, a figure that dwarfed stock market returns in the same period.[7] Klein argued that Blackstone's managing partners could hang on to what mattered to them—control over the management of the funds and the ability to continue raising new ones—while generating a permanent capital base for the parent company and—not coincidentally—turning some of the wealth that Schwarzman, Peterson, and other partners had generated into cold hard cash. "It was very astute," says junk bond analyst and money manager Marty Fridson. "They seemed to realize that the market would never be at these levels again; a smart investor knows that the time to sell is when the market is at the peak and about to head south again. It was as if they'd said, 'Well, if people are willing to give us capital very cheaply, if they are willing to pay a premium—why not?' "

A Study in Contrasts

Aside from the timing and the nature of the deals—two parts of the Wall Street system for raising capital, raising capital for themselves through that system—the two IPOs could not have been a greater study in contrasts. The NYSE remains in many key ways a symbol of "old" Wall Street, despite the fact that 95 percent of the trading now takes place via computers rather than on the venerable trading floor. In contrast, Blackstone is the epitome of the "new" Wall Street. Even the purpose of the two IPOs was different. While that of the NYSE was simply a way to get the stock publicly traded (no fresh capital was raised), the Blackstone IPO was a way to help cofounder Pete Peterson (the former Lehman banker) make his wealth liquid: when the IPO was over, Peterson had sold all but 4 percent of his stake in Blackstone in exchange for $1.88 billion. Steve Schwarzman kept a 24 percent stake in the firm but still made nearly $700 million from the IPO.

Peterson and Schwarzman both rejoiced in lavish displays of their

wealth, with Schwarzman sometimes taking it to extremes. For his sixtieth birthday, celebrated on Valentine's Day 2007, Schwarzman commandeered the Park Avenue Armory; comedian Martin Short was the evening's master of ceremonies, Patti LaBelle sang a song written especially for the master of the universe, and Rod Stewart performed in an evening that—lobster, filet mignon, and all—cost $5 million, by some estimates. That was just slightly more lavish than Schwarzman's annual holiday parties, the 2007 version of which had an orchestra playing themes from James Bond films while models dressed as the various "Bond girls" mingled with hundreds of guests. He's also a property junkie, owning lavish homes in Manhattan, Jamaica, Florida, and Saint-Tropez, in addition to the Hamptons estate.

In contrast, Duncan Niederauer, the former Goldman Sachs banker who replaced John Thain at the helm of the stock exchange, plays down his own wealth in a more "old" Wall Street way even as he continues to urge the Big Board forward into a new era. He and his family live in a relatively modest New Jersey suburb and, until the exchange's security people put their feet down and insisted he agree to a car and driver, preferred to drive himself to work early every morning in a pickup truck. Schwarzman attends galas for high-social-impact institutions such as the New York Public Library; Niederauer prefers to work for Habitat for Humanity and an array of autism nonprofits. (His son was diagnosed as autistic as a toddler.) Still, Blackstone's IPO was "new" Wall Street, and the high-octane private equity business had, in the eyes of investors, a lot more pizzazz than the stodgy business of facilitating trades. While the exchange's stock had dipped below its $31 IPO price by the summer of 2007, Blackstone and its underwriters were confident that all that glamour would command a premium valuation.

Certainly the buyout business seemed white-hot, with several veterans speculating openly that 2007 or 2008 would see what many bankers and analysts had believed to be impossible: a $100 billion buyout. "That November 2006, we were working on three or four deals all at once, and then we got a call to work on

structuring what would have been an $85 billion buyout," says one Citigroup banker. (By way of comparison, the largest buyout to date had been the $33 billion purchase of hospital chain HCA in the summer of 2006.) The bankers figured out ways to sell no less than $35 billion of term loans and worked through different strategies for financing the rest of the transaction but—to the poorly hidden relief of at least some of the bankers—the transaction fell apart. "Someone made the comment, 'I think we just flew too close to the sun.' "

Even for those who believed in the fundamental strength of the private equity model, the rapid-fire pace at which new buyouts were being done, the enormous deal sizes (seventeen of the twenty largest deals in history were announced in the eighteen months that preceded Blackstone's IPO), and the equally gargantuan valuations and levels of debt aroused unease. "Why would I want to buy stock in Blackstone if a guy like Steve Schwarzman is selling?" was the question heard across Wall Street. Those qualms didn't stop the underwriters (led by Morgan Stanley and Citigroup) from rounding up more than enough interest to price Blackstone's shares at $31 apiece, at the high end of the range. Behind the scenes, the level of nervousness was growing, say people who were involved in the underwriting and the road show. "Steve decided to accelerate the pricing by two days," says one of the bankers. "He saw the environment deteriorating."

In Washington, Senator Charles Grassley (the ranking Republican member of the Senate Finance Committee) was "stomping around," in the words of one private equity deal maker, introducing, along with his Democratic counterpart and committee chairman Max Baucus, a proposal that would tax the 20 percent share of profits earned by partnerships such as private equity, venture capital, and hedge funds at the rate applied to corporate profits rather than at the much lower capital gains tax rate. Meanwhile, the leveraged loan market—on which Blackstone and other private equity funds relied to help finance their deals—was beginning to crack. "In 2005, a normal backlog of paper that banks had committed to finance and waiting to be sold would be about $70 billion, but by

June of 2007, it was $380 billion," says Tom McNamara, the private equity banker. "The tidal wave of paper in search of a home was so overwhelming that almost overnight we started to hear investors starting to say no to deals and commenting that they didn't need to buy everything, especially at the prices being asked." Schwarzman's instincts were right. Within days of the Blackstone IPO, shares of the newly public company (trading under the symbol BX—pronounced "bucks," as in cash) were falling; by early July 2010, the stock was changing hands for $16.50 a share, about half its IPO price of $31, although three times its 2009 low.

Flying Too Close to the Sun

Before the Blackstone IPO had been completed, the pendulum reached one extreme and began, slowly, to swing back in the other direction, gathering speed as it went and culminating in the Wall Street debacle of 2008. During the months that elapsed between the two IPOs, nearly everyone on the Street—from veteran regulators to the greenest traders—recalls experiencing some kind of eureka moment: a point in time where they stopped what they were doing and reflected to themselves that the good times they were experiencing were unsustainable. For some, the warning signal was a particular deal that made them realize just how much risk their institution and the rest of the market was accepting without question. For others, it was an offhand remark by a colleague, or being confronted with the kind of careful research presented by a handful of Wall Streeters such as Mike Gelband to their colleagues and bosses.

In the early spring of 2006, during the celebration of the stock exchange's IPO, the warning signs were subtle and articulated only by those willing to be provocative and challenge the status quo. Even months later, few were willing to listen to Gelband and others like him, those whom Wall Street CEOs such as Fuld were quick to label as false prophets of doom and professional worrywarts. After all, fee income and profits at investment banks and other firms hit

record levels in 2005, for the fifth year in a row; so, too, did compensation. Collectively, Wall Street firms pocketed $34.1 billion in bonuses in 2006. At the annual Robin Hood Foundation gala that December, the hedge fund managers who had founded the antipoverty charity took from the rich (themselves) and gave a record $48 million to the poor of New York City.

As the weeks passed and the clock ticked down to the Blackstone IPO in mid-2007, the warning signs became more pronounced. Crude oil prices had been rising, putting a crimp in the budgets of those who, unlike Schwarzman, didn't have billions in spare cash to cover the increased costs of heating even one home. But with twenty-twenty hindsight, one would have to say the real party pooper was the Federal Reserve, which had begun raising interest rates back in June 2004. Until then, policy makers had spent some three years flooding the American financial system with cheap capital in hopes of staving off a sustained period of recession and averting deflation in the wake of the stock market crash that had begun in 2000. That prolonged period of readily available, ultracheap debt fueled the boom in private equity deal making that made private equity firms such as Blackstone so superficially appealing, as well as generating other trading and underwriting fees for fixed-income bankers across Wall Street.

It also distorted the perception of the risk of many transactions. Why worry that many of the new asset-backed securities being repackaged by Wall Street involved so-called subprime credit card receivables and mortgages—debt owed by borrowers with tattered credit histories? Low interest rates would cover a multitude of sins, and in the meantime, there were rich fees to be harvested. Until there was evidence that Wall Street's hubris, in the shape of its quest for more and more profitable fee-generating business, had collided head-on with the forces of gravity, no one on Wall Street wanted to worry. "Why would we borrow trouble?" says one former senior Wall Street executive. "We had to keep making money, keep our shareholders happy."

The Quest for ROE

Keeping shareholders happy had been the name of the game on

Wall Street ever since the first big wave of investment bank IPOs culminated in the decision by Bear Stearns to go public in 1985 and Morgan Stanley to follow in 1986. By the early 2000s, a tidal wave of consolidation and the collapse of the regulatory barriers that had once separated investment banks and commercial banks had reshaped the competitive landscape dramatically. Just as the changes in the 1960s had pushed many firms out of the business, the trends of the 1990s caused bank and investment bank CEOs to question their ability to go it alone. Technology costs were soaring; paying key employees enough to stop them from jumping ship and heading off to work at hedge funds or buyout shops drove up expenses, as did maintaining a global footprint. Meanwhile, profits from traditional businesses, such as trading, were continually under pressure.

For many Wall Street institutions, the answer seemed to be joining forces with a giant global institution. The U.S. division of UBS, the Swiss powerhouse bank, acquired PaineWebber in 2000, ending the latter's 120 years of independence. (The PaineWebber brand name vanished three years later.) Credit Suisse, UBS's rival at home in Switzerland and overseas, had become an aggressive investment banking competitor to firms such as Goldman Sachs and Morgan Stanley in the late 1980s, when it snapped up First Boston and its powerhouse M&A division, which employed two of the biggest buyout bankers around, Bruce Wasserstein and Joseph Perella. (Wasserstein died suddenly in late 2009 at the helm of Lazard, while Perella now runs his own boutique, Perella Weinberg Partners.) It followed that up with the purchase in 2000 of Donaldson, Lufkin & Jenrette.

The big U.S. banks were just as interested in getting a share of Wall Street profits that, in good years, dwarfed the skimpy margins they could earn from commercial banking operations. Sanford "Sandy" Weill got the ball rolling by forming a new financial services behemoth, Citigroup, which would bring together a major bank (Citibank) and an insurance company (Travelers Group). Back in 1997, Wall Street's Salomon Brothers ended nearly eighty years of effective independence when it agreed to be acquired by

Travelers Group; when Weill created Citigroup, he brought together a commercial and a major investment bank for the first time since the Depression-era passage of the Glass-Steagall Act. Weill's 1998 deal forming the future Citigroup violated that law, but Weill was given a two-year waiver; sure enough, in 1999, an obliging Congress officially repealed the crucial parts of Glass-Steagall and opened the door to the creation of other financial conglomerates. J.P. Morgan became JPMorgan Chase; other players, including Bank of America, became viable competitors to the traditional stand-alone investment banks on Wall Street. One after another, small investment banks sold out or were acquired by their larger rivals, with Deutsche Bank picking up Alex. Brown. Chase had acquired Hambrecht & Quist before its own purchase by J.P. Morgan. NationsBank purchased Montgomery Securities and later merged with BankAmerica to become Bank of America.

Now traditional Wall Street firms such as Morgan Stanley, Bear Stearns, and Lehman Brothers found themselves jostling for deals and profits with new or suddenly stronger players in the investment banking arena, such as Citigroup, UBS, and J.P. Morgan, all of which had vast amounts of capital at their disposal. It didn't matter whether they had originally been commercial banks or investment banks; all were now engaged in a relentless battle to maximize their return on equity. "The higher the ROE, the higher the book value of the investment banking operations and therefore the higher the stock price can climb," explains Jeff Harte, an analyst at Sandler O'Neill who has been studying the investment banking universe for many years. "It tells you how hard the bank's managers have been making the capital work, and how good they are at doing their job."

A bank can boost its ROE by moving into higher-margin products or into business areas that don't require it to use a lot of its own capital (one reason so many institutions are eager to move into wealth management), or by using leverage, which is borrowed money. Between 1975 and 1984, securities underwriters reported an average after-tax ROE of about 16.2 percent. Commercial banks had a smaller return on equity because their equity base tended to

be much larger; in the same period the ROE of commercial banks averaged 12.3 percent.[8] By 2000, average ROEs had crept higher, even as traditional high-margin businesses came under pressure. Three years later, as both the financial markets and the investment banking industry began to recover from the dot-com blowup and the Enron and WorldCom governance scandals, a gap started showing up in the ROE data.

Goldman Sachs was pulling ahead of the pack decisively: in 2004, it generated an ROE of 19.8 percent while perennial rival Morgan Stanley earned 17.2 percent, Citigroup investors were rewarded with 17 percent, and Bank of America posted an ROE of 16.5 percent. Bringing up the rear was Merrill Lynch, with an ROE of 15.7 percent. Among the major Wall Street players, the only institution able to challenge or surpass Goldman in the ROE sweepstakes was Bear Stearns, which, thanks to its aggressive use of leverage and willingness to put its capital to work on its proprietary trading desk, earned an ROE of 19.1 percent.[9]

"The call went out around the Street—we had to beat Goldman's ROE," says one former top banker who worked for a rival firm. "Every quarter, there was a debate over how we could reduce equity and increase leverage to make the ROE look better, over ways to squeeze an extra penny or two out of each of the business units." The pressure on Wall Street's CEOs and CFOs made them look, once again, at the fate of Phil Purcell at Morgan Stanley. Overlooking Purcell's shortcomings, they focused on the fact that it was discontented shareholders who had spearheaded the coup d'état. Had Morgan Stanley posted a higher ROE in 2004 (when it trailed all but one of the four other top investment banks), they figured those investors wouldn't have been quite as eager to oust Purcell. "It was very, very apparent to every CEO on Wall Street that Phil Purcell had been run out of Morgan Stanley because he couldn't keep up with the ROE that Goldman had, because he wasn't using leverage enough and taking enough risks," the former banker adds.

The pressure on the rest of Wall Street to keep pace with Goldman Sachs continued to grow as Goldman's ROE increased and

the gap between its performance and that of its rivals widened. In 2005, Goldman reported an ROE of 21.9 percent, climbing to 33.3 percent in 2006 and again in 2007. At Bear Stearns, meanwhile, 2005's ROE actually fell, to a measly 16.5 percent, as did that at Morgan Stanley, which hit 15.9 percent. At Merrill, it rose to 15 percent and up another fraction to 15.7 percent in 2006; Citigroup saw ROE rise to 17.5 percent in 2005 and then 17.9 percent in 2006. Wall Street was motivated to catch up with Goldman, since a hefty ROE was usually followed by an equally large payday for employees. In 2007, for instance, when Goldman paid an average of $661,490 to each of its employees, those at Lehman Brothers earned about half that, or $332,470.[10]

Chasing Goldman Sachs was a risky proposition. "Goldman was posting those kinds of returns because of decisions it had made years ago. When, after the downturn in 2000, all the other investment banks really cut back their exposure to risk and walked away from their risky business lines, Goldman Sachs didn't," Harte points out. In other words, they had been thinking strategically when their rivals hadn't been focusing on the long-term opportunities at all. They had learned to zig when others zagged.

Elsewhere on Wall Street, the perception was that Goldman had relied solely on risk taking—borrowing to finance proprietary trading and investments—and that firms that hadn't kept up had failed to do this as thoroughly or as adeptly as Goldman. That implied that the problem could be quickly reversed if Goldman's rivals just hired the right people, focused on the right products, and pursued the right strategies. Some of Goldman's rivals, like UBS, hired consultants to advise them on how to keep up with Goldman. At Citigroup, managers approached Bob Rubin—the Goldman Sachs alumni now playing a senior strategy role at the firm since becoming a director—with ideas for how to beat Goldman at its own game; aggressive as he was, Rubin firmly rejected many of the ideas, say people familiar with the events; Citigroup simply had neither the talent nor the risk management skills to make it worthwhile. "Part of the reason that didn't happen the way they expected was that they missed out on the fact that Goldman had

been investing in things like building up commodity trading in Asia long before 2003," when commodity markets ignited, Harte adds. When Goldman's ROE surged and investors in its rivals demanded that they do what it took to match those gains, taking two or three years to design and implement a long-term strategy wasn't an option. "The only way to accomplish what investors wanted as rapidly as they wanted was [by] taking on more leverage and getting more deeply into riskier businesses, or at least businesses that, if you were evaluating them properly, had more risk in them than might appear on the surface."

Chasing Market Share

By the spring of 2006, the battle for market share was at its most feverish. Across Wall Street, bankers deciding whether to undertake a new piece of business never asked themselves whether that transaction was good value for investors or even their clients over the long term. Nor did they seem to question whether the short-term rewards (the fees, higher profit margins, and higher ROE) made sense in light of the longer-term risks to the investment bank, its clients, or the financial system. The only question that mattered was whether the deal could be done and how much the institution could earn from it.

The risks associated with the securities the banks were packaging or underwriting were less important than the bank's ability to shift that risk off to someone else—specifically, to transfer it to an investor. Buyout banker Tom McNamara knew he would be viewed as less than a team player when he questioned his boss about a large private equity transaction that took place in the autumn of 2006. In the same way that subprime borrowers were buying homes with a 5 percent down payment rather than the traditional 20 percent, the buyout firm proposed to invest only a fraction of the equity typically committed to deals of this sort. McNamara's boss, he recalls, looked at him and asked, "What's your problem? Can't you sell the [junk bonds and leveraged loans]?" McNamara,

in a bid to explain his concerns, began to reply, "Yes, but—" only to have his boss cut him off. "That's all I need to know. If we don't do the deal, [our biggest rival] will. So do it." McNamara never again questioned a borderline deal, however risky it looked to him.

That pattern was the same across Wall Street. "How can a loan officer who is under pressure to produce loans realistically say, 'Maybe we should sell less loans?' and keep their job," said Mike Mayo in his FCIC testimony. Even Mayo, theoretically an independent analyst, experienced the backlash. When he wrote critically about compensation issues within the banking world in the late 1990s, some of the Wall Street institutions he was charged with monitoring began to block his access to the data he needed to do his job. "The reaction … was that these issues were none of my business." He began disclosing the lack of access to his clients and testified to Congress about the problem. "If I face a backlash even after I testify to Congress on backlashes," then why expect more from someone at the heart of the system? Mayo queried.

Certainly, none of the clients questioned the readiness to make a deal on the part of Wall Street. "We examined each deal in a vacuum," admits Jake Martin, the private equity firm executive. Looking back, he says, it's easy to understand why buyout fund managers such as himself and their bankers never moved beyond thinking how to do each individual deal long enough to consider the effect on the financial system of all that low-cost, high-risk borrowing. "It's a flaw of human nature." Martin says no one stopped to think about the cumulative effect of all this leveraged lending. Now, he acknowledges, it should have been obvious that those large and risky loans were going to make any downturn far worse than it otherwise would have been. "When everybody is doing exactly what you're doing, that is the time to stop and question what it is you are doing," he now says.

In 2006, the cumulative impact of all that frenzied deal making was showing up in the profit statements posted each quarter by Wall Street's investment banks. One after another, they announced big jumps in revenue, earnings—and, of course, ROE. Back in 1996, Morgan Stanley had earned $22.1 million in fees handling a dozen

mergers for private equity clients, and a total of $52.1 million from all of the investment banking mandates those funds had awarded to it. In 2006, the firm earned $271.7 million in M&A fees alone, and $520.7 million from sponsors in all kinds of investment banking fees. Not only were those private equity transactions growing in number, but the rate of growth in profitability (and thus contribution to the ROE) dwarfed that of conventional transactions. In 1996, advising on an investment banking transaction for a sponsor earned Morgan Stanley an average of $1.3 million; a decade later, the average fee had soared to $3.35 million. No wonder McNamara's bosses didn't want to stop and question the deals they were working on, any more than a buyout manager wanted to discover that his bankers were suddenly insisting they would only finance his deals on more conservative terms. By comparison, the rate of growth in fees paid by clients for routine investment banking transactions was far more modest: the average transaction earned the bank only $1.9 million, up from $1.35 million in 1996.[11]

The bankers who spent their time frantically cobbling together leveraged loan packages for their buyout firm clients and CDOs stuffed with more and more questionable mortgage loans, coined a new phrase. When one voiced a qualm, another would toss out the acronym "IBGYBG," or "I'll be gone; you'll be gone." In other words, by the time the chickens came home to roost—by the time the deal eventually soured and left investors demanding explanations—the bankers in question would have long since pocketed their bonuses and moved on. None of them, it seemed, spared even a thought for the institutions for which they had worked and that would be left behind, much less for the financial system.

The Thundering Herd Runs Amok

The hunt for ROE would prove to be particularly dramatic at Merrill Lynch, the ninety-two-year-old investment bank best known

for the strength of its vast retail brokerage network, dubbed the "thundering herd." While Morgan Stanley and Goldman Sachs had earned their investment banking chops by working with corporate clients to underwrite stock and bond issues and advise on mergers, Merrill traditionally demonstrated its clout by selling those issues via its horde of brokers. The problem was that simply acting as the middleman or gatekeeper in plain-vanilla transactions was no longer the best way to earn a respectable ROE. Merrill's board of directors had handed CEO Stanley O'Neal a clear mandate to make the firm competitive, by which they meant generating a higher ROE. At the end of 2005, Merrill's ROE was only 15.7 percent, compared to the average for the investment banks of 18.4 percent.[12]

That's when directors approved a new compensation policy: the more O'Neal and his chief lieutenants could boost the firm's ROE, the more generous their compensation packages would become. Now O'Neal had an explicit incentive to do what he wanted to do anyway—transform "Mother Merrill" into an elite Wall Street institution that could be spoken of in the same breath (without irony) as Goldman Sachs. O'Neal was convinced that the way to do this was to push Merrill into new business areas, away from its traditional reliance on the now stodgy business of underwriting and selling stocks and bonds. He told everyone on Wall Street that he intended to take Merrill in the direction of becoming a principal player in the world of trading and as an investor. In 2006 he demonstrated just how to do so and hit the ROE targets set for him.

Even as the compensation committee was drawing up its new rules the previous year, he and his senior executives had begun to take the first steps to deliver what investors and directors wanted. They started by carving out a role for Merrill in what would become (as of that date) the second-largest leveraged buyout in history, the $15 billion purchase of car rental chain Hertz from Ford in December 2005. It collected fees for advising buyout firms Clayton, Dubilier & Rice and the Carlyle Group on the deal, and pocketed more fees for underwriting the billions of dollars of loans and bonds needed to finance the transaction. But Merrill Lynch also

became an investor alongside the two private equity firms, which collectively invested only $2.3 billion of their own money in the transaction, using the debt that Merrill raised to pay for the rest. Within ten months, Merrill had recouped $400 million of its $748 million share of that equity stake, thanks to a series of "special dividends" that Hertz paid its new owners. One of those special dividends was paid out of the proceeds of Hertz's IPO in November 2006, which also generated (not coincidentally) more underwriting fees for Merrill. By the end of 2006, one analyst calculated that the firm had already doubled its money on the Hertz investment—even without taking into consideration the value of all those fees. Merrill beat out every investment bank except Goldman Sachs for the title of most profitable firm on the Street that year, and generated more profits than it had in its history.

Merrill began investing more aggressively alongside private equity firms in other buyouts. When its bankers visited executives at HCA, America's largest for-profit hospital chain, in early 2006, they arrived with a decidedly different kind of pitch, one that HCA wasn't accustomed to hearing from bankers. Instead of suggesting that HCA buy some more assets or even bid for a rival, Merrill proposed that it would put together a "club" of buyout funds—itself chief among them—to take HCA private in a leveraged buyout. After recovering from their astonishment, the HCA honchos agreed to be acquired by a group that brought Merrill together with Bain Capital and KKR. The $31.8 billion deal would finally eclipse the KKR-financed acquisition of RJR Nabisco in 1989 and become the largest-ever such transaction. That's what grabbed the headlines; left unanswered was the question of just how the buyout investors would add value.

"This deal was a real red flag," recalls Marty Fridson, who analyzed the junk bonds being sold to finance the transaction. "What was the plan for improving HCA? Nothing." There were whispers of a secret plan to sell a bunch of hospitals and restructure the company, but nothing was announced or materialized, he says. "Really, they were just buying a company that was selling at a fifty-two-week low and using borrowed money. Basically, they were

saying to their own investors, 'There aren't any more beaten-up or battered companies that need us to help fix them.... So we're going to buy stocks in the public market with borrowed money and, knowing that stocks go up over time, count on that to help us earn a good return.' " Fridson points out that investors could have done the same thing for themselves by purchasing HCA stock on margin —and they wouldn't have had to pay a 2 percent fee or 20 percent of the profits to the buyout funds. "But that wouldn't have had the allure of being invested in a top buyout firm," Fridson adds with a dash of cynicism. Sure enough, one of the partners—KKR—had marked down the value of its stake in HCA by a third by early 2009, according to a regulatory filing.

Still, in the short run, O'Neal's team was finding other ways to make all these new fees and other earnings from deals such as the HCA buyout generate a bigger bang on the bottom line that had more to do with accounting than investment banking. One logical strategy to boost ROE and make it look more impressive was to reduce the amount of equity on the investment bank's balance sheet; the smaller the number of shares over which those earnings must be divided, the higher the ROE. So the firm spent $9 billion to buy back stock and borrowed to add assets to its balance sheet. Instead of selling its own stock at the top of the market—Blackstone's strategy—Merrill was buying it back.

Rivals and risk managers understood why O'Neal and the board had signed off on the plan. Still, some questioned the wisdom of the strategy, despite the record-breaking earnings Merrill posted quarter after quarter in 2006. "They were counting on the good times keeping going, and that their ability to unwind the risky, high-leverage deals they were doing would always be there," says one hedge fund manager who says he decided to sell Merrill Lynch stock short, betting that its price would decline, after hearing of the stock buyback plan. "Okay, so they maximized their ROE in the short term, but then they took away the capital cushion they might have used to cover any losses when things went wrong." Anyone with any sense, he adds, knew that a reckoning was just a matter of time.

But within Merrill's executive suite, no one seemed to be looking further ahead than the next three-month earnings announcement, at least when it came to risk. As well as the profits and fees associated with the investment in Hertz and other transactions in which it was a principal rather than an intermediary, Merrill had made $7 billion using its own capital to make trading bets, up from $2.2 billion in 2002. In January 2007, a triumphant O'Neal reported "the most successful year in [Merrill Lynch's] history": the investment bank had earned a record $7.5 billion and its ROE hit 20.7 percent, beating Citigroup, Bear Stearns, and even Morgan Stanley. If the company needed its own fleet of Brink's trucks to haul away its gains for the year, so would O'Neal. Although his salary for the year was a relatively paltry $700,000, his total compensation package soared to $48 million. Few within the firm seemed to be concerned that by the time the Blackstone IPO was priced, Merrill was sitting on a record $1 trillion in assets, more than double the level of four years earlier.

Working more closely with private equity firms wasn't the only high-risk business that Merrill Lynch had pursued as part of its quest for a higher ROE. Another source of hefty profits in 2006 and into the first half of 2007 came from a corner of the banking world that was still further away from Merrill's traditional area of expertise and Wall Street's core functions. Merrill had joined what was becoming known as the shadow banking system, moving beyond assisting buyout managers to saddle their portfolio companies with artificially cheap debt loads to help America's homeowners saddle themselves with artificially cheap debt in the shape of mortgages and home equity lines of credit. Drawing on new technology as well as their sales network—they could resell their structured products to clients in the same way that they marketed stocks and bonds—Merrill could earn outsized fees for packaging and repackaging home mortgages and other income-generating assets for resale to yield-hungry investors. It had started small—securitizations amounted to only $350 billion or so in 1981—but by 2001, Wall Street underwrote $3.3 trillion of newly securitized bonds.

The market for residential real estate had hit $18.4 trillion by the end of 2004, and the mere idea of finding a way to link such a gargantuan market with the ultraliquid debt markets was alluring. Making it possible was the fact that investors were fed up with the low returns that accompany low interest rates and were clamoring for bondlike investments that generated higher yields in much the same way that investment bank shareholders were clamoring for higher earnings and an ROE to match that of Goldman Sachs. Maybe a push into structured finance could keep both groups happy?

The Mortgage Machine

In the summer of 2006, as one team of Merrill bankers and investors prepared the way for Hertz's IPO in a few months' time, another group was negotiating the $1.3 billion purchase of First Franklin, a San Jose, California–based mortgage origination "machine" that had underwritten some $29 billion of home loans the previous year. The motivated seller was National City Corp., a bank based in Cleveland, Ohio; perhaps its executives, like those of Blackstone, were relieved to be getting out of at least part of the mortgage business at what already seemed to be the peak of the market. For its part, Merrill Lynch was an equally motivated buyer. Its mortgage bankers were relieved to have another way of feeding its securitization habit, one the firm had acquired early on in Stan O'Neal's tenure as part of his push to boost risk-taking businesses and ROE.

Securitization was one of the first-generation innovations on Wall Street in the post-Mayday environment, pioneered by Lew Ranieri and his colleagues at Salomon Brothers. "Like all innovations, it started out as a great idea and ended up in craziness, with loans structured in ways that only a few Ph.D.'s can understand, and where there's no obvious purpose for its existence," says Rob Kapito of BlackRock.

Kapito was one of the next-generation innovators in the securitization market during his years at First Boston (later absorbed

by Credit Suisse), where he worked for BlackRock's founder, Larry Fink, to develop what was then referred to as the collateralized mortgage obligation (CMO) market in the early 1980s. He watched the market explode in both size and complexity. The CMO was another way to put together a pool of mortgages and make them appealing investments by splitting them into tranches, or slices. The topmost tranche—the senior layer—would pay less in interest but would be of lower risk or higher quality, or perhaps be shorter term in length; in one alternative structure, one tranche would consist of bonds that sold at a discount and paid no interest (zero-coupon bonds), while the other would be an interest-only tranche that would fluctuate in value along with interest rates (as investors prepaid their mortgages, the flow of interest income would taper off). "The whole idea was to give investors a security that met their specific needs—low risk, or high yield, or shorter duration," notes Kapito. By the late 1980s, he adds, the CMO market was starting to run amok. "All of a sudden there were structures out there that didn't make sense, Ph.D.'s making bonds look better than they really were—and they blew up. And we all said, 'Okay, let's get back to something simpler.' "

In the era of rock-bottom interest rates that began in the fall of 2001, when the Fed started slashing interest rates, and reached its peak in June 2003, when key lending rates fell to 1 percent, it made sense for both sides of the market—and for bankers—to take another look at the way home mortgages were securitized; at this point, new mortgage origination had hit a record of $3.9 trillion. Many homeowners wanted to refinance their properties, while new buyers were being lured into the real estate market by the combination of ultracheap financing and ample liquidity, thanks to the de facto national financing market that securitization had created during the 1980s. Not surprisingly, issuance of mortgage-backed securities soared. They also became more complex, and thus more profitable for the Wall Street firms who were buying these mortgages from savings and loan institutions as well as the growing array of nonbank institutions that had set up shop explicitly to make these loans.

In 2000, mortgage-backed-security-related transactions generated only $690.7 million in fees; by 2006, that had climbed to $2.3 billion. And the average transaction generated $1.8 million in fees in 2006, up from $1.3 million six years previously.[13] It didn't hurt, either, that a bank that could funnel its mortgage loans into some kind of structured product—especially a highly rated CDO—could reduce the amount of capital it had to set aside to guard against writedowns. Even trading in these securities was becoming a money spinner. All that home-buying activity sent housing prices soaring: the median house price jumped 27.6 percent in the three-year period between 2001 and 2004, when Federal Reserve policy makers decided to begin pulling away the punch bowl full of cheap money. In contrast, for more than a century, housing prices had risen less than 1 percent a year. That rise in valuation triggered still more activity for mortgage originators and parts of the shadow banking system, as borrowers refinanced their mortgages or took out lines of credit secured by the equity that had suddenly appeared.

Merrill Lynch wanted a piece of that business, and O'Neal hired Christopher Ricciardi from Credit Suisse to get it for them. Ricciardi was an expert in collateralized debt obligations, around which the latest incarnation of the mortgage finance market was built. In the latest twist on the CMOs that Kapito and Fink had structured at First Boston in the 1980s, CDOs were divided up by risk level, with higher-risk pieces carrying a higher yield; some tranches won a triple-A credit rating from Moody's and Standard & Poor's, and offered a small but still appealing premium over other top-grade securities. Part of Ricciardi's job was to make sure he could get the mortgages he needed in order to structure the mortgage-backed bonds and then the CDOs.

Under Ricciardi, whose efforts ultimately propelled Merrill into first place in the CDO league tables, Merrill Lynch was a particularly aggressive bidder for the mortgages that mortgage originators were churning out at an increasingly rapid rate to meet the insatiable Wall Street demand. By 2004, those mortgage originators were convinced that Merrill was buying market share—

in other words, it was paying more than its rivals believed the mortgages were worth just in order to obtain the loans to stuff into their CDO creation machine. By the end of 2005, CDO issuance had nearly doubled from 2004 levels, hitting $271.8 billion.[14]

But 2006 and the first few months of 2007 would mark the peak of this bull market and deliver some of the first major warning signs of the apocalypse that was taking shape here just as in the private equity arena. At least it did for those who, like Lehman's Gelband, were looking for any signs that the boom was really a bubble in disguise. Fitch Ratings, a credit rating agency, slapped an alert on one subprime lender as early as the final months of 2003. By early 2004 the Federal Reserve system (which regulates banks) began picking up signs that the quality of the loans being made by banks, nonbank mortgage originators, and others was deteriorating. That year CDO issuance would peak at $520.6 billion and subprime lending would also reach new highs, five times the level of five years earlier. Lenders were scrambling to feed the Wall Street mortgage machine, even if that meant lending money to people who could present no evidence that they earned enough to keep up payments on the loan or whose credit ratings were wobbly. They developed new structures to enable them to rationalize signing off on these risky mortgages, including "no-doc" loans (also known as liar loans), which didn't require any proof of income, and interest-only loans. Among the most toxic were mortgages with ultralow teaser rates that would reset later at much higher levels that the unwary borrowers often could not afford.

The aggressive marketing of mortgages to fuel the CDO creation machine tipped over into fraud, a number of former salespeople have admitted. Within a month of the day he started working as the head of the mortgage fraud investigations division at Ameriquest, one of the biggest subprime players, Ed Parker later told the Financial Crisis Inquiry Commission that he had spotted signs of fraud in the loans being made. The response? Those whose bonuses depended on the machine working smoothly and at maximum velocity complained that Parker "looked too much" into the loans. By November 2005, he had been demoted, and then—evidently

having failed to take the hint—Parker was laid off in May 2006. The reason for the fraud initially surprised Parker and his peers, until they were told to "look upstream." In other words, they needed to recognize the hunger on Wall Street for more and more mortgages that could be bundled up and resold to investors.

Wall Street itself was doing whatever it could to keep the mortgage machine chugging along. In October 2005, Merrill Lynch had purchased a 20 percent stake in Ownit Mortgage Solutions, one of the growing coterie of nonbank mortgage originators, to keep the mortgages flowing onto its books. Within a few months, Ricciardi had left to launch a specialized CDO investment boutique of his own; he wasn't around to see the value of the mortgage-related assets on Merrill's books spike to a high of $52 billion from a mere $1 billion back in 2002.

The CDOs being structured with those mortgages carried increasingly exotic names that gave no hint of the risky nature of the underlying assets; some hinted at prosperity (Golden Key) or the good life (Costa Bella). All generated lavish fees for the Wall Street firms. Every time another $500 million or so of mortgages were repackaged first into mortgage-backed bonds and then into CDOs, the underwriters picked up $5 million in fees. BlackRock portfolio manager Scott Amero could boycott the deals when he realized what was happening, but that was it. "Look, I couldn't stop the market; I couldn't stop Wall Street from doing what it was doing," Amero says now. "All I could do was stop participating in this Wall Street–style food fight as everyone demanded higher yields."

By the fall of 2006, even Ranieri, the godfather of the mortgage-backed securities market, had sent out an edict banning anyone who worked for him from touching the increasingly poor-quality CDOs.[15] By then, Merrill was negotiating the acquisition of First Franklin, described by the firm in a press release as "one of the nation's leading originators of non-prime residential mortgages" (aka a big subprime lender). Dow Kim, president of Merrill's investment bank, who had taken over the business on Ricciardi's departure and publicly pledged to the team of mortgage bankers that he would keep the good times—and deal flow—rolling.

proclaimed his view that owning First Franklin would enhance "our ability to drive growth and returns" higher.

It should have already become clear that subprime lending, whatever it had done for the ROE of Merrill Lynch and other investment banks in earlier days, was more likely to be a source of losses than profits in the years to come. Merrill announced the First Franklin transaction in early September; by December, when they forked over the purchase price and celebrated the closing, the investment bank was in the midst of a spat with its 20-percent-owned mortgage provider, Ownit. Some of the loans that Ownit had fed to Kim's banking team were going sour within months of origination, just as Amero had discovered, and Merrill was pushing the firm to buy back the loans.[16] Ownit, balking, closed its doors in December, just as First Franklin became part of Merrill Lynch. While CDO issuance would keep climbing until the late spring of 2007—about the same time that Blackstone completed its IPO—and would peak at $178.6 billion in that three-month period, it was becoming increasingly clear that hyperaggressive risk taking on Wall Street was no longer a recipe for quick and outsized profits.

The love affair between Wall Street and extreme banking had been intense, exciting, and highly lucrative during the fifteen months that separated the IPO of the New York Stock Exchange and that of Blackstone the following summer. Everyone had been eager to keep the music playing and to continue dancing. But in their mania to generate ever higher returns on equity, Wall Street institutions had succeeded in distorting the financial grid beyond all recognition as they pursued one fee-generating opportunity after another. There was no possible reason for any banker to create a CDO-cubed, as bankers acknowledged in the calm that followed the Wall Street storm of 2008. "But we did it anyway," one former Citigroup banker admits somewhat sheepishly.

The irony was that Merrill Lynch's frenetic dealmaking in pursuit of higher returns on equity and a dominant market share in the CDO business ended up driving some of the final nails into the investment bank's coffin. In a move that was becoming all-too-typical, Merrill became its own best customer: As the FCIC

reported, 134 of the 142 CDOs Merrill built and sold between 2003 and 2007 contained at least one slice of another Merrill CDO; anyone digging into a Merrill Lynch CDO during this period was likely to find that at least 10 percent of the collateral was made up of securitized mortgages from another Merrill CDO. The problem? Too few investors had the time, resources, or inclination to do that much digging while Merrill Lynch had every incentive to just keep chugging along, dumping whatever it couldn't sell into the next CDO that rolled off the assembly line.

The Chickens Come Home to Roost

For centuries, the coronation of a new pope in the Roman Catholic Church was accompanied by an odd custom. As the new pontiff, arrayed in all his glory, walked toward St. Peter's Basilica, the master of ceremonies would halt the procession three times, fall to his knees, and raise a small silver platter on which burned a piece of cloth. "Sic transit gloria mundi," he would intone, urging the new pope to remember that all worldly glories vanish in time. Unfortunately, no one was on hand to remind Wall Street that the laws of nature and the rules of gravity still applied to them. While rising interest rates and the perils of reckless lending to homeowners and leveraged buyout deals alike would be slow to register on the minds of Wall Street bankers (Gelband being one of the rare exceptions), within days of the Blackstone IPO being completed, it was clear that Wall Street was in for trouble.

Wall Street's investment banks and their leaders would end up paying a heavy price for their obliviousness. In March 2007, Bear Stearns proudly proclaimed in a proxy filed with the SEC that its ROE was among the highest of its key competitors. A year later, its ROE had slumped to 1.9 percent and JPMorgan Chase stepped in at the behest of the Federal Reserve to prevent the entire financial system from having to pay too great a price for the risks that Bear Stearns had taken to beat its rivals in the ROE sweepstakes. "I guess, in hindsight, you could say that was a bit of hubris," admits former

Bear banker Tom Casson. By the summer of 2007, Merrill Lynch had $31 billion in leveraged loans sitting on its books that it needed to sell, while Citigroup had another $57 billion—but there were no willing buyers. They were stuck owning securities that they had hoped to be able to sell to yield-hungry investors; now that the music had stopped, they were on the banks' balance sheets. "We did eat our own cooking, and we choked on it," John Mack later admitted to FCIC commissioners. One by one, buyout deals—some announced, some still being negotiated—began to fall apart.

The most dramatic change occurred on Wall Street itself. Bear would be absorbed by JPMorgan Chase, Lehman filed for bankruptcy, and Merrill sought refuge in the reluctant embrace of Bank of America, whose top executives reeled at the size of the losses they were expected to absorb along with Merrill's operations. (Eventually, Merrill's losses would be so large as to effectively erase the investment bank's profits for the last eleven years; those at Fannie Mae eradicated twenty-plus years' worth of profits, according to calculations presented by Kyle Bass of Hayman Advisors LP to the FCIC.) Only later did it become public that Bank of America CEO Ken Lewis wanted to use those enormous write-offs as a reason to walk away from the deal, which undoubtedly would have led to Merrill's filing for bankruptcy protection. Only thinly veiled threats from Bernanke and Treasury secretary Hank Paulson kept him onboard, and by the fall of 2009 he had been fired as chairman of the company (by shareholders, at the company's annual meeting) and forced to step down as CEO (by the board of directors).

Lewis wasn't the only casualty. John Thain resigned after negotiating the sale of Merrill, although he soon returned as CEO of CIT Group, a commercial lender that had filed for bankruptcy in 2009. John Mack, exhausted by the effort to save Morgan Stanley, announced his decision to retire as CEO, although he stayed on as chairman. Across Wall Street, bankers whispered that the chaos of the previous two years had contributed to the sudden death at age sixty-one of Lazard's Bruce Wasserstein. The legendary deal maker died two days after being admitted to the hospital with an irregular

heartbeat in October 2009. And as for Richard Fuld, who had ousted Mike Gelband for not being a team player? Months after his firm collapsed, a sleepless Fuld spent the evenings wandering through his mansion in Greenwich, Connecticut, a community that was also home to many of the hedge fund managers who were among his firm's biggest and most lucrative clients. "How did it all go so disastrously wrong?" he wondered.[17]

There would be no more record-setting deals from which the surviving institutions could reap big fees. Among the last to collapse was the massive $48.5 billion proposed leveraged takeover of giant Canadian telecom concern BCE Inc. by a group that included the veteran buyout firm KKR. Announced only days after the Blackstone IPO, the transaction would have become the largest leveraged buyout in Wall Street history. Instead, it staggered along, half alive, as bankers and buyout firms tried frantically to pull off the deal in the months that followed the demise of Bear Stearns. The events of September 2008 were the last straw; the BCE deal was formally laid to rest two months later.

"Old" and "new" Wall Street suffered equally in the downturn and in the subsequent market chaos that accompanied the "deleveraging," as the process of unwinding all the complex debt instruments and structures was referred to. At the New York Stock Exchange, the lack of leverage started to show up in the shape of declining trading activity by hedge funds, the exchange's most lucrative group of clients. Thanks to that trend (as well as ongoing concerns about competition at home and in the exchange's new European business), NYSE Euronext's shares were trading at $36.62 at the time of this writing, down from their $81 first-day price. Blackstone, for its part, was changing hands for a mere $14.95 by the spring of 2010. Citigroup, a stock worth more than $50 a share in early 2006, could be picked up for less than $1 a share in early 2009. Veteran bankers were fleeing to join start-up firms, fearful of regulation that would limit the scope of their activities or even—heresy!—the size of their bonus checks. Wall Street was on the verge of yet another transformation. What remained unclear was perhaps the most important question of all: whether this would

return the Street to its roots as an intermediary or carry it further away from its core function as the money grid.

PART II

GREED, RECKLESSNESS, AND NEGLIGENCE: THE TOXIC BREW

On Tuesday, September 16, 2008, the major players in the unfolding financial crisis gathered in the Oval Office at the White House in order to brief President George W. Bush on the magnitude of the catastrophe that was looming. Treasury secretary Henry Paulson warned the president that, only days after Lehman Brothers had filed for bankruptcy and Merrill Lynch had sold itself to Bank of America in a deal arranged over the course of a weekend to prevent itself from following suit, insurance giant AIG was now teetering on the edge of collapse. "How have we come to the point where we can't let an institution fail without affecting the whole economy?" Bush wondered aloud after listening to his economic and market advisors lobby in favor of a bailout for AIG.[1]

The answer lies in a toxic blend of three elements, all of which were part and parcel of Wall Street by the beginning of the twenty-first century and all of which flowed from the same cultural breakdown on Wall Street itself. Individually, each could have damaged the ability of Wall Street to fulfill its core function effectively and created immense stress on the financial system as a whole, and each is addressed in a separate chapter in this section. But they evolved and reached an apogee almost simultaneously. Together, they would prove to be a recipe for disaster.

All three revolve around human behavior, more specifically on the kinds of incentives that exist on Wall Street to take foolish risks and the disincentives that should be in place to keep that risk taking within reasonable limitations. "The mixture of unlimited capital, limited liability, and incentive compensation inevitably led to testing the levels of risk," veteran banker Peter Solomon told FCIC commissioners. "It might be argued that public ownership and the compulsion to increase earnings per share propels employees towards greater risk." Especially when risk taking is so lavishly rewarded: Wall Street's pay packages rapidly became one of the biggest and easiest targets for its critics, not least because they made bankers who often were no more than moderately intelligent human beings into multimillionaires. "I know my limitations; I know I'm bright enough, but I'm no genius," says one former senior

banker who toiled at Lehman Brothers and other firms. “Certainly, many of the top guys were only just of average intelligence. But they were being paid for being ruthless and taking on as much risk as possible. The goal was to beat Goldman Sachs at its own game. It was clear to us all that the closer we could come to doing that, the more likely we were to walk away with tens or hundreds of millions of dollars, rather than just become single-digit millionaires.”

Even if Wall Streeters were encouraged to behave with reckless abandon, as long as they generated higher and higher returns on equity, it was still possible for the CEOs and directors of any of the investment banks or institutions such as Citigroup to apply a counterweight to any irrational exuberance that might bubble up as a result. Risk management had been a buzzword across Wall Street for decades. The 1998 collapse of Long-Term Capital Management should have highlighted the vital role that risk management could play in helping a financial institution avert catastrophe, both for itself and for the financial system. Alas, while Wall Street firms paid lip service to risk management, in practice they tended to rely too much on models that even their architects admitted were full of flaws. The problems at the rating agencies were just as bad, if not worse: despite their role as the protector of institutional and individual investors, both Moody’s and Standard & Poor’s had done a shoddy job of designing models that could cope with the most basic possible scenarios. Standard & Poor’s, for instance, admitted to one major player that its housing-price model couldn’t cope with negative numbers; if housing prices declined nationwide, the model would be useless. Even when the models were relatively robust, those using them massaged them to produce the results that were needed, or presented the results in a way that was calculated to get their audience to agree that the risk was manageable.

Jaidev Iyer now is the managing director of the Global Association of Risk Professionals (GARP); his former job was as head of operational risk management at Citigroup. In that role, he watched leaders at Citigroup develop risk management models showing that the bank’s capital was adequate to cover all possible

scenarios, with a 99.97 percent confidence rate. “Think about that. What they were really saying was that the capital was adequate for all but three years out of every ten thousand years!” Iyer understands the reason for Citigroup’s arrogance. “To get a double-A credit rating from Moody’s meant that you had to have that much confidence that your capital was enough to ride out any shocks, and Citigroup wanted that rating” because it would ensure that the company was seen as a stable, solid institution and thus cut funding costs. The problem was that Citigroup was basing its high confidence level on only four or five years’ worth of data. “That doesn’t begin to be enough to tell you what will or could happen, especially when you are dealing with markets and products and strategies that didn’t even exist a decade ago,” Iyer says.

Still, just as it was in the interests of Wall Street’s bankers and traders to take as much risk as possible in hopes of earning outsized bonuses, so it was in the interests of their top managers and even their boards of directors to egg them on rather than rein them in. When Bear Stearns went public in 1985, Wall Street’s investment banks had an average of $258,677 of capital for every employee. If that figure were merely adjusted for inflation, by 2000 it would have been about $540,000. In fact, by that year Wall Street had more than $1 million in capital for every employee, and as much as $3.5 million at some firms.[2] The pressure was on for those employees to make all that capital pay off by finding new ways to earn returns. And the way to do it wasn’t by becoming more cautious and risk-averse. Behaving like that wouldn’t help Lehman, Merrill Lynch, or Citigroup become the next Goldman Sachs. Rather, they needed to out-Goldman Goldman by taking on more risk.

None of that would have mattered had Wall Street had any effective adult supervision. What the money grid needed in order to protect it from the consequences of the greed, ineptitude, and folly within Wall Street’s institutions was a team of well-compensated, intelligent, and aggressive outside regulators monitoring what those people were getting up to and keeping them honest. And those regulators needed backup from legislators willing to give them both

the resources and the political capital they needed to get the job done.

Instead, the money grid got a regulatory mess: a cat's cradle of agencies with responsibilities and mandates that sometimes overlapped and sometimes clashed. All too often, that web of regulatory supervision left large and increasingly significant parts of the markets, such as derivative securities, almost entirely uncovered. And their staff members—whose ambition, in some cases, was to stop guarding the henhouse for less than $100,000 a year and quintuple their annual income by joining the foxes in devising new ways to raid it—too often lacked motivation, direction, or support from their political masters.

"Perfect storms happen when you create the opportunity for them to do so," says Iyer. Teaching future risk managers, he likes to use as a case study the Titanic—the "unsinkable" boat that sank less than three hours after hitting an iceberg in the North Atlantic, taking more than 1,500 passengers to a watery grave. Had Titanic's builders and captain not been so convinced that their vessel was unsinkable, had there been enough lifeboats, had the weather been better (enabling the lookout to spot the iceberg), or had the iceberg not brushed alongside Titanic's hull (damaging multiple watertight compartments), the death rate might have been much lower. While it is unclear how many actual deaths can be attributed to the disastrous Wall Street events of 2008 (many bankers tell stories of acquaintances who opted to commit suicide when their firms collapsed or they were laid off as a result of the cost cutting that eliminated more than 300,000 jobs in less than a year), the Street's great meltdown has certainly had a disastrous impact that has stretched well beyond its boundaries, all because the checks and balances that should have prevented the disaster either weren't functioning or weren't even in place to begin with.

Everyone was focused on what Wall Street could do for them, rather than on what they needed to do to maintain the health and integrity of the money grid. The bankers wanted more interesting jobs and career paths, punctuated with lavish paydays. On reaching the corner office, they needed and wanted to beat Goldman Sachs

by generating bigger and better returns. Meanwhile, the regulators wanted a peaceful and uncomplicated life; the politicians wanted votes. Collectively, they displayed a reckless indifference to the extraordinary risks that had become obvious before the credit bubble finally began to burst.

To prevent it all from happening again, like a bad nightmare that we can't escape, we need to do more than get angry about how much Wall Street bankers take home each year in their bonus checks. We need to understand how each part of this behavioral dynamic contributed to the crisis, and find a way to re-create effective checks and balances that encourage the right kind of risk taking but discourage some of the rash excesses of recent years.

By the time the final bill is presented to Congress, the cost of the financial industry's bailout may top $2 trillion, by many estimates. The immediate catalyst for that massive rescue attempt may have been fear of what would happen if those who should have protected the money grid allowed it to sink like the Titanic. But the reason the bailout, however distasteful, was unavoidable is the same reason that it behooves all of these interested parties to find real solutions to the problems presented by compensation policies, risk management failures, and regulatory shortcomings: the fact that we need a functioning financial system. In all three, participants placed their own interests ahead of those of the financial system. If Wall Street—the money grid—is to survive future shocks, we can't afford to have that happen again.

CHAPTER 5

"You Eat What You Kill"

At first glance, David Rubenstein and John Whitehead seem like unlikely party poopers. Both men had made billions of dollars by rising to the top of the heap on Wall Street and had overseen two of its most powerful institutions. But as the Street celebrated a record-breaking 2006 and plotted how to earn still more fees and proprietary trading and investing profits in 2007, both Rubenstein, cofounder of the Carlyle Group, one of the largest private equity firms, and Whitehead, the former senior partner of Goldman Sachs, were worrying publicly about Wall Street's addiction to easy money, particularly in the form of multimillion-dollar bonus days. "Greed has taken over," warned Rubenstein at a private equity conference in the spring of 2007.

The eighty-five-year-old Whitehead was even more forthright in an interview with Bloomberg News reporters that May. He blasted the lavish pay packages at his former firm, where the average employee had pocketed $621,800 in 2006. Goldman's top traders walked away with tens of millions of dollars apiece, and even secretaries could count on a yearly bonus worth a few thousand dollars. That was double what Goldman employees had earned a decade earlier, before the firm had gone public, and 20 percent higher than 2005. It flew in the face of the fact that Goldman traditionally had been more restrained when it came to compensation than many of its Wall Street peers: its bankers were told firmly that a large part of the value they generated was because of Goldman's brand name rather than their individual efforts. Until they became partners, they learned, they would have to reconcile themselves to viewing the firm's high status as part of their

"compensation."

But by 2006, even Goldman seemed to have joined the bonus party. Not only were the denizens of Wall Street—and Goldman Sachs in particular—already far richer than their counterparts on Main Street (the national wage grew an average of 2 percent that year), they were getting even richer at a far faster clip. Whitehead said he was "appalled" that Goldman was leading the way "in this outrageous increase" in Wall Street compensation. He tried to convince Goldman's board to donate $1 billion of its record $9.5 billion earnings for the year to charity; he had even turned to the Bill & Melinda Gates Foundation for help devising some specific proposals about how such a philanthropic donation could be deployed. Goldman's active partners weren't interested, however: their priority was on maximizing returns to shareholders, and a massive philanthropic donation would harm, not help, that cause. Besides, why run the risk of losing its top producers to rivals by donating part of their bonus pool to charity?[1]

Whitehead's concerns were the exception rather than the rule in 2006. Few on Wall Street demurred when they were handed six-, seven-, or even eight-figure bonus checks that year. Anyone outside the Street who voiced concerns about investment banking compensation policies or levels was largely dismissed as an envious crank who either didn't have what it took to survive on Wall Street or had chosen a field that wasn't as lucrative or glamorous as investment banking. Certainly, Dow Kim, co-head of investment banking at Merrill Lynch, likely wasn't second-guessing his own 2006 Wall Street pay package any more than were the lavishly paid Goldman Sachs bankers of whom Whitehead complained. That year, Kim pocketed a salary of $350,000 for his efforts, a comfortable sum, if modest by Manhattan standards. But Wall Street salaries are just the tip of the iceberg; in gratitude for his 2006 performance, Merrill's compensation committee awarded Kim a cash bonus of $14.5 million and another $20.2 million worth of stock in the investment bank. His total compensation package was worth $35 million, one hundred times his nominal salary.[2] But then, Kim was a particularly valuable employee for Merrill Lynch:

it was he who, after the departure of Christopher Ricciardi (the man who had pushed Merrill into the forefront of the CDO league tables), kept Merrill's CDO creation machine churning at an ever-faster rate.

The Rainmakers Rake It In

As Wall Street's transformation proceeded during the 1980s and '90s, investment bankers who could dream up products and generate outsized profits were increasingly valuable to Wall Street institutions. According to one study of Wall Street compensation, bonuses and salaries became "excessively high" in the mid-1990s and stayed that way until 2006.[3]

Wall Street put a premium on creativity and innovation, at least within those firms that were intent on beating their rivals and maximizing their profits. The result was a jump in demand for investment bankers with more sophisticated skill sets—the ability to structure, evaluate, and trade junk bond transactions, say, rather than just handle the lower-risk Treasury bond trades. However much as Wall Street's elder statesmen might lament the fact, the relentless quest for innovation and new sources of growth inexorably had created a war for talent and fueled runaway growth in salaries and bonuses. Taking a hard line on compensation would have required an investment bank to tacitly acknowledge that they were prepared to forfeit growth—an unacceptable alternative.

At Merrill Lynch in 2006, few employees were more important than Dow Kim, who promised to do whatever it took to keep Merrill ahead of its rivals in the battle to capture the largest possible chunk of the ever-growing market for spinning mortgage securities into CDOs.

In 2006, Merrill created $147.2 billion of new mortgage securities-backed CDOs, up from $90.3 billion the previous years; some of the more complex structures could earn Merrill fees of as much as $15 million for each $1 billion CDO. That was enough to make Merrill Lynch the top underwriter of CDOs in the country,

from number fifteen in 2002; in the 2002–2007 period, it underwrote one hundred of these vehicles, compared to only seventy-three for Citigroup. And for the folks at Merrill Lynch, that was something to celebrate, rather than worry about. “Every time we went to meet with someone at Merrill, they would speak in hushed, reverential terms about this guy, Dow Kim,” says Mark Vaselkiv of T. Rowe Price. “He and guys like him were leading their firms and Wall Street as a whole into the brave new world of mortgage-based derivatives, and his team worshipped the ground he walked on, it seemed, at least in part because he was making them so much money.”

It was only a matter of months before problems surfaced. Kim told the CDO team to do “whatever it takes” to hang on to market share and seize the lead in the race for the top spot in the league tables, according to allegations by former employees made in lawsuits filed after Merrill’s sale to Bank of America. Even as Kim pocketed his gargantuan bonus, he must have been aware that his CDO assembly line was working almost too well. Kim’s division was turning out more mortgage-backed securities than the firm could structure into CDOs and creating more CDOs than it could sell quickly. By 2006, there were few “real money” investors left in the market, the Financial Crisis Inquiry Commission would later point out; data showed that 80 percent of the mezzanine tranches of CDOs that Merrill originated in late 2006 and into 2007 were sold to other CDO managers. As a result, more of the increasingly risky securitized assets were left sitting on the investment bank’s own balance sheet; by the end of 2006, Merrill had $44.5 billion in mortgages, CDOs, and other related assets sitting on its balance sheet, up from $29.2 billion the previous year and only $15 billion at the end of 2002.[4] At the same time, it was becoming harder and harder to find a counterparty willing to let Merrill hedge the risk that the value of those assets would slump before they could be sold to investors. In May 2007 Kim left the CDO-creation machine he had structured to others to run, and set out to launch his own hedge fund.

Everyone involved in creating, launching, and marketing the

CDOs knew that the size of their bonus depended on keeping the machine humming as rapidly as possible. There was no incentive to holler stop.

Outsized Pay and Outsized Losses

But by late summer 2007, it was clear that the securities on Merrill's balance sheet contained a lot of subprime mortgage assets on which the firm would have to record large losses as their values plunged. Sure enough, in October 2007, Merrill slashed the value of the CDOs and subprime mortgages still on its books by an astonishing $8 billion, nearly double the sum estimated only a few weeks earlier. By year-end 2007 it had announced another $11.5 billion in CDO-related write-downs, leaving Merrill with the largest loss in its ninety-three-year history, and the first it had recorded in nearly two decades. In only months, any gains Kim and his team had made for Merrill over the years they had toiled there while pocketing small fortunes for themselves had evaporated. Ultimately, Merrill's losses would be large enough to swallow eleven years' worth of profits.[5]

Not surprisingly, the outsized paydays reported by Kim as well as Wall Street CEOs such as Merrill Lynch's Stan O'Neal—who walked away with $160 million or so of deferred compensation, stock options, and other goodies as well as years of lavish pay packages despite presiding over the carnage—touched off outrage and protest that has stretched from the Oval Office right down to the folks in the streets. How could Wall Street folks be paid so well for doing so badly? And what does any banker do in a single year that is worth a $14.5 million bonus—at least, what that is legal?

But the incomprehension is mutual. In Wall Street's worldview, its inhabitants put in long hours doing increasingly complex jobs that few others have the ability to handle, even if they are willing to tolerate the extraordinary stress and the complete absence of any kind of work-life balance. Naturally, the argument goes, they are well paid for those efforts. Even long after Wall Street's

compensation policies became a hot-button issue, some prominent individuals were still willing to defend them. Thomas Donohue, president and chief executive officer of the U.S. Chamber of Commerce, admitted that the bonus payments made by Goldman Sachs and other firms in 2009 may seem "obscene" to the average person—and perhaps even to himself. But Donohue still believed they were justified, he said in early 2010. After all, those lavish pay packages were awarded to "very unique kinds of people," he explained to a reporter. "They are like mad scientists. They are all mathematicians and they are very mobile. They can go to private equity and hedge funds."

One of those financiers, Jake DeSantis, an executive vice president at AIG, spent a year helping to dismantle the company in the wake of its toxic derivatives blowup. When he discovered that Congress, President Barack Obama, and Andrew Cuomo, New York's attorney general, to name just a few, were determined that he shouldn't receive the bonus AIG had promised him, DeSantis blew his stack and published his resignation letter in the New York Times. "[We] have been betrayed by A.I.G. and are being unfairly persecuted by elected officials," he railed.

The response was both immediate and predictable. On the New York Times website, where DeSantis's letter had been published in its entirety, a steady stream of responses flowed in. Why, wondered a reader named Rob, did DeSantis fail to grasp why his "retention payment" (undisclosed, but potentially around $750,000) was "so offensive to taxpayers in a country where the median family income is approximately $48,000 [?] … Please clean out your desk. Security will take your key and show you to the door." Another respondent, Tim Burke, pointed out the flaws in DeSantis's comparison of himself to a plumber who is penalized when an electrician burns down the house that they have both been working on. If both the plumber and electrician were hired by the same contractor and the plumber was present when the electrician "laid a trail of flowing gasoline between all the homes in the neighborhood, then the plumber might reasonably expect his own payment might be at risk." And someone called only IW took a jab

at the lifestyle of the rich and (in)famous bankers. “Even if this guy was not in the CDS [credit default swaps] business himself, where does he think that the money was coming from to pay for his 10 cars and house in the Hamptons? … I am sure you can survive on $80 a bottle champagne rather than the stuff you are used to, Jake.”[6]

DeSantis wasn’t alone in triggering public outrage. After bankers lost so many billions of dollars so rapidly, their lavish lifestyles came under harsher scrutiny. In one spectacularly ill-considered move, John Thain, after replacing O’Neal at the helm of Merrill Lynch, cheerfully signed off on a now-infamous $1.2 million redecoration of the firm’s CEO suite of offices; the payments included $1,400 for a parchment “waste can” and $13,000 for a chandelier for a private dining room. Then, only weeks before the emergency takeover of Merrill Lynch by Bank of America was completed, Thain rushed through $4 billion in bonuses to Merrill executives, to prevent them from fleeing to a better-capitalized rival, bolting to a hedge fund, or starting their own boutique.

No one on Wall Street doubted Thain’s abilities; after all, he won partnership at Goldman Sachs and reinvented the New York Stock Exchange before snatching a kind of victory from the jaws of defeat for Merrill by negotiating the Bank of America deal. And it’s certainly true that many Merrill executives—like those elsewhere on Wall Street—had managed to generate profits for their firms despite the extraordinarily difficult market environment and by Wall Street standards deserved some kind of reward. But jaws dropped when word leaked out that Thain wanted Bank of America to recognize his achievement in pulling off the merger by awarding him a $10 million bonus. Few of Merrill’s massive problems had occurred on his watch, of course, but Thain had earned $84 million in compensation the previous year; Merrill had even reimbursed him for a bonus that he had forfeited by walking away from his prior job at the New York Stock Exchange to join Merrill. Was Thain oblivious to the degree of public outrage? It certainly seemed so; word leaked out that he had calmly informed Bank of America executives, in connection with the proposed bonus, “I really think

I'm worth that."[7] (In the end, he didn't get it; belatedly recognizing the degree of public outrage, he waived his bonus for the year.)

Had Wall Street gone insane? Possibly. Certainly the Street's compensation system had gone badly awry, although the problem had less to do with the sheer magnitude of the salary and bonus checks than those on Main Street might have believed. True, those were exorbitant, and some people on Wall Street sheepishly admit they had a tough time explaining their jobs and their compensation to family members even before the subprime debacle—and not just because the world of finance was so complex. The real problem was that as Wall Street investment banks had morphed from closely held partnerships into publicly traded entities, their compensation structures had remained stuck in the past. Paying out 40 percent or more of each year's revenue in salaries and bonuses had been the norm within a partnership, and remained standard within the new publicly traded entities. But that compensation model didn't take into account the changes that had occurred within the financial services industry.

Wall Street had once been a fragmented business, with a large number of firms vying with each other for market share and none of them in a position to shake the system to its foundations on its own. But by the late 1990s, Wall Street had become a business dominated by global behemoths formed through a series of mergers. Even when the businesses themselves remained relatively small, as Bear Stearns and Lehman had done, they became critical to the financial system because the linkages between those firms and the rest of the system grew exponentially. At the time of Lehman's collapse, for instance, the investment bank had more than a million derivatives trades outstanding; at the other end of each was another financial institution of some kind.[8] All but the smallest and most isolated Wall Street firms are now "systemically critical," as Fed chairman Bernanke has phrased it; each one plays a much greater role in the health of the system than ever before. In other words, Wall Street institutions had become too big to fail, a phrase that is now repeated endlessly by everyone discussing the future of the financial system. In that environment, risk taking wouldn't be

restricted by the usual concerns of collapse—there was no moral hazard. Even firms that publicly proclaimed that they didn't believe a financial institution should be so systemically important were quietly confident that their bank was among that elite group that would receive some kind of assistance from the powers that be should it become necessary.

But while Wall Street had changed, increasing the level of systemic risk, the compensation system was set up in such a way that it encouraged players such as Dow Kim to boost that risk level even further by using leverage or putting a firm's own capital on the line in hopes of generating higher returns for shareholders. "We lost the checks and balances, a system that provided a kind of curb on excessive risk taking, when we moved away from the partnership model," argues John Costas, the former UBS investment banking head. Once, even those who hadn't yet become partners in a firm, the deal makers and traders such as Dow Kim, would have been very conscious of the risks they were running, since it was their own capital—past, present, and future—that was on the line, argue Costas and other Wall Street veterans. In contrast, today's bankers were largely employees, with every incentive to maximize risk taking and few, if any, to curb that risk.

True, many Wall Street employees, from the top all the way down the line, did get a majority of their annual pay in the form of stock, options, or restricted stock, or opted to keep the bulk of their savings in their own firm's stock. At Bear Stearns, for instance, some 30 percent of the company's stock was owned by employees, whether in the form of stock grants made during the annual bonus payment season or direct or indirect investments. Owning stock didn't give bankers any sense of being the company's owners, however. The capital that they were using to place their bets—structuring riskier leveraged loans for private equity clients and riskier CDO structures that would sit on their own balance sheet until they could find a willing buyer—didn't belong to them, they felt. "There was no question that we saw it as other people's money," says one former senior banker.

In fact, employee ownership may have backfired. Just as had

occurred at companies such as Enron and WorldCom in the 1990s, employees were motivated to take on more risk rather than curb their risk appetite as the market environment became more difficult. “We wanted to boost the share price” so that their holdings were worth more, the banker says. “The risk managers were the guys that tried to stop us from doing that.” Aggravating the problem, that banker adds, was the fact that Wall Street firms increasingly began to see themselves as being more accountable to the demands of shareholders than to the needs of clients, at least at the top levels of the company, where policy was made. “Who were our clients? They were ourselves first—because half the revenue goes to us—and then the shareholders.”

Swinging for the Fences

In a nutshell, Wall Street’s compensation policies rewarded traders, investment bankers, and even CEOs for taking enormous risks in exchange for enormous profits rather than for keeping an eye on whether the risks they were running made sense for either the firm itself or the financial system as a whole. “It’s that asymmetry that’s at the heart of so much that has gone wrong,” says Seth Merrin, cofounder and CEO of Liquidnet, a next-generation trading system. Merrin began working as a trader when he graduated from college with a political science degree and couldn’t even find a job as a waiter. Within a few years, he was running a risk arbitrage desk and pulling down a Wall Street–sized salary, but already he was aware of the gap between the sums he and his colleagues were paid and the value they delivered to customers. “There was such a mystique to Wall Street; everyone saw it as so automated and efficient, as if it were a supermarket,” Merrin observes. “But it wasn’t, because it didn’t have to live on supermarket profit margins. And people on the Street there were paid for generating wider profit margins, not for lowering costs to customers.”

In the late 1980s, Merrin decamped from mainstream Wall Street to launch his first “alternative” trading network, an electronic order

management and routing system. He assumed that as Wall Street firms came under pressure to cut trading costs, that new discipline would spread to other areas of the business, including compensation. Instead, he saw the rate at which bonuses climbed escalate still further and become more out of whack with compensation policies on Main Street. “Everyone is their own profit center within a Wall Street firm and you eat what you kill,” he explains.

Compensation has little to do with how well the investment bank’s clients fare, much less how the risk taken by the investment banker to earn those hefty profits affects the financial system. Sometimes it doesn’t even matter how the investment bank itself performed, as was the case with Merrill Lynch in 2008, when hundreds of employees pocketed million-dollar bonuses in a year in which the company and the financial system nearly collapsed and were saved only by drastic action. A federal judge who later refused to sign off on a deal between the SEC and Bank of America (which acquired Merrill Lynch and whose top brass agreed to the bonuses) regarding these bonuses wondered aloud, incredulously: “Do Wall Street people expect to be paid large bonuses in years when their company lost $27 billion?” The answer was yes. “There’s a big incentive to swing for the fences,” says Merrin. “Should they pull it off, they are compensated extraordinarily well.” The only people who suffer are those whose direct actions cause the losses. Even then, “if they lose a couple of billion the next year, well, they don’t give back what they earned the previous year. All they are is fired and rich.”

It’s normal in American society for those who are successful to be well paid and for those who become stars in their field to be lavishly rewarded. True, some gripe when a major league baseball team promises a superstar pitcher the equivalent of thousands of dollars for every ball he hurls from the mound during the next three years. But by and large, Americans feel that if someone has performed well, she deserves whatever the going rate is for her services. As long as the pitcher hurls strikes, the grumbling remains muted.

Most of us have few problems when a successful cardiac surgeon makes millions or billionaires such as Bill Gates and Warren Buffett earn a place on the Forbes 400 list of the richest Americans. Perhaps we find that acceptable, or at least tolerable, because it reassures us that if we work hard and succeed, we too will be rewarded with mansions, yachts, art collections, fast cars, and $6,000 shower curtains or lots of whatever money can buy that we hanker after. But the ultra-wealthy can squander that tolerance: all that is required is for the average American to believe either that the wealthy individual has achieved those riches through some kind of fraud or deception or at the expense of the little guy on Main Street. Just ask a corporate CEO convicted of cooking the books or a star baseball player accused of taking steroids. And Main Street's tolerance for Wall Street's riches has always been a bit more fragile than it is in the case of the entertainment industry, sports, or even the rest of the business world, perhaps because so few people understand why packaging up mortgages and redistributing them is worth so much money. Like him or loathe him, at least we can all gape at Donald Trump's buildings and understand where the money comes from to fuel his flashy lifestyle. When it comes to the bankers who structure—and restructure—Trump's loans, however, the value of their services is harder to grasp for anyone outside Wall Street's magic circle.

But while populist outrage focuses on the dollar amounts involved, it is actually the incentives at the heart of the compensation system that produce lethal results such as the near-total collapse of the financial system in 2008. If our hypothetical exorbitantly paid cardiac surgeon has a 90 percent success rate among his patients, saving lives daily, then most Americans would agree he's entitled to every dollar he earns. But if he charges more than his peers and has a lower survival rate, grumbling and outrage will follow. And if half his patients are dead at the end of a year, odds are he won't even be able to retire to enjoy the income he has earned so far. The families of those patients will sue him, the medical association may yank his license to practice and, depending on the degree to which he was negligent, he could even face

criminal charges. There is, built into the medical system, a series of incentives and disincentives that link hard work, skill, and the results of the surgeon's work to compensation.

Now, let's assume that the compensation policies that prevailed on Wall Street in 2006 were the rule in medicine. That hypothetical surgeon would have been paid more for every operation he performed, regardless of the risk to the patient's life. Indeed, the higher risk the surgery, the greater the fee he could have charged, as long as the patient survived for at least a few months and as long as he could convince more patients to go under the knife. Should half of those patients die the next year, the hospital might fire him, but he'd probably leave with a golden handshake; the odds that he would be sued or face criminal charges would have been minute. In many cases, he could move to another hospital or set up his own medical practice and attract new patients. The problem with Wall Street's asymmetrical compensation is actually worse. A surgeon has to buy malpractice insurance, footing the bill for his own errors and those of his peers; when successful plaintiffs drive him into bankruptcy, they can collect the balance of any sums owing from the insurer. Alas, Wall Street doesn't have to purchase malpractice insurance; there isn't even a sense that there is a duty of care to the "patient"—whether that patient is the client or the financial system. And so, as we have just witnessed, taxpayers end up footing the bill for Wall Street's errors of judgment.

Of course, there was the FDIC, which was responsible for "insuring" banks and thrifts—or at least their depositors—against the collapse of an institution. But that covered depositors' assets only up to a certain sum; it wouldn't affect banking counterparty relationships. And even so, as an irritated Mike Mayo pointed out to the FCIC in early 2010, FDIC members—the banks—hadn't had to pay anything in the way of premiums for the ten years leading up to 2006, since the insurance fund was believed to be robust enough. That, he said, is "analogous to an auto insurance company not charging premiums until somebody had an accident or a life insurance company not charging premiums until somebody dies."

On Wall Street, most bankers and traders begin doing the bonus

math toward the end of the year. But their calculations aren't based on such issues as the strength of their company or their earnings relative to the risks they have taken, much less how well their customers have fared after consuming (purchasing) the products they have created, or their role in maintaining or hurting the financial system as a whole. They are looking at a far simpler equation: how much money did their business division make, and how much of that did they themselves contribute? "If someone generated $10 million in fees last year and got paid $800,000, they expect that ratio to stay pretty much the same year over year," explains one former senior banking executive. "If that guy goes to $20 million the next year, he expects to be paid $1.6 million at least. And he gets really irritated if his boss tells him he's only going to get $1.1 million."

That compensation system creates a series of perverse incentives, the executive explains. If it costs that individual $2 in (company-paid) expenses to make $1 in revenue, he doesn't care, because he's not being paid to control costs but to generate revenue. "And if someone tells him he can't spend that much, he'll probably fight for the right to run his business division as he sees fit." Similarly, if half of the business he generates is higher risk and lower quality, that also is irrelevant: every dollar of fee income is treated the same for the purposes of computing compensation. "I used to tell everyone I met that whatever they were earning, if they were on Wall Street, they were automatically overpaid," says the executive. Not surprisingly, he says, few of those he worked with agreed with him, his personal assistant (who took home $100,000 a year plus a bonus) among them.

In that context, it's not shocking that Dow Kim was so well rewarded for boosting Merrill's exposure to CDOs, even as the percentage of those packaged securities containing riskier mortgage loans to subprime borrowers increased every quarter. Joseph Stiglitz, a professor at Columbia University, summed up the conundrum in his testimony to the House Financial Services Committee in October 2008. "The problem with incentive structures is not just the level but also the form," he warned. As

they stand, he pointed out, they are "designed to encourage excessive risk taking and shortsighted behavior."

Bonus Junkies

It wasn't always this way. Once upon a time, working on Wall Street was about as lucrative as any other profession that demanded an advanced education and a hefty time commitment from its practitioners, such as the law or medicine. Only a handful of people at the pinnacle—such as J. P. Morgan himself, who as a financial industry tycoon was as much a user of the system as he was a part of it, earning massive profits from restructuring businesses and entire industries—found Wall Street a ticket to great riches. At Morgan Stanley, bonuses rarely added up to more than a month or two's worth of salary for lucky recipients; a fraction of their annual salary.[9] For every J. P. Morgan, there were thousands of bankers toiling on Wall Street in relative obscurity, well paid but not lavishly so. In the words of former Morgan Stanley partner Fred Whittemore, the goal of investment bankers was to become "respectably rich in a respectable way,"[10] a phrase that was in tune with the 1930s pledge by Jack Morgan (J. P. Morgan's son) to Congress that the House of Morgan was committed to doing "first-class business in a first-class way."

By the 1980s, that approach to compensation seemed to be as much of an anachronism as Morgan Stanley's insistence on being the sole lead underwriter on any deal it did for clients. When Bob Greenhill's merger advisory group began generating hefty profits for the firm, resentment began to build among other partners at what they perceived to be Greenhill's arrogance. "Greenhill should remember that whatever success he has comes from the franchise," one of the firm's partners griped.[11] Increasingly, however, that wasn't true; a star banker, analyst, or trader could become his or her own franchise, as Greenhill and later figures such as controversial technology banker Frank Quattrone proved, hopping from one firm to another with full confidence that their clients would follow

them.

Loyalty shifted from the firm and the franchise to the department. Ultimately, at many firms the individual banker or trader owed his loyalty to that department only as long as it was profitable to do so. (The exception was at firms that retained a strong culture, such as Goldman and, until recently, the old J. P. Morgan.) As that process continued, Lou Gelman, the former Morgan Stanley banker, reflects wryly, Wall Street became more about doing any class of business for first-class pay, while bonuses had become multiples of annual salaries rather than fractions. "Nobody on Wall Street gets paid for turning down a deal," he says. "What are you going to say at the end of the year when your buddies ask what your bonus was? No one says, 'Oh, I turned down these five deals because I didn't think they were good for our franchise'! Because what was good for the franchise wasn't turning deals down, it was making more money." And that franchise wasn't always the institution itself, but some subgroup within it, from proprietary trading to telecommunications banking. In years when newly public companies lost money and saw share prices plunge, employees in profitable subgroups still pocketed bonuses. It was the payment of just that kind of bonus in 2008 that sparked such outrage.

And as the 1980s drew to a close, the value of those bonuses began to move into nosebleed territory. In the first stages of the bull market, during the late 1980s, the average Wall Street bonus remained less than the average salary—ranging between $14,000 and $15,500 a year. It wasn't until 1986 that researchers found that the average annual earnings of an investment banker began to exceed those paid to another group of professionals where skill and experience is also prized—engineers.[12] That gap continued to widen. Suddenly, in 1991, the average bonus doubled to $31,100, and continued to climb before peaking (for now, at least) at $190,600 in 2006. (In 2010, the average bonus fell back to $128,530, as Wall Street boosted base salaries in response to new regulations.) Over a seventeen-year span, bonus payouts to Wall Streeters grew at an average annual clip of 11.7 percent; during the same time frame, the rate of growth in the average wage declined

from around 4 percent to as little as 2 percent. Interestingly, the total bonus pool grew more rapidly than the average bonus, signaling that the benefits were going to the higher-compensated employees.[13] The growing Wall Street pay packages both contributed to the soaring cost of living in New York, and then, in a vicious circle, kept increasing to keep pace with that cost of living. By the late 1980s, in Manhattan at least (given sky-high real estate prices and the soaring cost of private school tuition), it was difficult for a senior banker to maintain his or her standard of living on salary alone, especially as it tended to stay relatively flat when compared to bonuses. Back in the 1970s, a Morgan Stanley partner could earn about $100,000 a year and financier Saul Steinberg bought one of the costliest apartments in Manhattan at the landmark building at 740 Park Avenue (formerly occupied by Mrs. John D. Rockefeller Jr.) for a mere $250,000. Today, only a Wall Street CEO or a handful of the industry's top producers can expect to earn the inflation-adjusted equivalent of $100,000 ($525,000 in 2009 dollars) in salary. At Merrill Lynch, for instance, the salaries of the six top executives in 2006 ranged from a mere $275,000 to $700,000 for CEO Stan O'Neal.

The apartment at 740 Park Avenue remained one of the city's most expensive, but someone such as Dow Kim would have had to pay out not two and a half times his annual salary (adjusted for inflation) but closer to a hundred times to purchase such a trophy property. In 2000, when Steinberg sold his apartment, a member of Wall Street's new elite, Blackstone Group's Steve Schwarzman, paid $37 million for it. (Adjusted for inflation, the 1971 purchase price would have been closer to $1.1 million in 2000 dollars.) Few on Wall Street were even in a position to fork over two and a half times their bonus payment to acquire the apartment. Years of outsized paydays at investment banks, hedge funds, and private equity funds meant that only a few investment bankers were now wealthy enough to contemplate such a purchase. (One of Schwarzman's newest neighbors is John Thain, who spent $27.5 million for his own duplex in 2006.)

Why have bonus payments and compensation grown so

exponentially? Ask anyone on Wall Street, and you'll get a list of reasons (today likely to be delivered in a rather defensive manner) that sound a lot like those advanced in Jake DeSantis's resignation letter. Bankers, they say, earn every penny of their money, thanks to their hard work, skill, and expertise. It's certainly true that the professional life of a Wall Street banker, like that of a professional athlete, tends to be a Hobbesian one—nasty, brutish, and short. Walk onto a Wall Street trading floor and you won't see too many gray heads among those bent over computer trading terminals. Trading is a young person's game (and still largely a young man's game); people burn out at a relatively young age. Even in the world of investment banking, if you're still at it in your mid-fifties, it's either because you're a genius and on the fast track to the CEO suite, or because you don't have anything else in your life that you'd rather be doing.

Tony Guernsey of Wilmington Trust points to another reason for the magnitude of the pay packages. "People want the best service, period; it's no different than having the best plastic surgeon or a barracuda lawyer. If you want to sell your company, you want to maximize the price. You don't care what he makes as long as you get more than you thought you would." In the late 1990s, one of Guernsey's wealth management clients approached him for help selling the magazine publishing company he owned. Guernsey and his client picked Steve Rattner, then the acknowledged chief deal maker at Lazard and a star media banker, to handle the sale. Rattner sat down with some twenty potential bidders, including S. I. Newhouse of Condé Nast, to discuss the company and the potential deal.

"The first lot of bids came back at between $60 million and $90 million, and Newhouse was the low bidder," recalls Guernsey. Rattner, orchestrating an auction among the five most likely buyers, sent a draft contract back to them with instructions to alter it as they wanted, warning them that any changes they made would represent their final bid. "Four bids came back—and Si [Newhouse] won it with the highest bid of $175 million!" Guernsey says, grinning at the memory. "And that is why Steve Rattner has always

earned the big bucks—he brings home the premium valuations for his clients."

Unfortunately for their clients, bankers like that may be harder to find on Wall Street these days. (Rattner himself decamped in 2000 and set up his own private equity firm before becoming President Obama's "car czar"; since leaving that past, he has paid fines to settle a series of allegations by regulators that he paid kickbacks to win business.) And as Wall Street has increasingly turned away from agency business—doing business as an intermediary for clients like Guernsey's—in favor of proprietary deal making and trading, it has become more difficult to point to excellent client service as a rationale for such enormous paychecks, especially since many of the bankers who still served clients did so at firms that were ramping up those proprietary activities at a far greater rate.

Tom Casson, the former Bear Stearns banker, still argues that he and his colleagues earned their bonuses by slaving, day in and day out, to deliver excellent results. "I would tell the new guys that anything less than perfection in a spreadsheet or a PowerPoint presentation earned them an F; it's the same standard of success as surgery," he recalls. But would Casson and his peers have had the platform on which to build a banking business—much less had the opportunity to be richly rewarded for their undoubted efforts—if it hadn't been for the fact that Bear itself was, as Casson acknowledges, a giant hedge fund? And even if Casson had recognized the degree of leverage on his parent firm's balance sheet, would he have questioned either that or his compensation? "Probably not," he admits. "I would have drawn comfort from the fact that it was the standard across the investment banking industry; everybody was doing it."

In fact, the real reason for the hefty paydays came to have as much to do with the need to retain their top performers as with client service excellence. (Certainly, the very common comparison to other professions, whether surgery or the law, doesn't hold water: although the jobs can be just as grueling and all require advanced education, only exceptional lawyers and surgeons will be able to earn seven-figure compensation packages, and then only

after a decade or two of experience.) Increasingly, private equity and hedge funds were cherry-picking the top performers at investment banks and inviting them to move to their corner of Wall Street, where bureaucracy and regulation was less arduous and where, when it came to compensation, the sky was the limit. After all, while Wall Street CEOs were making tens of millions—and suffering lots of headaches—hedge fund managers were raking in billions a year in profits for their firms, and up to hundreds of millions for themselves.

SAC Capital's Steve Cohen, one of the most famous hedge fund investors, lived in a modest home in Greenwich, Connecticut, for several years, even after leaving Gruntal & Co. in 1992 to set up his own hedge fund. (Early visitors to that home recall that Cohen and his first wife would bring plastic patio chairs into the living room to accommodate overflow guests.) But Cohen's lifestyle changed as his earning power increased exponentially; he pocketed first tens of millions, then hundreds of millions of dollars a year in both management fees and as his share of profits earned for investors in his hedge fund empire. (In December 2009, Cohen's first wife, Patricia, filed a lawsuit claiming that he had hidden millions of dollars of those riches from her during their 1990 divorce. A spokesman for Cohen, whose net worth is now estimated to be around $6 billion, called the allegations "patently false" and the case was dismissed by a federal court judge in March 2011.) That was a lot more than he would ever have been able to make at Gruntal, where he likely would have remained earning single-digit millions. In 1998, Cohen and his second wife, Alexandra, bought a 35,000-square-foot home in Greenwich that gets bigger with every year that passes (the couple requested permission to add an extra 1,100 square feet in late 2008) and offers its inhabitants and guests still more amenities.

Visitors report the Cohen mansion now includes not only an indoor swimming pool and an outdoor ice rink but its own Zamboni machine to keep the ice in pristine shape for impromptu hockey games. Indoors, the plastic chairs have given way to Cohen's art collection, which he has already spent close to $1 billion

accumulating. Most famously, that includes a fourteen-foot-long tiger shark pickled in formaldehyde, for which Cohen paid artist Damien Hirst some $8 million; he is said by those who know him to have dismissed the costs associated with renovating and then replacing the molting shark (some $100,000) as the equivalent (in Cohen terms) of a cup of Starbucks coffee. Just as startling as the flaking shark is a work that Cohen has displayed in a frozen container in his own office: a sculpture of a human head made out of freeze-dried blood by the artist Marc Quinn.[14]

Meanwhile, Cohen's protégé David Ganek had become a second-generation hedge fund wizard. Founding Level Global Investors in 2003, Ganek pocketed more than any Wall Street CEO in 2007 (between $70 million and $100 million, according to estimates by Trader Monthly) despite the relatively small size of his $2.5 billion fund. He is one of the new breed of Wall Streeters gravitating to 740 Park Avenue; he paid $19 million for the duplex that ITT chairman Rand Araskog once called home, making him a neighbor of Schwarzman and Thain. (Ganek closed down his fund in late 2010.) These days, 740 Park was looking more like a building designed for Wall Street; it boasted fewer captains of industry and scions of wealthy families among its residents.

For star traders at Wall Street investment banks, Cohen and Ganek were the guys to emulate. They could make far more money doing their own thing than those working at a Wall Street investment bank could hope to do over the course of their working lives. The investment banks were hardly oblivious to the threat: if they hoped to continue not just serving but competing with the biggest hedge funds and private equity funds, they realized they would have to fight to keep their most skilled traders and deal makers within their own walls. That meant rewarding promising newcomers and boosting salaries for a critical mass of veterans, and making sure they had as much capital as they needed to generate profits from proprietary deals and trades. After Vikram Pandit and two other senior bankers left Morgan Stanley to form the Old Lane hedge fund, and top M&A bankers Joseph Perella and Terry Meguid, among others, set up Perella Weinberg Partners LP, the

firm's new CEO, John Mack, offered an array of incentives to keep other employees from following their example. (Among other perks, Morgan Stanley's employees were now allowed to invest part of their annual bonuses in the firm's own hedge funds and buyout funds.) John Whitehead, at least, would have preferred Goldman Sachs to call the bluff of employees threatening to decamp to greener pastures. "I would take the chance of losing a lot of them and let them see what happens when the hedge fund bubble, as I see it, ends."[15]

Whenever Wall Street's compensation policies have rewarded short-term profit generation at the expense of the longer-term interests of the firm, its clients, or the system, it has led to abuses, risk managers and other analysts argue. Behind any rogue trader, from Nick Leeson (who brought about the collapse of Barings Bank in the 1990s) to Jérôme Kerviel (who cost French bank Société Générale $7.9 billion in a trading scheme not uncovered until 2007), you'll find a bank employee who had hoped to make a big profit for his bank and a big bonus for himself by taking a big risk, they point out. Instead, the rogue lost control of his trading positions and covered them up, often aided either by colleagues who hoped to protect themselves or by a lack of internal controls at the bank in question.

The controversy surrounding Wall Street investment research is just as dramatic as any rogue trading scheme and shows how compensation policies that offered rich rewards to employees for inappropriate behavior easily became an accepted part of Wall Street. Research analysts working for investment banks knew from the 1980s onward that their output—the analysis of various stocks, bonds, or investment strategies—was valuable to their employers only insofar as their recommendations generated either trading fees or investment banking revenues. A sell rating on a stock could be a career-limiting move for an ambitious analyst if it led to the company's management steering all their business to another firm.

As trading margins shrank, the pressure grew for analysts to help bankers win lucrative underwriting or merger advisory deals. And the analysts seemed eager to play along, realizing that since their

recommendations no longer helped the firm make trading profits, they needed to find an alternative way to demonstrate their value. Richard Braddock, CEO of Priceline.com, publicly declared that his firm picked Morgan Stanley to underwrite its 1999 IPO because of Mary Meeker, the firm's influential Internet and technology analyst. Meeker obligingly slapped a buy rating on Priceline.com and kept it there even as the firm lost 97 percent of its value over the next three years. At Merrill Lynch, Henry Blodget didn't downgrade a stock that he privately acknowledged to be a "piece of junk" until after the company in question had completed an acquisition on which Merrill earned advisory fees. At the end of 2000, Blodget sent an e-mail to his bosses at Merrill trumpeting his role in earning some $115 million in banking fees that year; he was rewarded with a big boost in his bonus, earning a total of $5 million.

That e-mail, along with thousands of others, were accumulated and studied by then New York attorney general Eliot Spitzer and his staff during their probe of the investment analysis business in 2001 and 2002, revealing a pattern of questionable judgment on the part of the analysts and their bosses. Perhaps the most dramatic example was the case of Jack Grubman, the star telecommunications analyst at Salomon Smith Barney (a division of what is today known as Citigroup). Grubman earned as much as $20 million a year in salary and bonus and helped his firm pocket at least $1 billion in fees arranging mergers or underwriting stock and bond issues for the companies he followed. But a CEO who couldn't generate lucrative deal fees for Salomon Smith Barney found it hard to get Grubman's attention, much less communicate the company's story to potential investors, although that, theoretically, was the heart of Grubman's job. "I tried to go to Jack and say we're the best of our peers and we're solvent, but I couldn't get in his office," Howard Jonas, chairman of IDT Corporation, told a New York Times reporter at the time the research scandal finally surfaced. "If you had big merger-and-acquisition opportunities, then you had a chance."[16]

A host of the companies that Grubman did pay attention to and give buy ratings to—including Global Crossing, McLeod USA, and, famously, WorldCom—ended by filing for bankruptcy protection.

(Until Lehman Brothers filed for bankruptcy six years later, WorldCom would remain the largest U.S. bankruptcy in history, involving $41 billion in debt and $107 billion in assets.) Grubman, along with other Salomon Smith Barney bankers, had advised WorldCom CEO Bernie Ebbers—now serving a twenty-five-year prison sentence for fraud and conspiracy—on dozens of deals, reaping fees for the investment bank. He continued to recommend the stock to investors right up until days before the company reported a $3.8 billion accounting error. Those on Wall Street may have been blasé about Grubman's ongoing bullishness when it came to telecom stocks—they knew that his firm wouldn't have stood a chance of winning the lucrative banking mandates had he cooled off—but even they blinked in astonishment at Spitzer's ultimate disclosure: a series of e-mails demonstrating a link between a sudden about-face on AT&T's stock (just in time for Salomon Smith Barney to win a top spot in the underwriting syndicate for stock in the wireless phone division, about to be spun off as a separate business) and his own personal financial interest. Specifically, Grubman agreed to raise his lukewarm rating on AT&T to a buy in exchange for help getting his toddler twins into the top-tier preschool at the 92nd Street Y—that help, it turned out, involved a $1 million donation from his firm.

Nearly everyone was happy. The toddlers were admitted to preschool, the Y got its donation, AT&T got its buy recommendation, and Salomon Smith Barney won a place alongside Goldman and Merrill as a lead underwriter for the AT&T wireless transaction, and thus a share of the fees that would help boost its status in the year-end league table rankings of each investment bank's market share.

Grubman and other exorbitantly well-paid Wall Streeters who have run afoul of specific securities laws, such as Mike Milken, will never work on Wall Street again. But they still got to keep the majority of their compensation for the years they spent there, and can, if they choose, parlay their experience into other jobs in the corporate world.

When Dow Kim left Merrill Lynch in early 2007, it was to set up

his own hedge fund. Normally, that would have been simple; even raising $3.5 billion in assets would have been relatively straightforward had Kim opted to leave midway through 2006 and waived his massive bonus. But his departure came just a few months too late; by the time he began trying to raise money, the problems with the products he had constructed for investors and that now were stuck on Merrill's balance sheet were apparent. Merrill itself, which had promised to back Kim's fund at the time of his departure, quickly reversed that pledge only months later. As of mid-2010, Kim hadn't raised enough from outside investors to formally announce the formation of his fund or begin deploying capital. On the other hand, he hasn't had to sacrifice any of the profits he made by structuring subprime CDOs, except for the value of any stock in Merrill Lynch that he still owned. (Kim was an active seller of Merrill Lynch stock in the year or two before his departure as his compensation levels climbed, according to insider-trading filings with the SEC.)

Efforts at Reform?

Several Wall Street firms began to tweak their compensation packages in late 2008 in response to the public outrage, introducing the concept of the clawback to investment banking pay packages. The first and most obvious step was for CEOs and other top executives to waive their bonuses for the year, and one by one, the announcements appeared. In some cases, those announcements were accompanied or rapidly followed by new pay policies, such as John Mack's proclamation at Morgan Stanley that in the future compensation would be tied to "multi-year performance and each employee's contribution to the Firm's sustainable profitability."

The ten-page brochure published by Morgan Stanley the following spring spelled out the basic tenets of this new approach to pay, including a commitment that 75 percent of compensation would be in the form of stock and that those stock awards to senior executives would be "at risk" for three years and would depend on

the firm continuing to earn a solid return on equity, generate profits for shareholders, and perform well compared to its peers. Moreover, an employee who "engages in certain conduct detrimental to the Company or one of its businesses—causing, for example, the need for a restatement of results, a significant financial loss or other reputational harm"—up to three years after the compensation is first awarded could have any bonuses clawed back by the firm.

Before 2009 was over, Goldman, embroiled in a public relations nightmare that had a lot to do with plans to pay out what might be record bonuses to its own team, announced something roughly similar. Goldman's top managers wouldn't get a penny of cash in their bonus checks, only stock. Moreover, those shares would remain "at risk" for five years, longer than those issued by Morgan Stanley as bonus payments. Other firms devised even more creative new policies. At Credit Suisse, illiquid assets such as leveraged loans and commercial mortgage-backed securities were placed into a $5 billion fund, shares of which were then awarded to executives as part of their bonus. The fund, set up in January, had already gained 17 percent by August 2009, Credit Suisse told its banking team. (The bank's stock, however, had soared 86 percent on the Swiss stock market in the same period.)

To a large degree, these initiatives recognize and respond to the degree of public outrage at Wall Street's lavish paydays of the kind displayed during congressional hearings when Representative Henry Waxman displayed a chart showing the growth in the pay packages awarded to Lehman Brothers CEO Dick Fuld. Fuld, sitting at the witness table, quibbled with Waxman's calculation that he had earned $484 million between 2000 and the firm's collapse in 2008, arguing that it was closer to $250 million, mostly in Lehman stock. "Is that fair?" Waxman demanded (largely rhetorically) of Fuld. While getting rich, Fuld and his colleagues "were steering Lehman Brothers and our economy towards a precipice." Overblown and hyperbolic statements on the part of other representatives and senators—many of whom had been quite happy to accept donations from Wall Street during its glory days—followed thick and fast.

Proposals for salary caps at firms that had accepted bailout money that they hadn't been able to repay were adopted; regulators and legislators were kept abreast of all bonus payments.

To some on Wall Street, the actions and rhetoric emanating from Washington were entirely logical. "I say this as a citizen: I think that what is going on is fair," argued Leon Cooperman, the hedge fund executive and former Goldman Sachs partner in the spring of 2009. "If business looks to government to moderate and control the downside risk, then the government has the right to control and moderate the reward. So we now need to get used to living in a world where that kind of stuff will happen and where government is going to be more interventionist." To others, it was an overreaction. "I grew up without much money, and my goal in being on Wall Street was to make $15 million or so over a number of years and then leave," says Casson frankly. "If anyone had tried to put a lid on how much I could earn in exchange for all my work, I would have looked for somewhere where my earnings weren't limited."

Most of the compensation reform schemes that were proposed or announced overlook the fact that past efforts to rein in greed have had all kinds of unintended consequences. After a Chinese wall was created between investment banking and research, as part of the reforms that followed Spitzer's investigation and the Grubman scandal, bankers no longer had a voice in which companies analysts covered or even which analysts were hired. Not surprisingly they balked at subsidizing the research division. Analysts' compensation was cut in half; many fled to hedge funds.[17] Those reforms, while theoretically creating less-biased research, didn't result in the creation of better quality research, at least not in a way that was easily accessible to the general public. "Come on, Mr. Obama, how are you going to attract anyone of the right caliber who wants the headache of running these firms, if you put these salary curbs in place?" wonders Guernsey, a private banker who has worked with many of Wall Street's top deal makers. "I have never overpaid for someone who is a top performer. Pay is how those top performers are recognized, traditionally."

Address the Cause, Not the Symptoms

The biggest problem with the various compensation reform initiatives is that they tackle the surface issues, not the root causes of the problem. Salary caps, for instance, are likely to be effective only in driving the most skilled Wall Street veterans out of those parts of the financial markets that are now being most rigorously monitored by lawmakers and regulators and into overseas institutions or other segments of Wall Street over which the government has little control. Those hedge funds that have ridden out the storm so far, for instance, continue to reward their employees as lavishly as ever. In the spring of 2008, Fortress Investment Group gave thirty-eight-year-old Adam Levinson $300 million in stock in the publicly traded hedge fund to persuade the star trader to stick around, despite the fact that the massive stock grant diluted the value of the holdings of other, public investors.[18]

True, in some cases investors have succeeded in pushing back management fees from 2 percent of assets to a more modest 1 percent and "persuading" managers to accept a smaller chunk of profits than the traditional 20 percent or 30 percent. In London, the three top executives at GLG Partners voluntarily cut their own salaries to $1 each, although they remain investors in their own funds and will continue to collect a share of any profits. One of the top hedge fund groups, Renaissance Technologies, is waiving its 1 percent fee on a newer fund that has performed poorly, people familiar with the industry say. Another large hedge fund group plans to collect its "incentive" fee at the end of three years on the net result of that three-year performance, rather than at the end of each year on what the fund had earned that year, says Patrick Adelsbach, a principal at the hedge fund research and advisory firm Aksia LLC. That is a big departure from the classic hedge fund compensation model that rewarded its managers at the end of each year for what had happened in the previous twelve months, which saw managers transform paper profits into cash fees thanks to the

wonders of mark-to-market accounting. “Marking,” or putting a market value on a hedge fund portfolio on December 31 of each year, gives hedge fund investors an idea of how their managers are performing. But the manager collects 20 percent or more of any gains in the value of that portfolio as a performance reward, regardless of whether or not that increase in value proves lasting.

Even when a risky transaction in that hedge fund portfolio later went sour, there was no way to claw back what had already been paid out in fees. All that investors could do was limit future manager paydays until the fund had recouped those losses. “A lot of managers found a way around that, too,” says a grim-faced Cooperman. “A lot of them, rather than working to make that money back, just say, ‘I quit,’ and hand the capital back to investors. If you tell me as an investor that you’re going to work for nothing and then when you do have losses just quit on me, that’s just not right.” Cooperman takes an even dimmer view of the increasingly popular strategy of shutting down one money-losing hedge fund partnership, only for its manager to reopen for business under a new name in less than a year.

If salary caps succeed only in driving the most talented bankers to parts of the market that government edicts don’t reach, they won’t get to the heart of the problem. Nor will policies that end up discouraging bankers and traders from taking any kind of risk whatsoever by making it too risky from a career and compensation standpoint. And while clawbacks are at least a step in the right direction, it’s a retroactive approach to solving the compensation conundrum. Of course it would be wonderful to be able to recoup past bonuses paid to people whose poor decisions and lack of attention to the risk associated with what they were doing end up bringing the financial system to its knees. (After all, murderers can’t collect life insurance premiums or otherwise inherit anything from their victims.) But it would be better still if the bright minds on Wall Street and in Washington could devise a compensation system that rewarded the denizens of Wall Street for avoiding such catastrophes in the first place.

Part of doing so boils down to defining more clearly who their

clients are. Ever since investment banks began going public, they have emphasized the degree to which their interests are aligned with those of their investors by pointing out the large stock holdings of their senior executives and the degree to which bonuses are paid out in stock. Having at least some "skin in the game" is seen as the goal, as Peter Blanton, a veteran banker, recalls from his days at Credit Suisse. "When the merchant banking team put together a deal, the folks that blessed it had to put some of their own personal capital into it as well as putting their names on the due diligence. It was a policy. There was a sense that without having skin in the game, we were just agents, without a long-term stake in the outcome." That attitude wasn't confined to the deals the bank did, but applied to their governance policies more generally. Gary Cohn, president of Goldman Sachs, told the Wall Street Journal in a 2009 interview that in his opinion, paying employees in Goldman Sachs stock is the "ultimate clawback." "When I got paid three years ago in $240 stock and it was trading [at] $54 or $53 … it certainly felt like a clawback to me," Cohn insisted. "We have always had … the ability to withhold stock or take it away for anything … done illegally [or] immorally."[19]

But if a heavy reliance on stock ownership was the foundation of a healthy compensation policy, then why did Bear Stearns and Lehman Brothers collapse? In both firms, from the CEO's suite down to the most junior bankers, ownership of the company's stock was encouraged and viewed by all as the best way to build wealth. And yet at both firms, groups of traders and investors were taking the same kind of outsized and risky bets as Dow Kim, who also collected more than half of his salary in the form of stock in Merrill Lynch.

By the time that bankers across Wall Street received their record pay packages at the end of 2006, interest rates had been climbing for nearly two years and the rate of economic growth had begun to slow amidst concerns about sky-high energy prices. The subprime lending cloud had begun to take shape overhead. And yet Wall Street, in the early months of 2007, was cranking out more mortgage-backed securities in the form of highly structured CDOs,

not fewer. And those CDOs were packed full of securities that carried more risk, not less. "To all intents and purposes, whether you got paid in cash or stock, the principle remained the same," says one former senior banker. "You were earning bonuses for maximizing fees, and the higher the fee income, the higher revenues and profits rose, and the better the ROE looked compared to your rivals, and the better the stock price did. It's all the same thing: pay was tied to profits." And at the end of 2007, the compensation on Wall Street hadn't fallen nearly as fast as some of the investment banks' stock prices. It's a cliché on Wall Street to say that financial markets are all about greed and fear; compensation, however, had become a matter of fearless greed in the mental calculus of at least a significant minority of traders and bankers eager for another record bonus day.

As long as compensation remains tied to competitive metrics—how much Bank A's return on equity exceeded Bank B's, or whether Bank B's share price grew more rapidly than that of Bank C—it won't matter whether an employee's bonus is 50 percent or 75 percent in stock. "One of the problems is that people lost sight of who their customers are, because there were so many of them, and instead focused only on delivering what their shareholders demanded of them," says a former senior banker who has now left the industry. "But do shareholders always know best? Is a rising stock price always the answer to every question?"

An asymmetrical compensation scheme that lavishly rewards excessive risk taking but fails to effectively punish failure is toxic in any environment, but when it isn't balanced by some broader consideration—the risks to the company, to investors, and to the financial system's health—then it becomes even more lethal. What happens, for instance, when a banker or trader is rewarded for his or her success in passing on a risky investment to a customer? Unless the problem is systemic—spread across Wall Street as a whole—the odds of such a problem wreaking long-term havoc on an investment bank's stock price are low. And if that banker or trader is otherwise a star, generating lots of fees from risky products of which only a few blow up (even though many others fare far less

well than the banker or salesman had promised), the odds of that individual facing a clawback—especially in a more normal Wall Street environment—are slim. After all, only a minority of mergers and acquisitions end up being successful, generating long-term value for shareholders of the companies doing the deals, and yet the bankers who propose, structure, and help to execute these transactions are rarely held up to scorn or asked to return their fees.

One of the most novel proposals for revising Wall Street compensation revolves around an attempt to bring back the spirit, if not the reality, of the era of partnerships when, as Lehman alumnus Peter Solomon recalled, the partners of a big investment bank sat around in one large room, literally or figuratively peering over each other's shoulders to ensure that their peers weren't taking too many risks. It may not be possible or even desirable to transform today's publicly traded financial institutions back into private partnerships.

But there may be creative alternatives. In a paper written for a conference held at the University of Seattle Law School, two law professors from the University of Minnesota put forth the proposal that any banker earning more than $3 million a year should be required to sign a joint venture agreement with their employer. "That would make them personally liable for some of the bank's debts," Claire Hill and Richard Painter conclude in the paper—and hopefully instill in them a greater awareness of the consequences of their risk taking. The duo point out that reckless risk taking is a Wall Street tradition. "Michael Lewis's description in his 1989 book of the term used for a star trader—a 'Big Swinging Dick'—reflected … an ethos in which investment bankers engaged in risky conduct and were no longer personally responsible for their actions."[20] Sure enough, a rogue trading scandal followed shortly after Lewis's book was published. Despite a boost from Warren Buffett, Salomon Brothers' brand name was damaged.

The two law professors point out that most of the existing proposals already out there—whether the prospect of vanishing bonuses or tying pay to the performance of not just the banks but also the debt securities that it sells to its clients—don't go far

enough. By and large these still involve "no risk of loss for bankers—only forgone gains." What is needed, they argue, is a proposal that is based on a different perception of banking as a "type of socially useful yet potentially 'ultrahazardous' activity that should involve … some measure of strict personal liability.[21] The limited partnership proposal is just part of their suggested reforms, which also include the proposal that bankers can shield only $1 million of their annual compensation from creditors in the event of their firm going bankrupt—the rest would be "assessable." That means that if a banker gets a $3 million stock bonus and his firm later goes bankrupt, $2 million of that stock—valued at the time it was granted—would be assessable, meaning the banker would have to pay its full market value at the time of issuance, or $2 million, to the firm's creditors.

Another proposed solution involves an approach that the Credit Suisse initiative hints at—putting Wall Street firms on the same side of the table with all their clients, not simply their shareholders or those that pay them fees. "If you're going to make a loan, or package some mortgage-backed securities and sell them, shouldn't your rewards be tied to the long-term success of the securities that you put your company's name on and sell to clients?" suggests private equity manager Tom McNamara. "You get paid when the things you sell pay off for the people that buy them, not when you sell them."

Paying out employee bonuses on the basis of deals that have only just been completed—long before it is possible to determine whether or not they were as rewarding for investors and other clients as they were lucrative for the institution selling or structuring them—is at the heart of the problem, in the eyes of many Wall Street veterans. Investment bankers shouldn't be richly rewarded unless their clients also make money, and certainly shouldn't be compensated when deals prove disastrous, whether for a client, the investment bank, or particularly for the financial system as a whole. One lawyer points to a structured product created within one part of an investment bank: the desk that created it earned a fee, but then another group of traders created a derivative structure atop the

original product that blew up, generating a big loss for another part of the same firm: "No one was tracking what happened across the various desks, so this product generated fees for people, even though it was utterly dysfunctional," the lawyer says.

McNamara, like many of the investors who have been consumers of the products that Wall Street generates, argues that investment banks should find some way to tie the success of the banker or trader not just to fee generation or corporate profits but to the success of their clients and the system's well-being. It's a view that is shared by Columbia University's Joseph Stiglitz. "Those who originate mortgages or other financial products should bear some of the consequences for failed products," he argued in his congressional testimony. Specifically, he recommended that the institutions originating mortgages be required to hang on to 20 percent of what they structure and sell. Stiglitz and others suggest that if that philosophy was extended to all of the transactions across Wall Street, with investment firms being required to retain a stake in every leveraged loan, junk bond transaction, or structured product that they sell, Wall Street would have a greater interest in maximizing not only the dollar value of the deals it does but also the quality of those transactions. In 2008, many of the products that caused meltdowns within Wall Street's investment banks were those that they had hoped to sell on to other investors but which ended up stuck on their balance sheets with no buyers in sight. "Isn't it ironic?" muses BlackRock's Rob Kapito. "These were the same securities that they wanted to sell to us, the buy-side institutions. If they'd succeeded, everyone would be talking about how well they'd done and how successful they had been." And the buy-side institutions and their own investors—401(k) plan participants, pension funds, individuals—would have faced even larger losses.

Questions of Value

Wall Street's core function may be that of a utility, but it is an unusual sort of utility. Rather than transmitting clean water or

reliable electricity supplies, it redistributes money throughout the financial system—and money is a far more exciting commodity than water or electricity. If you're running a power-generating station, it's easy to accept that what has value is the company you work for, rather than the commodity you are transferring from point A to point B. Certainly, if your bosses offered to pay you in kilowatt-hours, odds are that you would decline politely. But Wall Street transmits money, and a bit of every dollar that flows through the financial grid sticks to different players—the investment banks, trading firms, brokers, money managers, et cetera—in the shape of fees. Given that money is the one commodity that can be readily exchanged for any other tangible good someone might want, from food and shelter to a pickled shark by Damien Hirst or a trophy apartment on Park Avenue, it's hardly surprising that for those who live on Wall Street, life revolves around not just transferring money but finding ways to scoop up a bit more of the stuff for themselves.

Greed is an emotion as old as time, and it's asking too much of human beings to expect that those on Wall Street should take as detached a view of the commodity that they see pass through their hands as the manager of a power-generating station takes of kilowatt-hours. The Archbishop of Canterbury, the spiritual leader of millions of members of the Anglican Communion, suggested that investment banking bonuses should be capped, and called on their recipients to repent, arguing that "people are somehow getting away with a culture in which the connection between the worth of what you do and the reward you get [is] obscure."[22] But turning bankers into individuals who look down on money may be not only impossible but undesirable—after all, the money grid's job revolves around how to make the flow of capital more efficient and profitable for all concerned. The key word is all—while the bankers can't corner those profits, they also shouldn't be totally disinterested. Perhaps the appropriate strategy is to bring financial professionals to think of their jobs in the same way that lawyers view the law, or doctors the profession of medicine. Those groups certainly hope to earn large sums as a reward for years of education and training, but they recognize and acknowledge that their self-

interest goes hand in hand with a higher public and social interest, one that is explicitly acknowledged in medicine's Hippocratic oath and its cornerstone, the pledge to "do no harm." Placing one's own financial interests ahead of the interests of a patient or client can get a lawyer disbarred or force a doctor to relinquish her medical license.

The solution isn't to take a hammer to the current model, as defective as it may be, by imposing salary caps or punitive tax regimes. Rather, if Wall Street is to reach a point where its practitioners abide by their own version of a Hippocratic oath, what's needed is a longer-term strategy to tie compensation more closely not only to returns—whether short-term or long-term—but also to success in generating risk-adjusted returns and success in bolstering the health of the financial system as a whole. A first step in that direction is to be sure that even if Wall Street's firms pay out record sums in bonuses in the future (bonuses amounted to $20.3 billion of the financial industry's estimated 2009 profits of $55 billion, the New York State Comptroller's office announced), Wall Street compensation committees are taking risk as well as return into the equation when designing policies and fixing annual bonus levels. Of course, that assumes that those boards—and Wall Street—have a firm handle on what risk really is and how best to measure and control it.

CHAPTER 6

The Most Terrifying Four-Letter Word Imaginable

There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we do not know we don't know."

When then Defense Secretary Donald Rumsfeld delivered that cryptic pronouncement at a February 2002 press briefing, he was commenting on the instability in Afghanistan, not Wall Street. And yet within a few years, the phrase "unknown unknowns" had become one of the most popular ways to summarize all that had gone wrong in the investment banking world. Somehow it was all the fault of the "unknown unknowns": Wall Street CEOs, individually and collectively, had misperceived, misunderstood, and mismanaged the risks associated with their business and the financial markets because of factors that no one could have anticipated, much less avoided. Yes, these apologists agreed, Wall Street had failed the ultimate risk management test, but that was due not to greed or arrogance but just to the extreme nature of the risks themselves. No one on Wall Street, surely, could have imagined and planned for the sequence of events that followed the endless and constantly escalating quest for fees, they argue. Certainly, that's how Lloyd Blankfein characterized events, in a verbal sparring match with FCIC chair Phil Angelides. But when he defined them as being akin to a hurricane in their ability to be predicted and controlled, an exasperated Angelides (himself the former head of a large California pension plan) shot back, pointing out that while hurricanes were defined as "acts of God," the financial crisis was the result of actions and inaction by human beings. That's convincing, but it raises one more question. Is Wall

Street's conviction that they couldn't have prevented what happened to be blamed on self-deception, wishful thinking, or blindness?

In Chuck Bralver's eyes, it comes closest to being the latter. The very idea of flawless risk management makes him laugh out loud—in his opinion, this would require an infallible crystal ball. Still, he remarks, Wall Street appears to be oblivious to the ways that the changing nature of its business created new kinds of risk. Bralver, a former senior banker with Oliver, Wyman & Co., now oversees the Center for Emerging Market Enterprises at the Fletcher School, Tufts University's graduate school of international affairs. In both of those roles he has spent a lot of time thinking about the nature of risk and the discipline of managing risk. "True, each separate event that led to the crisis, or that happened as a result of it, had an extremely low probability of ever occurring at all," Bralver says. "Then they all happened—and they all happened simultaneously."

But that doesn't give Wall Street a get-out-of-jail-free card. Even if bankers can't be blamed for their failure to predict this perfect storm, they still could have developed robust risk management policies to protect their institutions and the financial system from the "unknown unknowns," Bralver argues. One of the justifications for the increasingly lavish pay packages awarded to Wall Street executives was the increased complexity and scale of the businesses they were running. "It's not an accident that this happened after the changes that had transformed Wall Street [into a place] dominated by very, very large institutions that were no longer owned exclusively by the same people making the decisions about what risks to take," Bralver says. "It's possible that some of these organizations had become too large and complex for the kinds of risks they were taking, or that the risk management processes hadn't kept pace with the risk."

But why not? Describing the market cataclysm as a "perfect storm" is a great sound bite and helps the folks on Wall Street convey both the nature and the magnitude of events for critics on Capitol Hill and Main Street alike. But surely the same giant leaps forward in computing power and financial wizardry that made

possible the creation of instruments such as a synthetic CDO-cubed structure or a credit default swap also made it feasible to ensure that those products were doing what they were supposed to and distributing risk more broadly throughout the financial system. At the very least, shouldn't it have been possible to gauge when these new products were being used in ways that increased the risk Wall Street was taking to dangerous levels? Or if the markets had become too fragmented, too complex, and too fast-moving to make that possible, then shouldn't someone somewhere have been prepared to step in and say, "Wait a minute—we can't accurately gauge the risks associated with what we're doing"? And then to ask the next logical question: If we can't grasp the nature of those risks, should we be courting them in the hope of earning returns?

LTCM and Systemic Risk

The events surrounding the collapse of Long-Term Capital Management (LTCM) in 1998 gave Wall Street an early warning of the perils associated with "unknown unknowns." No one at the beginning of 1998 had expected a series of unexpected and nearly simultaneous events culminating in the Russian government defaulting on its bond obligations; because no one considered such a string of events to be probable, no one seriously pondered what might happen to LTCM as a result of the bets it was making and the degree of leverage it was using if those events occurred. As it turned out, LTCM's losses were so gargantuan that they threatened not only the firm (that would have been only normal) but all of its counterparties—which included nearly every major investment bank in the United States—and the financial system itself. Many of those firms didn't realize the magnitude of the risks they had been running until it was far too late.

In the wake of the LTCM crisis, which should have delivered a salutary lesson about the dangers posed by excessive leverage and "contagion," Wall Street didn't take a step back from the daily hubbub to do a forensic audit of the risks to the financial system

that the hedge fund's problems had exposed. The immediate danger over, Wall Street returned to maximizing its fee revenue, profits, and bonuses and too often shrugged off the concerns of those who, like Lehman's Mike Gelband or New York University professor Nouriel Roubini (who began warning of the real estate bubble as early as 2004), saw a new "perfect storm" taking shape on the horizon. When it came to managing risk, it was the risk of losing fees or market share rather than the risk of a blowup that weighed on the minds of most bankers and traders. Worrying about risks that seemed remote was in no one's interest.

In early 2008, UBS produced a report chronicling a series of errors of omission and commission to explain to its shareholders how it managed to lose a record $18.7 billion in its subprime structured product businesses in the previous year. UBS management set the stage for the debacle by deciding to act on the advice provided by external consultants; the best way to catch up to and overtake its largest competitors in key business areas—notably Goldman Sachs—was by expanding its activities structuring and trading products based on subprime and adjustable-rate mortgages. What neither the consultants nor UBS management took into consideration were the extra risks associated with following those recommendations and how the bank might manage those risks.[1]

The report lays out in chilling detail the myriad opportunities UBS bankers at all levels had to gain insight into the looming credit crisis, all of which were overlooked or ignored. In one case, UBS created the position of senior risk manager in the bank's fixed-income division in 2006. Would that individual have been able to perceive the risks that were looming? Could he have convinced superiors to rein in their risk taking? Would the bank have acted quickly enough to avoid large losses? The questions are academic: as of the summer of 2007, the position remained vacant and the bank's managers behaved as if the risk management function didn't matter.

In a mid-2009 survey, Capital Market Risk Advisors, a New York risk management consultancy, found that only 70 percent of the investment banks, commercial banks, investment management

firms, and hedge funds polled had a chief risk officer. Of those chief risk officers, only 25 percent had a say on issues such as how much capital a group can risk, or other such specific rules and policies, but did not create firm-wide policy. More worrying still, the vast majority of those chief risk officers reported not to the company's board but to senior management, who have a vested interest in maximizing profits at all costs. The board, which should have access to as much crucial information as possible about risk taking and risk management, may be in a poor position to rein in excessive risk taking, since a third of survey respondents only allowed their top risk management officials to attend executive board meetings once a year, if at all.

No Adult Supervision

Even when risk management procedures are in place, Wall Street is littered with examples of bankers running roughshod over them. At UBS, for instance, bankers were supposed to seek approval for new CDO products up front. In practice they delayed doing so until their division had already purchased and warehoused many of the asset-backed securities that would be included in the new CDO. Saying no to a deal at that point was possible only in theory; the costs of unwinding those holdings made it unfeasible in practice.

Often UBS bankers didn't even know what assets lay beneath the subprime loans that they were eagerly repackaging into CDOs. Were they first or second mortgages? What was each borrower's credit score? That kind of due diligence was being conducted by some investors, such as BlackRock's Scott Amero, but not by the product vendors. Instead, UBS and others on Wall Street placed blind confidence in the ratings; after all, they reasoned, credit analysts at Moody's and Standard & Poor's wouldn't give a coveted triple-A rating to anything that didn't deserve it.

Crucially, nowhere within UBS did anyone try to understand the importance to the market of liquidity and what might happen to the bank if something caused that liquidity to evaporate. (They

didn't have to predict what might cause such an event; all they needed to do was simply consider the fact that it could happen.) Similarly, until UBS began writing down the value of the subprime securities on its books in the spring of 2007, senior managers simply relied on the assurances of the people running the business divisions that everything was hunky-dory.

Those rank-and-file bankers had their own incentives to downplay the risks associated with subprime asset-backed securitization and the booming CDO market, even as it became a bigger part of UBS's business. Basic risk management principles suggest that any booming business should automatically be given more scrutiny, especially as its revenues and profits become vital to the firm's financial health and even its solvency. But Wall Street's mix of incentives didn't reward that behavior; rather, bankers were rewarded for downplaying any risks, for being courageous and aggressive. That, CEOs such as Stan O'Neal and Richard Fuld were sure, was the only way they could ever succeed in catching up with Goldman Sachs and matching the latter's enviable return on equity.

On Wall Street, "success" was defined in terms of the rapidity and magnitude of the growth of the business for which an individual was responsible, rather than prudence. Indeed, as the UBS report makes clear, at some institutions there was an incentive to deliberately take on more risk and not to look too closely at the potential fallout; the riskier the mortgage loan they agreed to underwrite and repackage, the bigger the fees. The UBS team responsible for structuring CDOs could earn fees of perhaps 0.5 percent, or 50 cents for every $100 of value in the CDO, by buying only high-grade CDOs containing top-quality securities. Or they could earn at least double and perhaps triple that in exchange for structuring a mezzanine CDO containing higher-risk securities. It was a no-brainer: they pursued the riskier option, which offered the best short-term rewards for both themselves and their division.

Since UBS's compensation policy rewarded bankers and traders based on how much profit they generated, there was no incentive to look too closely at the source of that profit. Was employee A really smarter than employee B because he generated more profit? Was

he making more money because he was better at capturing alpha, returns that had nothing to do with what was going on in the broad markets? Were his returns due solely to the ultralow cost of capital? Was he jeopardizing the bank's health in order to enrich himself, taking risks that might pay off for him in the short term in the shape of a gargantuan bonus but that would hurt the institution over the long haul?

No one at UBS could begin to understand which employees were generating the best returns on a risk-adjusted basis. The data weren't there because all that mattered to those who had designed the reporting and compensation system was the bottom line. Thus UBS, like its peers on Wall Street, paid out hefty bonuses on the basis of earnings gains that proved ephemeral. The bank itself was oblivious to "the quality or sustainability of those earnings" until it was too late.[2]

At best, bankers and traders assumed that someone else higher up in the food chain was doing the worrying for them; that someone would come and tell them if they were taking unacceptable risks. On Wall Street, however, there was no "risk police" to rein them in. As in most of the business world, every business division tends to operate with a large degree of autonomy. Why would the head of mortgage origination check in with the head of fixed-income trading? Their overall objectives may be the same—to maximize revenue for their institution—but they go about it in different ways and they compete with each other for access to the firm's capital to accomplish that. Wall Streeters reason that this would be about as logical as the product manager for Colgate toothpaste making sure that someone selling Hill's Science Diet pet food or Ajax cleanser isn't creating problems for the company that employs them all, Colgate-Palmolive. "Look, we were all just doing our jobs, in our little silos," says buyout manager Jake Martin*. "It's hard to blame people for doing their job, or to suggest that they should have been doing more than their job—or even more so, doing someone else's job."

Unfortunately, the comparison between Wall Street and a consumer products company (or other nonfinancial business) isn't

that clear-cut. They weren't selling toothpaste or even breakfast cereal. At the end of the day, all the myriad parts of Wall Street still were engaged in operating the money grid and making sure that capital moved smoothly from point A to point B. That function may have accounted for a smaller part of the industry's revenues and profits with every year that passed, but Wall Street, however ruthlessly it might seek out profits for itself and however dispassionate its users could be in allocating capital only to those who would use it efficiently and provide a solid return on their investment, ultimately operated in the public interest.

Were the interests of clients and of the public as a whole best served by organizing a Wall Street firm by product line? Several veterans argue against that approach. "The various products are really just tools that somebody can deliver to their client," argues one former senior Wall Street executive. He believes that had Wall Street firms focused on the client and the client's needs as a way to maximize fees, instead of setting up a structure within which each product group battles to maximize its own revenues, the result would have been a healthier financial system. "A derivatives desk sells products that are great; they are tools, really powerful hammers," the executive explains. "But when a derivatives salesman or manager talks to a client, the solution they propose always involves the hammer that they happen to have available and want to sell. Let's use this hammer to pound in the nail, to pound on this screw, to pound on your computer when it's not working. As long as they can make a case that the hammer might be a solution and can keep selling hammers, they are rewarded." An investment bank that divided its business by type of client—hedge fund, private equity fund, pension fund, endowment, mutual fund manager—rather than by product wouldn't have ended up in the same pickle, he suggests.

Others on Wall Street—a majority—reject such revolutionary ideas. Instead, they take an odd sort of comfort in Wall Street's long history of booms and busts. That was Jamie Dimon's worldview, even after the hurricane had blown through Wall Street. In testifying to the FCIC, he sought to explain his view of what had happened

by relating a story involving his daughter, who had called him from school to ask him what a financial crisis was. When Dimon told her that it was a market event that occurred every few years, she then asked why everyone was making such a big deal about it. (This anecdote was one of the rare occasions when Dimon—who has emerged from the crisis with a reputation that has been burnished rather than stained—appeared to be afflicted with the same kind of tone deafness and foot-in-mouth disease that afflicts some of his peers.)

In every market cycle, traditionalists point out, investment banks take big risks and many end up making bad deals. Wall Street is a Darwinian place: only the very fittest individuals or firms survive. So no one is surprised when every so often one of those investment banks takes a step too far and goes belly-up. Even Drexel Burnham went from being the most profitable firm on Wall Street in 1986 to filing for bankruptcy in 1990. Sure, it's sad for the guys who work there, but the good ones, Wall Streeters reassure themselves, will find another job eventually. (Indeed, a number of Wall Street firms today still are full of Drexel veterans.)

So even as subprime-related losses mounted and investment banks scrambled to find emergency cash infusions from overseas to help fill the holes in their balance sheets that had suddenly appeared, Wall Street prepared for little more than another Drexel-like event, something that would be painful while it lasted but that could be contained without posing a systemic risk. When the Federal Reserve forced Bear Stearns into a shotgun wedding with JPMorgan Chase in March 2008, there were some thinly veiled sighs of relief in a few corners of Wall Street. This was the moment of capitulation, they reasoned; Bear Stearns would be the subprime meltdown's Drexel, the sacrificial victim of the latest round of Wall Street excess. The real estate market would bottom out; there might even be a recession. But, they reasoned, the rescue of Bear showed that the risks could be contained.

But the closer bankers were to having an overview of the system, the more anxious they became. It was increasingly clear that to the extent they had pondered the issue of risk at all, they had been

addressing the wrong set of risks. They hadn't factored into their sometimes perfunctory deliberations the degree to which the financial institutions had become intertwined, so that the collapse of one automatically became a problem for others who had agreed to be counterparties in myriad financial transactions with the now-defunct firm. As the long, hot summer of 2008 unfolded, it also became clear that they had underestimated liquidity risk. Investors were becoming cautious, fearful, and unwilling to buy; they saw values as too uncertain. When buyers weren't willing to buy, how could the owners of securities understand what they were really worth?

Within weeks, liquidity—the lifeblood of financial markets—had begun to drain away, a process that would culminate in the massive credit crunch that fall, after the collapse of Lehman and the $85 billion AIG bailout signaled just how great the market catastrophe was. It was a chain reaction, and one that revolved around the level of confidence Wall Street institutions had in each other. The first to suffer were the investment banks, which relied on short-term financing to keep afloat. First Bear Stearns and then Lehman Brothers discovered that their usual financiers in the commercial paper and the overnight repo financing market had begun to perceive that the quality of the assets put up in order to obtain that funding had declined.

Liquidity risk was one of the most contagious of all forms of risk, as soon became clear. When Lehman Brothers collapsed, the plunge in value of the company's commercial paper led to an old-fashioned run on one of the oldest money market funds in the United States. The Primary Fund, managed by the Reserve Management Co., had about 1.2 percent of its $63 billion in assets invested in Lehman's securities, or $796 million. Investors panicked about even that tiny level of exposure, and demanded that the fund return $20 billion of their capital. That was more than managers could provide quickly however rapidly they sold other, creditworthy securities to meet those redemption demands. The chaos spread: other money market funds boycotted the commercial paper market, unable to value securities in the midst of a liquidity

crunch. The money grid stopped working—in part because of Wall Street's failure to understand the nature of the risks it was running, and liquidity risk specifically.

Wall Street, it seemed, had disregarded the possible impact of a string of "unknown unknowns" on increasingly complex and fast-moving financial markets that were more reliant on leverage than ever before. "It was all about denial, and every day one more person would realize that they couldn't stay in denial any longer," says private equity manager Martin. Wall Street had spent too many years embracing returns and closing its eyes to risk; now it was more vulnerable to a "perfect storm," while at the same time less prepared to survive the havoc such a storm would bring. "Some of us knew that something nasty was inevitable; in a way, we were all waiting for our comeuppance, for our cavalier attitude to risk to come back and bite us on the ass," one senior Wall Street executive recalls of the summer of 2008. "We were waiting for the next shoe to fall."

Understanding—and Misunderstanding—Risk

Everyone thinks about risk and return every day, whether consciously or unconsciously. When you wake up in the morning, you face the decision to get out of bed and go to work. The return is pretty straightforward: you keep your job and earn a salary to pay your mortgage and cover the grocery bill. Sometimes you accept greater-than-usual risks because you see the reward as also being above average. How many men who normally wouldn't dream of speeding aren't tempted to do just that when they are driving their pregnant partner, now in labor, to the hospital?

What happens on Wall Street isn't all that different; it's just a bit more intense due to the fact that financial markets revolve very explicitly around the dual concept of risk and reward. An investment manager takes risks—buying stocks, bonds, or other securities—in hopes of earning a return for her clients; if those risks don't generate profits, it's because she has misjudged either the

investment's return potential or the risks associated with it. Similarly, every time a trader on a Wall Street bond desk takes a bullish or bearish position in Treasury notes ahead of the employment data released on the first Friday of every month, he is assessing how much he could earn if the data show that 300,000 new jobs have been created the previous month or how much he might lose if it shows that 150,000 jobs were lost. Different data will have different consequences for the value of his Treasury notes. A skilled trader needs to be able to judge the myriad risks associated with his conclusion about the data and the Treasury position he chooses to establish. If he gets it right, how much might he earn? If everybody else in the market agrees with his assessment of the risks and potential returns, it's like betting on the favorite in the Kentucky Derby: the return will be minimal unless the trader makes the bet riskier by borrowing the money—in other words, unless he can use a lot of leverage. Betting on an outside chance, in contrast, offers more upside potential but carries a lot more risk of a different kind.

One of the biggest problems with risk is that its real level and nature are clear only with hindsight. Consider two hypothetical money managers, both of whom buy Google stock at the time of its IPO and hold on to it for the next four years. Now assume that one of those managers invested 20 percent of the assets she managed in Google, while the other invested only 2 percent of her fund in Google stock. At the time of the investment, the first manager would be called reckless and foolhardy by her peers and probably also by some of her clients; few self-respecting professionals would choose to keep so many investment eggs in a single basket. But by the end of 2008, it is likely that manager's bet on Google, however risky it looked at the time, would have paid off. Now, let's suppose that she did something even riskier by investing the remaining 80 percent of the assets she managed in Treasury securities. The risk here is a different one; she's not running much market or credit risk, since Treasury bonds are among the safest investments around, but she risks dramatically underperforming her peers because the tradeoff for that low risk is a tiny annual interest payment. Of

course, what is seen to be risky behavior in one context may look prudent or benign in another, as Treasury bonds outperformed every other asset class, except cash, throughout 2008.

It's often hard to correctly identify or understand the risk that you are actually running. Wall Street veteran and risk analyst Leo Tilman points out that even as the fees investment banks earned from their traditional businesses slumped and Wall Street institutions turned to "active risk taking" to generate returns for their shareholders, they were lulled into a sense of false security about the level and nature of risk.[3] "When the environment that you're doing business in is very benign, the risk management models start telling you the level of risk is declining, so you feel comfortable taking on more risk," Tilman explains. Whenever investment banks alter their traditional business model in the pursuit of higher fees, higher returns on equity, and higher bonus packages, they automatically take on more risk, he says. The commoditization of traditional businesses—as discussed in chapter 3—forced Wall Street firms to focus on new kinds of business, most of which involved new kinds and often higher levels of risk, Tilman believes. "The paradigm of risk management never caught up with reality," he argues.

In Tilman's eyes, the CDO business, which produced so much of the carnage on Wall Street in 2007 and 2008, is prima facie evidence of the Street's misunderstanding and mismanagement of risk. To the likes of Merrill Lynch and UBS, buying up mortgage-backed securities and repackaging them into these new structured CDO products (the CDO would then be sliced up into tranches on the basis of different risk and return characteristics) was simply a new way to earn the same kind of fees they had always earned. It wasn't really a new business, they reasoned, especially in a low-interest-rate environment. They saw it as "a riskless fee business," Tilman says.

In the eyes of Wall Street, a business that generates a fee is inherently far less risky than one that requires a long-term investment of capital and where returns come in the form of profits following the sale of an asset some time in the future. So even as

the Wall Street firms committed more and more capital to the CDO business, they could tell themselves they were still acting as intermediaries between the mortgage originators and the ultimate investors. That gave them an artificial sense of security. Tilman argues that such behavior bordered on the delusional. "If you're gathering CDOs together in a warehouse and packaging them up, and the market suddenly freezes, well, that's a big risk," he says. "It doesn't matter that you would have eventually earned a fee from the transaction. If you believed it was a plain and straightforward transaction and if you didn't hedge the risk of keeping all those [mortgage-backed securities] on your balance sheet while you packaged the CDO, well, you didn't understand the risks you were really taking."

Tilman watched the debacle take shape and then unravel from positions at BlackRock and later as an investment strategist at Bear Stearns advising the firm's pension fund clients and other institutional investors. In his view, this pattern showed up across the whole array of Wall Street's most popular and most profitable new business lines. "Opening a proprietary trading desk, providing short-term financing for leveraged buyouts, serving hedge funds, starting an in-house hedge fund—none of this is as low-risk as people convinced themselves it was."

Of course, everyone on Wall Street knows that their business revolves around risk. But when you ask them about it, they'll tell you it's not about Wall Street taking risks, it's about Wall Street helping its clients offload what they consider to be unacceptable risks to another player. It's about risk transfer. The classic example of this is one of the most basic derivative securities, the swap: in its original form, this was a way for a company to exchange debt on which it had to pay a variable interest rate for fixed-rate debt, making its finance costs more predictable. Still, as big investment banks became more complex and placed more emphasis on using their capital to generate returns, they admitted it was time to hire in-house risk managers.

Ideally, Wall Street risk managers should play the role of circuit breakers. They should be able to force the bankers and traders at

the various investment banks and other institutions to pause to consider whether they really understand the risks they are about to run and whether the potential return seems worth it. Unfortunately for everyone, Wall Street's relationship with risk managers hasn't always been healthy or productive. Financial institutions have pushed risk management to the sidelines and overlooked it entirely just when they needed it the most: when the level of greed is rising to new heights.

The Least Popular Guys on the Street

Wall Street loathes a party pooper—the guy who arrives on the scene and shakes his head in solemn disapproval of the antics while everyone else is having fun. This most unpopular subspecies wants you to walk away from a deal that is going to generate hundreds of millions of dollars in fees, especially when it's going to cost you a zero on the end of your annual bonus check.

Risk managers on Wall Street are about as popular and welcome as a sensible spouse or cautious bank manager whispering words of reason to a Vegas gambler about to bet the ranch at blackjack. The last thing that a Wall Street banker wants is for that risk manager to acquire enough power internally to force him to listen and limit the risk he's taking. Bankers see risk as a way to make profits for themselves and the firm's shareholders; risk managers, meanwhile, want to be sure the institution survives long enough to book those profits. Not surprisingly, those interests often clash, and finding a compromise is hard because both have logic on their side. Play it too safe, and the bank won't make money; take too much risk, and the bank won't exist much longer.

On Wall Street, however, the political power is in the hands of those who want to take more and more risk, not those who advocate caution. That's because the bankers and traders who generate the heftiest profits over the longest time periods (and who also have the diplomatic skills to win the support of large numbers of other big revenue producers) are the people who rise to the

positions of power within investment banks and other financial institutions.

That's what happened at Goldman Sachs, which once had maintained a balance of power between trading and investment banking within its leadership. (One odd couple was Bob Rubin, a veteran trader, and Stephen Friedman, known for building the firm's merger advisory business, who were co-chairmen of Goldman in the 1990s.) But by the new millennium, the leadership was coming under the control of the traders, such as Blankfein and Gary Cohn, the firm's president, both of whom had begun their careers at J. Aron, the commodities and futures trading business Goldman had purchased. Their trading operations were driving profits, and they were comfortable with risk; still, their priority was clearly on maximizing returns. That's how any banker gets to a position of power and influence in the first place, and it's what they need to keep doing in order to keep shareholders happy and retain their jobs. Anyone who wonders if it might be wiser not to push the risk envelope just has to recall the fate of Phil Purcell or Mike Gelband.

Jaidev Iyer learned the lesson about the balance of power between risk managers and reward seekers firsthand during the twenty-eight years he spent at Citigroup. From the Global Association of Risk Professionals (GARP) offices in New Jersey, Iyer has a panoramic view across the Hudson River to the gleaming office towers of Manhattan, including the skyscraper where he toiled as head of operational risk for Citigroup. He has an equally panoramic view of what went wrong on Wall Street. "Everyone is to blame," he says flatly. "No one is exempt, and I include risk managers in that." But risk managers carry a different burden and thus a different kind of blame, he argues. "Their primary failure was a failure to understand or communicate the risks."

Think of the old legend of the turtle and the scorpion. The scorpion, who needs to get across the river but can't swim, asks the turtle to carry him. The turtle initially scoffs at the idea. "Are you mad?" he demands. "You'll sting me while I'm swimming and I'll drown." The scorpion points out that if he did, he'd drown, too. "Where's the logic in that?" he inquires. The turtle, convinced, tells

the scorpion to hop aboard, and starts swimming. Halfway across, the scorpion stings the turtle. As they sink to the bottom of the river, the turtle turns resignedly to the scorpion and asks, "Why did you do it? You said there'd be no logic in you stinging me." "It has nothing to do with logic," the scorpion answers sadly. "It's just my character."

On Wall Street, the turtle is the risk manager who knows full well that the nature of the bankers and traders is to take as much risk as they can in pursuit of profits. Failing to find an effective way to communicate the potentially toxic consequences of loading up the bank's balance sheet with subprime loans is the equivalent of the turtle agreeing to ferry the scorpion across the river. The risk manager becomes complicit, indirectly, in the subsequent losses and write-downs.

Iyer says managing risk on Wall Street is more easily said than done, since risk managers don't generate profits for their firms and can even recommend actions that would curb short-term gains. "The guy who is always forecasting Armageddon is never going to be the guy anyone wants to listen to; if you listened to him all the time, you'd never do anything," Iyer says. "You have to do that without becoming a wet blanket."

Still, Iyer admits that during his years at Citigroup he found it difficult to always practice what he preaches. At a 2007 meeting of the bank's risk committee, he annoyed Tom Maheras, the powerful co-head of investment banking, by suggesting that the latter hadn't set aside enough capital to provide for some operational risks Iyer had identified. Maheras, a bond expert and a veteran of Salomon Brothers and its high-risk, high-return culture, was an aggressive banker who had risen to the top ranks of Citigroup. Transforming the bank into the dominant global fixed-income trader and propelling it toward the top of the underwriting league tables meant taking on more risk, he was convinced. Sure enough, Citigroup's average value at risk (VaR, pronounced as one word to rhyme with car), a measure of how much the bank could lose in a single day if its strategies fell apart or the markets turned sour, soared from $63 million in 2001 to $105 million by 2005.

Perhaps Maheras's track record made him comfortable with risk taking. Bankers who worked with him agree that to Maheras, risk equaled returns. Setting aside more capital to guard against future losses, as Iyer suggested was prudent, would crimp Maheras's style and potentially cap profits. Not surprisingly, Maheras was angry; Iyer's suggestion promptly died. More surprising, Iyer was told not to attend further risk committee meetings. Most surprising of all, it wasn't Maheras who had banned him but the bank's senior risk managers. "They wanted to keep Tommy happy," says Iyer with a shrug.

Others trying to alert top management at Citigroup to looming problems received even shorter shrift. Richard Bowen was named chief underwriter at Citigroup in early 2006—just as Wall Street approached the abyss. That promotion meant he was in charge of making sure that all the mortgages Citigroup's business divisions acquired for resale to government entities like Fannie Mae or other investors met the bank's quality standards. Within months, Bowen realized that nearly two-thirds of them didn't, according to the FCIC report. That meant that if they lost value, investors could demand that the bank repurchase them. Attempting to signal the danger to his superiors, including Bob Rubin, led only to expressions of concern; the only action was a renewed push to boost market share. "So we joined the other lemmings heading for the cliff," he said in an interview with FCIC staff.

Bowen's career also went off the cliff; after he began sounding the alarm, his bonus was slashed, he went from supervising 220 people t o overseeing only 2, and his performance evaluation was downgraded, the FCIC reported. He wasn't alone: across Wall Street, numerous other risk managers or business-unit heads who detected the risks their institutions were running and who tried to apply the brakes, were fired, sidelined, or stripped of any power. At Merrill Lynch, for instance, risk managers no longer occupied positions on the trading floor where they could watch what was occurring in "real time."

Maybe it shouldn't have been all that astonishing. However important the risk management function seemed to be to those

performing it—they knew their activities helped keep their institutions from incurring large losses or running afoul of regulators—risk management didn't generate profits. And profits are all-important on Wall Street, whose icons are bankers such as Maheras, Joe Perella (now out on his own again after leaving Morgan Stanley), or Jimmy Lee at JPMorgan Chase. This list would include some hedge fund managers and buyout investors. But ask the average investment banker the name of Wall Street's smartest risk manager and you'll likely get a blank stare in response. Even the most successful toil in anonymity.

The UBS forensic analysis of the causes of its massive losses confirms that risk managers had trouble getting their message across. In some cases, they had become too eager to please the more powerful bankers. The UBS report cites one example after another of occasions when managers at all levels silenced points of view that conflicted with their own. UBS bankers complained that the bureaucracy associated with risk management caused them delays in earning revenue from new businesses; their logical response was to find ways to bypass the risk management team or to co-opt them. When bankers explicitly requested more favorable treatment for pet projects, risk managers listened agreeably. In one case the report concluded that if the risk team had been more alert to their circuit-breaker role, such a request could have pushed the bank "to rethink the rationale for the business model as a whole."[4]

Some on Wall Street did listen to what their gut was telling them: that when things seem too good to be true, there is usually something amiss. Whether or not the increasingly popular quantitative risk models captured it, risk-conscious bankers and their analysts knew instinctively or had learned from experience that when it seemed as if nothing could go wrong, it was time to look around for the hidden iceberg ready to rip a hole in the side of the vessel. But to be able to ask the right questions and draw the right conclusions required not only common sense but also the willingness to be a contrarian, even in the absence of evidence that there was a real reason to be alarmed.

Asking Questions, Challenging Models

At Sandler O'Neill, a boutique investment bank catering to financial institutions, CEO Jimmy Dunne was aware that he had a few hundred million dollars' worth of trust-preferred securities (a kind of low-cost financing favored by financial companies) sitting on the firm's balance sheet in the spring of 2007. That was routine; Sandler O'Neill was warehousing the securities while awaiting the right time to repackage them and sell them to investors. But Sandler O'Neill's balance sheet was much smaller than those of firms such as Merrill Lynch, making Dunne nervous. He started investigating the firm's risk.

It all boiled down to just one question, which Dunne asked in the summer of 2007. He wanted to know how much collateral the firm had on its balance sheet in connection with the trust-preferred securities. Hearing the answer, and realizing that the figure was out of whack with the historic average, Dunne reacted instantly. "I told them to get out [of the positions in the trust-preferred securities], forget what the models said [about value], to just sell everything. I had to assume the worst-case scenario, for the sake of the firm."

Dunne had learned over the years that following closely in the footsteps of bigger Wall Street institutions wasn't necessarily prudent. More than a decade earlier, his closest friend and the head of investment banking at Sandler O'Neill, Chris Quackenbush, had pointed out that just because a firm is bigger doesn't mean its behavior or attitudes are worth emulating. They had both learned that lesson when Sandler O'Neill underwrote a new stock issue for a client alongside Salomon Brothers (now part of Citigroup). Quackenbush cautioned Dunne that the SEC rules required underwriters to stay out of trading activity in the stock for two days after the issue was priced and sold. The next morning, Dunne spotted Salomon's trading desk busily making a market in the stock and raking in fees. He stormed into Quackenbush's office, furious at losing potential profits to a rival firm. "I said, 'Look, pal, don't tell me they don't have lawyers and risk guys all over at Salomon.

Come on, we're losing money!' "

Quackenbush—one of the sixty-six Sandler O'Neill employees killed in the 2001 terrorist attack on the World Trade Center—stood up to Dunne. "He said he didn't give a hoot—only he didn't use the word hoot—about what another firm was doing," Dunne recalls. What mattered was that Sandler O'Neill should do the right thing and not take foolish risks. Dunne says those events taught him a lesson he would later recall as he watched Merrill Lynch, Citigroup, and others accumulate massive exposure to subprime CDOs. "The big guys may build the system that the rest of us have to live in, but we don't have to follow what they are doing blindly," he says today.

It would have been far harder for Citigroup to sell or hedge the $43 billion in subprime securities sitting on its balance sheet than it was for Sandler O'Neill to slash its much smaller exposure. But in the summer of 2007, Citigroup's CEO, Chuck Prince, didn't seem to be asking the same questions that Dunne was. Indeed, it wasn't until he convened a meeting in September to discuss the market meltdown that was already under way that Prince grasped the magnitude of the bank's exposure. His once-blissful ignorance would cost him his job before the year was over. At Merrill Lynch, Stan O'Neal had built a culture revolving around his dream of transforming the firm into the next Goldman Sachs; now he too was put out to pasture. (Nearly simultaneously, and perhaps not coincidentally, Merrill finally created and filled the position of chief risk officer.)

Wall Street investors were much more alert to subprime-related risks. They watched with concern as Wall Street's CDO creation machine churned out more and more of these structured products, each containing a higher proportion of subprime loans than its predecessor. But then, they were looking at the market from the perspective of an investor, and had long had concerns about the extent to which ultralow interest rates failed to reflect the real levels of risk. "The pricing became ridiculous," says Bill Kohli, a fixed-income manager at Putnam Investments in Boston. "The more risk you took, the better your performance was; [bond] yields got

so low that in order to generate the same returns you had a few years earlier, you had to take a lot more risk."

If Wall Street's investment banks and the mortgage companies who were providing them with their raw material didn't get the trade-off between risk and return, investors did. For them, buying CDOs was a long-term investment, in contrast to Merrill Lynch or Citigroup, which planned to pass the CDOs to someone else, along with their risk. To compete with their rivals, investment managers need to offer superior returns, but to keep their own investor base satisfied, those returns have to be steady and consistent. Taking too much risk raised the odds of losses, which would in turn cause fund investors to demand their money back.

By 2006, it seemed to Kohli and many of his peers that whichever way they turned, they saw only risk. Many bond managers recognized that yields being offered on corporate bonds were ridiculously low by historical standards; since bond prices and yields move in the opposite direction, for investors to make money by buying those bonds, the yields would have had to fall still more, an improbable scenario. Yield levels were so low that just pocketing a bond's income stream wasn't an attractive option, either. And anyway, how many of those securities might run into trouble if the economy stalled and borrowers struggled to make payments?

Another risk was that an increase in bond yields would send the bond's price, and therefore its value, plunging. Many still decided to hold their noses and buy higher-yielding products, reasoning that many of those structured CDOs had been assigned triple-A credit ratings by Moody's or Standard & Poor's. Somehow, a majority of them managed to overlook the odd fact that for every blue-chip U.S. company worthy of earning a triple-A rating from one of those credit rating agencies, there were thousands of structured products carrying the same seal of approval. Others began to balk as the products became increasingly complex or opaque, or valuations reached what they considered to be extreme levels. Some, including BlackRock's Scott Amero, did the due diligence into the loans that underpinned these securities and recoiled in horror at what they

found. Between the summer of 2006 and late 2007, the number of borrowers who defaulted on their new mortgages only months after signing on the dotted line doubled, as the FCIC reported. Some homeowners never even moved into their new abodes. "Buyers of CDOs are given a take-it-or-leave-it deal; the investor isn't at the table participating in the discussion of how to structure the CDO alongside the issuer and the guy from Moody's or S&P," says Ed Grebeck, CEO of Tempus Advisors, who teaches courses on structured finance at New York University. "For fixed-income managers, this was what was available—end of story." And fixed-income managers were encouraged to put their trust in those ratings; after all, the ratings told them whether a particular bond could be added to their portfolios.

Aware that the CDO vendors are in the business of boosting their own bottom line, some investors began focusing instead on relative risk. "There were blue-chip companies that were the subjects of leveraged buyouts, and many of those leveraged loans and bond issues, while a bit pricey sometimes, weren't flawed," says Amero. "They certainly suffered [in the midst of the credit crunch], but they [were] still securities that we believed [were] fundamentally good." He points to the loans sold in connection with the $26 billion buyout of First Data Corp. by KKR as an example (although the company, as of early 2010, was recorded as incurring a loss for KKR itself).

Some investors couldn't react to the risks they identified. A bond fund mutual fund manager, for instance, has to invest in the kinds of fixed-income securities that are deemed permissible by the terms of the fund. But while such rules left many mutual fund managers in a bind, hedge fund managers had far more freedom of action. While raising capital, a hedge fund manager spells out the broad strategies that he intends to employ to generate returns in an offering document—a "long/short" or "event-driven" strategy, for instance—but he usually leaves himself with a lot of room to maneuver. So when John Paulson began to grow alarmed by what he believed was a credit bubble, all he had to do was decide how to profit from the recklessness of others.

Paulson, a former investment banker, decided that the subprime mortgage market was the part of the credit bubble that seemed the most overextended. He began using derivatives to short subprime mortgage securities in April 2005. It was the culmination of months of thought, analysis, and planning; the bigger any subsequent decline, the larger the profits Paulson's fund would capture. "We thought [this position] was a terrific risk-return tradeoff where you can risk 1 percent and make 100 percent," Paulson said in July 2007. "The exuberance in the credit markets and the massive liquidity was severely mispricing these securities."[5] That turned out to be the understatement of the decade. Paulson's Advantage Plus Fund returned 158 percent to investors in 2007 and another 37.6 percent in 2008, a year in which the Standard & Poor's 500 index fell 36.9 percent. The Credit Opportunities Fund fared even better, returning 600 percent to investors. Paulson himself pocketed an estimated $3.7 billion as his share of those returns; by paying heed to hidden sources of risk, suddenly he had become simultaneously a billionaire and a household name.[6]

If Paulson, working outside the mainstream investment banking community and relying on public information, could spot what was going on and take action, why couldn't Wall Street itself? Only a handful of mavericks such as Paulson spotted the opportunity to be a contrarian; few bankers seemed to have any sense of the risks associated with their own behavior and/or felt the need to act. Some of these were at Goldman Sachs, whose chief financial officer, David Viniar, convened a meeting in December 2006 to discuss subprime-related risks. The participants (who included risk managers) agreed they would kick off the new year by establishing a short position, a strategy that paid off richly for the investment bank and certainly contributed to its survival. Later, Lloyd Blankfein would attribute Viniar's initiative to what he described as Goldman's greatest "risk protection"—giving as much status, prestige, and compensation to the risk managers seeking to control the investment bank's finances as it did to the bankers and traders.[7]

For the most part, however, Wall Street seemed content to pursue its own peculiar brand of magical thinking. In the parallel universe

as imagined by investment bankers, risk was minimal and readily managed, the supply of cheap credit was endless, and buyers were eager and plentiful. Wall Street's willingness to act as if reality was what they imagined it to be generated a toxic combination of blind faith in its own ability to manage risk and willful blindness to what should have served as warning signals. The result would be the effective demise of three of the five largest investment banks (Bear Stearns, Lehman Brothers, and Merrill Lynch, the last of which opted to be acquired by Bank of America) in little more than six months in 2008. It also brought about the near collapse of Wall Street itself.

Wall Street's Magical Thinking

Key to Wall Street's magical thinking was its reluctance to look risk straight in the eye. Of course, until the summer of 2007, there were few obvious signs that the bull market in credit would have such cataclysmic consequences. Those who persisted in voicing discomfort about the pace at which deals were being done, at the lofty valuations or at the degree of leverage, might be proven right in the long run, but for now would be laughed at and shunned, and perhaps even lose their jobs.

"Even to someone with a lot of expertise in risk management, it was hard for us to envisage while we were absolutely awash in liquidity that the biggest risk we faced was the sudden evaporation in market liquidity," says Leslie Rahl, founder of the risk consulting firm CMRA, whose "workouts" have included many of the derivatives debacles of the 1990s. What seems obvious now wasn't at the time, she adds. "It seemed illogical not to just keep doing what had worked." After all, until early 2007, there hadn't been a bank failure in nearly three years. Even when Pittsburgh's Metropolitan Savings Bank collapsed in February 2007, there was no reason for magical thinkers to view it as anything other than an anomaly; only three institutions were shuttered by the FDIC that vear. the same number as failed in 2003.[8] And 2003 had turned out

to be a pretty good year for financial markets, they reasoned.

When Wall Street worried that it might be missing the warning signs of an extreme event that could threaten the financial system as a whole, the issue of a credit market bubble and subprime lending rarely served as the focus of those debates. Instead, risk managers at firms such as Lehman Brothers in 2006 worried about the impact of another terrorist attack like those of September 11, 2001, or of an epidemic of avian flu on global financial markets.[9] In contrast, the ultraliquid credit markets seemed unlikely to be the center of a financial markets disaster rivaling the 1929 stock crash in magnitude and significance. In the absence of any bank collapses and in the presence of record low bond default rates, the calculus made sense. Maybe there was a credit bubble out there, but bubbles can exist for a long time without bursting. An investor or banker who takes to the sidelines at the first hint of trouble can lose a lot of money and forfeit his credibility, the late 1990s had demonstrated only too clearly. Former Fed chairman Alan Greenspan wryly reflected on the relevance of that period, noting that "underpriced risk—the hallmark of bubbles—can persist for years."[10] (It took three years from the date Greenspan warned of "irrational exuberance" for the dot-com bubble to finally burst.)

Wall Street, by and large, wasn't listening to its risk managers. It wasn't doing its best to detect warning signs. While most experienced risk management professionals agree that the very time a business is booming is exactly the time to start worrying more about what risks might be going unnoticed (from excess leverage to the presence of a rogue trader), Citigroup's David Bushnell instead admitted to the FCIC that, in general, his risk management team actually boosted risk limits for a growing business. One of his team, Ellen Duke, later acknowledged that she didn't worry as much as she should have about the CDO business, in large part because she believed that the way the products were structured would reduce rather than increase the amount of risk. She confessed to being "seduced by structuring."

Wall Street seemed to be relying exclusively on a handful of quantitative risk-management models to save the financial system

from disaster. The immense forward leaps in computing power that had made possible the creation of complex derivatives and other structured products had also made it possible for mathematical minds to devise ways to track and calculate different kinds of risk across a multitude of different business segments rapidly and efficiently. Computers also made it possible to simulate shocks to the system and watch how markets behaved. These models had a kind of entrancing elegance to them, and that helped produce an unwarranted degree of confidence in the numbers they generated. What users of these models forgot is that simply being able to generate a number and label it "risk" didn't mean that the model's assumptions were correct, that the number was useful or would remain useful in all market environments—especially because a growing proportion of the securities that could swing most violently and trigger the biggest losses for their holders weren't publicly traded, but "over the counter" derivatives. The spread of derivatives made risk management a more complicated task. If an investment bank had shares of Cisco and General Electric on its books, for instance, the impact of a market shock would be relatively straightforward to calculate; those stocks trade on an exchange and have a clear market value. But only a fraction of the world's financial instruments are that easily monitored. What would happen to a corporate bond? They don't trade as often, and dealers in those bonds make a market in them on an ad hoc basis when a potential buyer or seller requests price information. Who would be willing to be an intermediary in times of market stress? And at what price? Then there are the derivatives, which also aren't traded on an exchange (except for the plain-vanilla variants, such as options and futures contracts) and which often are highly customized products that don't have a logical buyer.

That's just the very tip of the iceberg. Today's investment banks are global: their risks can be related to the trading they do with a Kazakh oil and gas company, the loans they make to a Thai retailer, or a buyout they finance of a Mexican food processing company by a European conglomerate. Throw a stone in the waters of global markets today and the ripples will take a more unusual shape and

stretch far wider than they would have a decade ago. Hence the allure of the quantitative risk management model in the eyes of investment bankers.

The Value at Risk Conundrum

The best-known of these models is the famous (or infamous) value at risk (VaR) model. "Essentially, that was the solution devised to the problem of a CEO who walked onto the trading floor and wanted a simple answer to the question of how much risk the investment bank was running today," explains Jaidev Iyer of GARP. "With VaR, you could give him a single number—how many dollars the bank could lose today if things went wrong." VaR vaulted into prominence when an international group of banking regulators, the Basel Committee on Banking Supervision, explicitly endorsed it as a way to gauge how much capital a financial institution is putting on the line, and thus to calculate how much capital it should set aside to shield itself should those risks backfire.

The result was the Basel II accord, first published in 2004, which required financial institutions to incorporate risk into their balance sheet decisions. In quest of additional profits, financial institutions pushed hard for a tradeoff: if they could demonstrate that they had all kinds of risk management models like VaR, then regulators would give them a break by relaxing requirements on how much capital they had to possess to guard against big losses. The tradeoff was alluring to the bankers; regulators would later argue privately that they had always had reservations but capitulated under relentless pressure from the industry. The balance had shifted: regulators now would, de facto, be more dependent on the banks' own in-house evaluation of the magnitude and nature of the risks the latter were running, despite the fact that those financial institutions had every incentive to underestimate those risks.

After a lot of debate—it took five years to hammer out the basic principles, and implementation still wasn't complete when the crisis broke—the signatories (including central bankers and other

regulators from twenty different countries) finally agreed that banks, investment banks, and other financial institutions could rely on VaR as a way to gauge risk. The lower the VaR, the less capital an institution needed to set aside to shield the firm from risk. But at the end of the day, no one was happy. "Nobody believed in it and nobody used it, except in the annual report and to tell regulators what was going on," says one former regulator. "Everyone in the regulatory community knew there were failings with this process. But at the same time, it had been so hard to agree on this, and so controversial, that no one who worked on Basel ever wanted to reopen the topic for discussion again."

The biggest problem with VaR—and with any other effort to model risk—is that while Wall Street may concern itself with numbers, human behavior is just as important a determinant of what happens there. And human behavior is notoriously difficult to quantify. But as VaR increasingly demonstrated throughout the Wall Street crisis, numbers didn't tell the whole story.

To start with, VaR couldn't give anyone an accurate picture of how well risk was being managed. For instance, the VaR associated with Goldman Sachs's sales and trading business was $101 million in 2007, meaning that on any given day, that was how much it might lose with a defined degree of probability. Goldman was second only to Citigroup in the amount of risk, and it also earned more in revenues than any other financial institution from those trading activities—$27.5 billion in 2007, up 21 percent from the previous year. On the surface, Lehman looks less risky in absolute terms. Its VaR was $92 million, and its revenues from sales and trading were about half of those at Goldman. But VaR doesn't tell the whole story. It was Lehman, not Goldman, that experienced the biggest increase in VaR (it more than doubled, the highest rate of growth of any investment bank in 2007), while it increased only 37 percent at Goldman Sachs. Moreover, the size of Lehman's VaR relative to that of its trading revenue was higher than the same ratio at Goldman. Moreover, Goldman lost money on fewer trading days in 2007 than in 2006; the number of days on which Lehman's traders lost money jumped from five in 2006 to thirty-three in

2007. Goldman made more than $100 million on each of eighty-nine trading days; Lehman pulled off the same feat on only thirty-one days.[11] In other words, VaR alone gives a hopelessly inadequate view of the two organizations' ability to manage the level of risk that they were taking. "It didn't tell you anything at all about the caliber of assets on the balance sheet connected with those risks, or the skill of the bankers and traders," argues one veteran banker and risk manager.

It didn't help that some of Wall Street's more aggressive CEOs were prodding their traders to take more risk and, like Stan O'Neal at Merrill, constantly asking the heads of various trading desks why they weren't taking on still more risk in pursuit of higher profits. Even as it increased, O'Neal was heard to expostulate that VaR was too low at Merrill, given the "real" risks and the bank's overall objective. Fixed income markets weren't cyclical anymore, O'Neal told board members; risk was a less risky concept. Not for a second did he contemplate the reverse theory: that the models no longer reflected reality.

The methodology used to calculate VaR is also problematic. VaR, like most other risk management models, is based on a series of assumptions, which in turn depend on probability and statistics. That means that VaR is shaped by what has happened in the past, and more specifically by what has happened most frequently. In some cases, there are a lot of data to draw on: the real estate market, for instance, has more than a century of reasonably reliable data, while the bond market has seventy or eighty years' worth. At the other end of the spectrum, risk managers can draw on only five years' worth of robust data available on credit default swaps, the newest breed of derivatives, which played a critical role in the market meltdown. VaR places more reliance on recent history than it does on the broad sweep of past events, but the biggest shocks have no historical precedent. As Greenspan sadly admitted to Congress, the models weren't designed around periods of maximum stress. Had they been, bank capital requirements would have been higher. Instead, Greenspan opined, "the whole intellectual edifice [of risk management] collapsed."[12]

VaR also relies on probability. The more frequently an event has occurred in the past, the greater weight it is given in VaR. (Another problem: the more time elapses between market crises, the fewer bankers and traders have actually witnessed extreme events; by 2008, only a tiny handful of former financiers recalled the events of 1929, and almost none of them were still working actively on Wall Street.) By definition, therefore, VaR discounts the risk associated with an extreme event such as the 1987 stock market crash or Long-Term Capital Management's collapse. But while those are statistically unlikely to recur, such "unknown unknowns" are exactly the events that are the most destabilizing and thus the most critical to risk managers. Nassim Nicholas Taleb became just as famous as John Paulson (if not as wealthy) following the publication of his book The Black Swan: The Impact of the Highly Improbable, which points out just how frequently those events occur. Before the rest of the world "discovered" Australia, all swans were white; every empirical observation over the course of millennia supported that proposition. And yet, as the discovery of the first black swan in the antipodes proved, it was a false theory.

It was what Lehman's risk managers couldn't imagine, because it was outside of the realm of their knowledge, experience, or the all-important data, that would lead to the firm filing for bankruptcy two years later. In Taleb's view, these "Black Swans" are far more common than we'd like to think, and the biggest risk management flaw of all is the fact that we are so reluctant to admit that there is no such thing as a perfectly functioning crystal ball. Could someone in 1900, with the knowledge that was available as of that date, have predicted World War I and its consequences, including the Third Reich and the rise of the Soviet Union? he wonders. Of course not. The knowledge of the future available to a citizen at the dawn of the twentieth century was as limited as ours is today. That has ramifications for trying to manage risk on Wall Street. "In finance," Taleb concludes, "people use flimsy theories to manage their risk and put wild ideas under 'rational' scrutiny."[13] Black Swans are, by definition, impossible to quantify until they have occurred and thus become knowable. by which time it's too late.

Those who rise quickly to positions of power on Wall Street these days tend to be people with strong mathematical skills and a natural quantitative bent, because that's what it requires to come to grips with the complex financial instruments that dominate today's financial system. These individuals gravitate to quantitative tools for help in understanding risk. When they spot a possible Black Swan rising like a storm cloud on the horizon, their first instinct isn't to ask themselves the most basic question: "What might this be? Is it something I recognize, or is it something new that is going to force me to alter the way I think about the world?" Instead they plunge into their comfort zone—quantitative analytics—to see if they can make sense of this mysterious cloud. By the time they realize they can't, that it's something new and very ominous indeed, it's too late.

Even after the collapse of Bear Stearns and Lehman Brothers, in which liquidity risk had played a major role, bankers still continued to focus far more attention on credit risk and operational risk than on developing methods for predicting whether liquidity is about to evaporate. Ironically, the level of risk associated with flawed models (including risk management models) was even less of a priority, something that only 58 percent of respondents attempted to manage, according to a survey conducted by accounting giant Deloitte in late 2008.[14]

Quantitative risk measurement and management tools will remain problematic as long as financial institutions have a vested interest in interpreting the results the way they feel best helps them continue to pursue profits at all costs. A firm with a high VaR can reassure itself that its traders are better than their rivals at managing that risk, so the level or rate of increase is nothing to be concerned about. Moreover, as long as that high VaR is accompanied by a jump in revenues and profits from taking the risks, what is there to worry about? For Sir Deryck Maughan, plenty. At an industry conference in December 2009, the British banker, now a partner at KKR, warned his colleagues that many of the mathematical models that had led financial institutions to discount or overlook what proved to be toxic risks were still being used. The industry, he said, had not "faced up to the intellectual failure of risk management

systems, which are still hardwired into many banks and many trading floors."

Above all, regulators still worry that the banks will try to compute VaR in such a way as to reduce their capital requirements. Since financial institutions can make money only on capital that can be used (and the leverage that they can apply while using that capital), the lower their capital requirements and the greater the capital they can use, the more likely the bank or investment bank is to generate an outsize ROE. That potential global competition to have the lowest possible capital, warned Sheila Bair, chairman of the Federal Deposit Insurance Corporation, in a June 2007 speech, "is a game with no winners." Bair worried that the Basel approach came too close to letting banks set their own capital adequacy standards, an approach she compared to letting each football player set his own rules in a championship match.

Bair's warnings, and her subsequent contributions to the debate over Wall Street's future, identify her as perhaps one of the most prescient Wall Street regulators of the last quarter century. At the time the Basel II signatories agreed to this approach, markets were unusually benign, volatility was at very low levels, and bank profits were strong and rising. That alone should make regulators think twice about what constitutes an acceptable level of capital, she cautioned. There is a "danger [in] thinking that banks will have enough lead-time to ramp up their capital as economic conditions deteriorate."[15] In light of the events of the next eighteen months, which included frantic and sometimes failed attempts to replace capital being eroded by write-downs, those remarks are striking. Bair, it seems, was able to do what Wall Street's best and brightest minds couldn't: envisage a day when the future might not be as rosy as the present. But then, regulators don't get bonuses for delivering profits to the banking industry.

The Lemmings, the Cliff, and the Laws of Physics

In 1831, well-trained English troops were marching in step across a

suspension bridge near Manchester when it suddenly collapsed. Those assigned to investigate the tragedy discovered that the reasons for the collapse were tied to the laws of physics. British soldiers were drilled rigorously until they could march impeccably in step, or cadence, as it's known. But when it came to crossing the newly designed suspension bridges, this pattern proved to be disastrous. In some cases, the cadence of the marching can match the natural resonance frequency of a suspension bridge; in those cases, even though each step adds only a tiny amount of energy, cumulatively the impact of so many marching soldiers in cadence puts so much stress on the structure that the result is devastating. Once engineers realized what was happening, they set about devising new kinds of alloys that would reduce the natural resonance of a bridge to the bare minimum. Meanwhile, military officials recognized that marching in step, however desirable in nearly every other circumstance, was a foolish risk to take when crossing suspension bridges; they began instructing their troops to break cadence when crossing bridges.

This famous example of one of the laws of physics at work has an uncanny similarity to Wall Street. A Wall Street institution's employees are trained to pursue ROE at all costs, almost blindly, in the same way that soldiers are drilled to march in cadence, until it becomes second nature. Neither group questions the nature of that training until something goes wrong. In both cases, the result is a high level of systemic risk that no quantitative model can capture until it's too late. Just as each soldier concentrated only on making sure his steps exactly matched those of his fellow soldiers ahead of and on either side of him, on Wall Street few people seemed to pay attention to anything beyond the transaction at hand and its role in maximizing their group's profits and the firm's return on equity.

The groupthink worried Myron Scholes, coauthor of the Black-Scholes valuation formula, which made it possible for options and all kinds of other complex derivative products to find a home on Wall Street. Scholes (whose formula is the subject of much scorn from critics such as Taleb, who argue that it makes risk appear too understandable and too quantifiable) points out the inherent

riskiness of ignoring systemic risk. “Any one bank can measure its [own] risk” using models based on Black-Scholes or other research, Scholes notes. “But it also has to know what the risk taken by other banks in the system happens to be at any particular moment.”[16] In other words, just as no drill sergeant today would insist that his soldiers march in cadence at all times, regardless of the circumstances or the terrain, no financial institution can afford to ignore the possibility that what appears to be a riskless transaction in isolation can create risk to both the institution and the system if it’s repeated endlessly across Wall Street. One bank doing subprime CDOs wasn’t going to torpedo the financial system, but the banking system en masse cranking out so many subprime CDOs that subprime lending became the tail that wagged the dog came perilously close to doing just that.

That kind of copycat behavior also damaged regulators’ efforts to rein in risk, recalls Sheila Bair. The banking regulator had a “peer intervention” analysis that was designed in the expectation that one banker had a better chance than a regulator of figuring out if another banker was taking on too much risk. The problem was that so many institutions were doing exactly the same thing, and the problems weren’t flagged. Everyone was doing it; it was the new normal and everyone was making money doing it. No one caught on to the risk management flaw, Bair told the FCIC commissioners, “until the risky activities undertaken by all became unsustainable.”

Wall Street needs to break out of its old ways of thinking about risk and leave behind the notion that it can always be identified, quantified, and controlled. What is needed more than a risk management system is a risk-aware culture, as Deloitte advocated in its survey. Those institutions the accounting firm spoke to in the latter months of 2008 were already aware that their risk management programs weren’t doing a good job for them. Fewer than half of the respondents believed that those risk programs offered “significant value”; nearly a third told surveyors that risk management didn’t generate any value when it came to either boosting the quality of their earnings or improving risk-adjusted returns. Only 38 percent believed their risk management systems

helped limit losses when risks rose to the surface.[17] Indeed, almost the only area in which financial institutions felt that risk management programs were of significant value was keeping regulators happy.

Alan Greenspan may blame models for risk management failures, but it was human beings who devised those models, established their core assumptions, and then interpreted the results. As Sheila Bair had feared, there were ample incentives for misreading the level of risk in the financial system. Not surprisingly, most of them revolved around the two core drivers of everything else that happens on Wall Street—fear and greed. In this case, the fear was of being left behind in the battle for market share, profits, and return on equity, while greed was the allure of outsized bonus checks in exchange for taking risks and discounting the lurking presence of a Black Swan event that couldn't be quantified anyway. In presenting the final FCIC report in late January 2011, panel member and former CFTC chair Brooksley Born pithily described what followed as risk management turning into "risk justification." When the upside payoff was potentially enormous, and the downside risk looked slight in terms of probability if not impact, then why not just set the real warning signals to one side, quietly, safely out of sight? In any event, the only way to rein in risk taking, many risk managers argued, was itself behavioral. "Top managers and directors need to keep asking how the bank is making this money, whether the business is sustainable, what assumptions is the risk taking based on, can we get clear and accurate and objective information on the business and its risks," argues one banker turned risk consultant.

"Risk models always are a bit deceptive," says Leslie Rahl, the veteran risk manager at CMRA. Let's say there are two portfolios, one of which is full of complex structured products while the other contains only plain-vanilla securities such as stocks and bonds. Both are run through risk management models that show that they have an equal level of risk—something that can happen in periods of prolonged market calm. Rahl says the response should be not to heave a sigh of relief and move on but to become concerned and

ask more questions about why two such disparate portfolios could appear to possess such a similar risk profile. "Until we come up with better methodologies, we have to find a way to adjust what the models say for the elements that the models can't capture," she points out.

Wall Street also needs to find a way to question its own assumptions, not just the conclusions drawn by models. The crisis we have just lived through wasn't as impossible to predict as some Black Swan theorists might argue. The risks associated with subprime lending were clear; as a study by Federal Reserve economists on the crisis showed, many Wall Street analysts correctly predicted that a slump in housing prices would batter subprime loans and the CDOs that contained them. But they ascribed a low probability to that ever happening.[18] "For fifty years, housing prices nationwide had always gone up, even if just a little bit," notes Michael Stockman, formerly a banker at UBS who now advises clients on portfolio construction as a managing partner of Corridor Quadrant. True, there were regional housing slumps, but one of the reasons that bankers felt comfortable giving mortgages to subprime borrowers was their confidence that even if they weren't good credit risks, the value of their collateral—the house they bought—would never deteriorate. Even movements in major real estate indexes were referred to as "appreciation," Stockman notes wryly. "No one could imagine depreciation." Indeed, when prices did fall, the move was dubbed "negative appreciation."

In medicine the adage that doctors first and foremost should do no harm causes physicians to second- and third-guess their original assumptions and send patients to other doctors for additional tests and second opinions. With no professional standard of that kind on Wall Street, there was no motivation for anyone within AIG's head office to query the results that its London-based division, AIG Financial Products, was posting. Between 1999 and 2005, the division's revenues soared 342 percent, to $3.26 billion, as its financial engineers delved into the business of selling insurance to investors in CDOs in the form of credit default swaps. The business proved so successful that by 2005, AIG Financial Products was

generating 17.5 percent of AIG's revenues, up from 4.2 percent in 1999; profit margins on the business had nearly doubled.

Across AIG, there seemed to be the will to believe that this business would be the insurance world's version of the Internet, an innovation that would utterly transform its business by enabling savvy firms such as AIG to sell insurance against credit risk in the same way they insured people against hurricane damage or death. Investors paid their premiums, just as someone buying fire or life insurance did. Because the CDOs AIG was insuring carried top-tier credit ratings, the firm didn't need to worry about setting aside capital to make good on the insurance claim. AIG figured that if CDO quality began to deteriorate, it would be able to respond. In fact, the calls for the firm to post collateral in connection with the slumping values of CDOs mounted faster than AIG could cope with; the firm had forgotten that it's the things that you fail to worry about or assume aren't risks at all that prove most toxic in the long run. AIG's de facto collapse and the more than $100 billion in bailout funds provided by the Treasury Department to keep it at least nominally afloat and prevent its collapse from fatally damaging every financial institution with which it had had dealings is one of the most clear-cut examples of what can happen when Wall Street stops thinking sensibly about risk on both an enterprise and the systemic level.

Enlightened self-interest may not be working to curb excessive risk taking. But Wall Street can't simply pass the buck, either, demanding that others perform this governance and risk management function on their behalf. For starters, it's by no means clear that regulators will do a better job; these days, some of them are likely to be the same former Wall Street risk management executives that stood by, oblivious, as the storm gathered and struck them.

Michael Alix, for instance, trumpeted the resilience of his risk management models and celebrated his risk management system's ability to ensure that Bear Stearns didn't hold too many risky securities at the same time in an interview with a BusinessWeek reporter back in 2006. Even when the markets were falling in

response to a rise in interest rates, a computer screen full of flashing red lights (signaling securities whose prices were declining) didn't alarm him, he bragged. "The machine works!"[19] Less than two years after Alix was named head of risk management at the firm, Bear Stearns proved definitively that the machine didn't work: it hadn't anticipated all the problems that Bear would face or the extreme market conditions.

In one of the irony-rich moments of the Wall Street crisis, Michael Alix himself went on to be named vice president of the New York Federal Reserve's Bank Supervision Group in October 2008, at the heart of the crisis. The appointment raised eyebrows and prompted some scathing comments across Wall Street, where Bear's former rivals were fighting to survive and figure out what to do next. But then, to many observers it was already clear that, far from helping Wall Street to rein in its worst instincts, regulators of all kinds—from the SEC down to the rating agencies—either were unable or unwilling to act or were even more oblivious to the risks than Wall Street itself. Wall Street may have been dancing as long as the music kept playing, in Chuck Prince's words. But to many it seemed as if the central bankers and securities regulators were calling the tunes and turning up the volume.

CHAPTER 7

Washington Versus Wall Street

The story of James Gilleran and his chain saw has become one of the most infamous in the growing annals of regulatory mismanagement of Wall Street. It dates back to the early summer of 2003, long before anyone on the Street realized that there was anything alarming going on in the real estate market, much less in the business of turning subprime mortgages into triple-A-rated packages of securities. Banking regulators were gathering to proclaim their support for the Bush administration's decision to reduce the regulatory burden that made it harder for the institutions they supervised to extend as many loans as they wanted. Gilleran, who had been named to head the Office of Thrift Supervision (OTS) in 2001, knew a great photo op when he saw it. At the press conference, he was one of four banking regulators to pose for dramatic effect behind a stack of paper representing regulations governing the lending business, all wrapped up in red tape. The other three regulators brought garden shears to demonstrate their willingness to attack the problem. In the photograph, Gilleran sported the biggest grin and the biggest weapon: a chain saw.

But then, James Gilleran had a lot of motivation to make his corner of the regulatory jungle happy by cutting red tape: the prospect of millions of dollars a year in fees from institutions that elected to operate a savings and loan institution, or thrift, as these entities are known. Just as the investment banks had every incentive in the world to maintain the lowest possible amounts of capital on their books, so many regulators—especially smaller, newer, and less well-known entities such as the OTS—had a built-in reason to lower their regulatory standards and overlook risky

behavior on the part of their regulatees in an effort to woo and retain "clients." Anyone familiar with the basic rules of organizational behavior could have predicted this would happen. OTS's budget depended on the number of institutions it regulated. The more institutions it could attract under its regulatory umbrella, the better it would fare, organizationally speaking. On the other hand, if it adopted a regulatory stance that its "customers" viewed as unduly harsh, a number of thrifts might suddenly decide that they were really commercial banks at heart and thus subject themselves instead to the oversight of the Office of the Comptroller of Currency (OCC) and the Federal Reserve.

This was exactly the kind of development that the FDIC's Sheila Bair had feared—that lax regulation and a less-than-rigorous approach to risk management would cause the lowest common denominator to triumph. Gilleran kept slashing away at both regulations and his own ability to enforce whatever ones remained on the books, in hopes of wooing more "clients." Even as the mortgage lending business—a big part of the savings and loan industry—swung into high gear, Gilleran's chain saw whirred into action: the OTS honcho cut the size of his staff by 25 percent.

OTS-regulated institutions became the biggest providers of the mortgages that would end up contributing most to the subprime meltdown, such as option ARMs (adjustable-rate mortgages), but complaints about predatory lending didn't seem to register on Gilleran's radar. As is now well known, it was during Gilleran's tenure that the worst of the flawed mortgage products made their debut; complex loans that borrowers didn't understand committed them to larger mortgage payments than they would be able to make. Only reluctantly did OTS later sign an OCC-orchestrated pact to halt the practice.

John Reich, who took over the helm of OTS from Gilleran in 2005, showed nearly as much zeal as his predecessor had done in the quest to make the organization the regulator of choice for America's financial institutions. His publicly voiced concern about the risk that overregulation would penalize both lenders and borrowers and keep Americans from the dream of owning their

own home must have been music to the ears of Angelo Mozilo, CEO of Countrywide Financial.[1] By 2005, Mozilo was a bit fed up with having to account for all his actions to the OCC. The latter, as the Washington Post later reported, didn't want Countrywide's senior officers deciding which appraisers should be chosen to calculate the value of the properties against whose value Countrywide was lending money and structuring mortgages. Logically enough, the OCC feared that that presented a conflict of interest: appraisers might come back with inflated valuations that would allow Countrywide to write more loans and pocket more fees from selling them (and the risk they entailed) on to investment banks and commercial banks to be repackaged into CDOs. In

2006, Mozilo decided to leave the pesky OCC behind and to become a thrift, subject to the more benign regulation of the OTS. Its new regulator had, Countrywide executives later said, promised to take a more "helpful" view of the appraisal selection process.[2] It proved to be a classic example of what became known as regulatory arbitrage.

Indeed, it wasn't a coincidence that OTS ended up as the regulator of choice of many of the financial institutions that took on the greatest risks in subprime lending and would later pay the ultimate price for their risk management failures and the regulatory shortsightedness of Gilleran and Reich. For years, the OTS's single most important client was Washington Mutual (WaMu), the feisty thrift that had built up a nationwide banking network and was writing mortgage loans as fast as it could. The OTS certainly didn't want Washington Mutual to leave its regulatory embrace. Perhaps that was why its regulators allowed the institution to slash the amount of capital it allocated against possible future loan losses more and more with each year that passed, even when it became clear that the risks associated with the real estate business and mortgage lending were rising. By the summer of 2005, loan loss reserves at WaMu were a mere $48 for every $10,000 in mortgage and personal loans, about 25 percent below the already low average level for savings and loan institutions regulated by OTS.[3] Not surprisingly, in what would prove to be their final fiscal year as

independent institutions, fees paid by Washington Mutual and Countrywide together accounted for nearly a fifth of the OTS budget.

One of the other institutions of which the OTS ended up as a major regulator was AIG, the giant insurance company that would become one of the biggest casualties of the Wall Street mayhem. As an insurance company, AIG was regulated by state agencies rather than federal banking or securities regulators. But it owned a savings and loan institution, and that meant the OTS received all the financial information about the company's operations. The OTS had warned AIG's board that its risk management procedures were full of holes. Nonetheless, when Federal Reserve officials put in a series of emergency phone calls on the critical weekend in September that led to the Lehman Brothers bankruptcy and the sale of Merrill Lynch, their OTS counterparts sounded downright bewildered to hear from them.

The OTS was unaware of the fact that within the next two weeks AIG would face a demand for nearly $40 billion in cash from its counterparties to offset the declining value of the securities it had posted as collateral. The losses were in AIG's financial products division, which wasn't regulated by the OTS; still, given the magnitude of the obligation, they would certainly wreak havoc on the company's insurance and thrift operations. That would be even more true if, as seemed likely, AIG had to file for bankruptcy as a result of the losses. (Such a filing was averted only at the last moment by one of the largest direct infusions of government cash of the entire crisis.) The OTS couldn't even begin to help its fellow regulators unravel the mess; the Fed decided instead to summon AIG's CEO, Robert Willumstad, to help it understand the magnitude of the problem.[4]

The OTS approach to regulation ended up as the focus of an audit report by the Office of the Inspector General at the Treasury Department. The latter concluded that OTS-supervised thrifts were able to file misleading statements about their financial position, in particular the amount of capital they held on their books. While IndyMac—which collapsed in July 2008—was responsible for its

own fate, the report says, the OTS had an opportunity to rein in the institution's hyperaggressive lending as early as 2005, when cash flow problems first surfaced.

The report is a review of several occasions on which the OTS permitted the institutions they regulated (including IndyMac) to backdate new capital infusions into the mortgage lending institutions, making their balance sheets look more stable than was really the case. In the case of IndyMac, that made the thrift look healthy only two months before the FDIC had to step in, close the doors of the suddenly insolvent institution, and reimburse its depositors. Even though at times IndyMac's thinly staffed regulator had up to forty people peering over the shoulders of the thrift's managers, the Treasury Department's forensic accountants concluded that they all either missed or didn't care about IndyMac's reckless behavior. (This included failing to verify that developers it was lending to had nailed down funding for all their projects and not overhauling its lax appraisal process for residential mortgages.) What did matter to OTS? "Growth and profitability [were] evidence that IndyMac management was capable" of managing their business and its risks, the report's authors concluded.[5]

Of course, other regulators weren't exempt from this.

Playing the Blame Game

When Wall Street's misaligned compensation policies set up incentives almost guaranteed to wreak havoc on the financial system, and when its internal risk management systems and models failed to work the way everyone believed they would, the theory was that the regulators and legislators—"Washington," for short—should have been able to prevent, control, or manage the crisis. After all, the raison d'être of the entire regulatory system is to serve as a last-ditch line of defense, one protecting the integrity of the financial system from Wall Street's worst instincts, referred to on the Street itself as "animal spirits." It was logical that investment banks were cheerleaders for their own interests. But the financial system

needed its own team of cheerleaders—or guards—and that role is supposed to be played by the regulators. These groups, including the OTS, were established to protect the health of the system, because of the importance of the money grid to the economy and even to society as a whole. They weren't there to help individual businesses maximize their returns or to promote the philosophical concept of free enterprise.

Chuck Prince, the CEO of Citigroup until his ouster in the fall of 2007, might insist on continuing to dance to the music that he heard. But it was a regulator's job to ask whether the music that he claimed to hear was real or playing only in his head. And if exhausted musicians were collapsing one by one on the stage even as the Wall Street CEOs continued to polka, then the task of a regulator was to step in and declare that the party was over. A well-functioning regulatory system is one that is able to detect when the music is out of tune, when half the musicians can't keep up with the dancers, and when the dancers are cavorting to imaginary tunes.

On an unseasonably warm and balmy St. Patrick's Day in 2009, exactly a year after the collapse of Bear Stearns began the final chapter in the meltdown, some of Wall Street's survivors headed to the Upper East Side of Manhattan. They were bound for Rockefeller University's Caspary Auditorium, site of a sold-out Oxford-style debate about the causes of the financial crisis, sponsored by Intelligence Squared, a nonprofit organization backed by a hedge fund manager, Robert Rosenkranz. The resolution up for debate that evening: "Blame Washington more than Wall Street for the financial crisis." If it weren't for the occasional splash of green in the audience, no one would have known that the day was one that other New Yorkers were celebrating. In contrast to Intelligence Squared's other monthly debates, audience members hadn't come to this one to be entertained or even educated. They were cross, worried, and anxious; they wanted to vent. "I just know that I wasn't responsible for all this mess," said a twentysomething laid-off banker who gave his name only as Pete, his anger palpable. "We're the most hated guys out there. No one believes us. Even the president tells us we're shit. Come on! It can't be all about Wall

Street!"

Indeed it can't, economic historian Niall Ferguson reassured Pete and others like him at the beginning of the debate. Ferguson admitted that he hadn't come to praise or defend bankers. "We blame them for much of what has gone wrong," he told the audience. "It's just that we blame the politicians more." The Wall Street hometown audience erupted in laughter and cheers; declaring open season on Washington is universally popular. As for Citigroup's Prince, who claimed Wall Street had no option but to get up and dance, Ferguson pointed out slyly, "You have to ask yourselves, ladies and gentlemen, who was playing the music." Why, the historian wondered, do politicians love to point their fingers at financiers in times of trouble? "Could it just possibly be that they're trying to divert our attention away from Washington's own responsibility for the debacle?"

The possibility that the fatal flaw lies outside Wall Street itself is a comforting one to many financiers, especially as they confront the specter of heavy regulatory reforms. "Blaming Wall Street is like blaming the atmosphere for thunderstorms," exclaimed John Steele Gordon, part of Ferguson's debate team arguing in favor of the motion. Street "panics" happen periodically, he pointed out. "It's the nature of the beast." On the other hand, Washington regulators are "supposed to be the guys with the striped shirts and the whistles on the playing field. They make up the rules, and then they enforce them. And then they sometimes change the rules in order to accommodate some of their friends."[6]

It was an uneven contest: Ferguson and his two allies won the debate hands down, helped in equal parts by their debating skills, Ferguson's charm and Scottish accent, and the audience's determination to heap more of the blame on Washington, an attitude that reminded some observers of the age-old children's protest about being punished for a misdeed: "But, Mom/Dad, he made me do it!" Certainly, those New Yorkers seemed ready to believe that Washington made them do it: before the debate, 42 percent of attendees had voted in favor of the motion that Washington was more at fault than Wall Street, but two hours of

debate later, 60 percent agreed with the proposition. Nearly ten months later, a somewhat cooler-headed Jamie Dimon insisted that, on the contrary, the buck stopped with Wall Street. "I do not blame the regulators," he testified before the FCIC hearings in January 2010. "The responsibility for a company's actions rests with the company's management." But there were still many to disagree with Dimon, to question whether Dimon believed his own argument, and to argue that Washington had actively urged Wall Street to pursue risky strategies, or at least served as an enabler of sorts.

Awarding the lion's share of the blame for the financial system's near meltdown to Washington rather than Wall Street is tempting, but it's also overly simplistic. True, Wall Street's regulators didn't try very hard to rein in the festivities at the height of the boom; some, such as Gilleran and the OTS, seem to have egged their constituents on to greater follies. But by the time the crisis was taking shape, the ability of regulators to fulfill their traditional role of protecting Wall Street's core functions—the smooth transfer of capital from those who had it to those entities that needed it—had been steadily eroded by several decades' worth of policy decisions. These culminated in a dysfunctional regulatory system that was rarely able to move beyond the nuts and bolts of each individual decision—separating research and investment banking divisions, moving to decimalization in trading systems, banning an "uptick" rule, promoting home ownership, fighting the prospect of an economic slump by keeping interest rates at rock-bottom levels for years, allowing parts of the financial system to shop for their own regulator—to focus on the big picture.

And when the big picture was mentioned, that picture wasn't one of the maintenance of a financial utility. No one discussed whether those initiatives contributed to the long-term health and stability of the financial system. Regulating other utilities is relatively straightforward, in both theory and practice, in part because there's a general acceptance among all interested parties that there is a broad public interest in having a reliable source of gas or electricity and an ample supply of clean water. (That's particularly true

because most regulatory agencies are established to police the behavior of monopolies or oligopolies providing services that society deems to be essential.) Even the managers of power plants and water companies that might have an interest in keeping costs low and maximizing profits know that they will personally suffer alongside everyone else in the community if those financial goals result in the power grid collapsing or the water becoming contaminated.

When it comes to Wall Street, however, the picture is far blurrier, and not just because no single Wall Street institution can lay claim to monopoly or oligopoly status. Wall Street isn't a business like any other; it can't be compared to retailers such as Walmart or consumer goods manufacturers such as Colgate-Palmolive. Even critics of excessive regulation will admit, especially after the events of the last few years, that all members of society have a vested interest in the survival of the financial system that can't be compared to even those giant corporate entities. (After all, we can always go shopping at Target.) Anyone who quibbles with that may want to discuss their views with the citizens of Iceland, who saw their own money grid almost completely disappear; some Icelanders returned to fishing to keep food on the table as the country's three McDonald's franchises closed their doors—good for the country's nutrition, doubtless, but a blow to its economy and psychology. It's deceptively easy for anyone to decide what makes for a good regulatory outcome in other utilities (clean water flows through the water pipes; electrical power is delivered when needed and in the quantity required to meet the demands of even the hottest summer days), and a failure is equally easy to spot (a blackout, for instance).

But on Wall Street, what makes for a good regulatory outcome is far more nebulous. Even the events of 2008 are subject to debate. Did they signify the failure of the regulatory function, because several major institutions collapsed, others required hundreds of billions of dollars of taxpayer capital to survive, and the entire money grid came within a fraction of an inch of the brink of disaster? Or was it a success, because legislators and regulators were

able to pull together in a remarkable last-ditch effort in the worst days of the autumn of 2008 and rescue the most systemically important institutions, those deemed too big to fail? The definition of a good regulatory outcome is equally subjective. Ask an investment banking shareholder, and he will likely reply that a hands-off approach by regulators that allows the companies whose stock they own to capture a bigger market share and maximize their profits is the most desirable system. Corporations want a system that provides them with low-cost access to capital, even when the transactions that they seek to complete are ones that are uneconomic for Wall Street to undertake. Money managers and individual investors want a system that protects them from Ponzi schemes and other abuses.

The very disparate views of the goals of financial market regulation were part of the problem. Another major reason that the financial system would be left unguarded and unprotected (in the eyes of some, at least) at a crucial juncture was the fact that to many on Wall Street, the laudable goal of protecting the money grid required tolerating the intolerable: government intervention. By the dawn of the twenty-first century, the kind of deregulatory fervor that James Gilleran displayed in taking a chain saw to symbolic and actual red tape wasn't an anomaly but part and parcel of the political and regulatory ethos in the United States.

For government intervention in the shape of regulation to be acceptable, the proposed rules must be able to clearly demonstrate their value in advance, this camp argued, a burden of proof that was hard to meet. The FDIC's Sheila Bair admitted that when banking supervisors had to rely on judgment, the absence of clear reason for concern—such as losses from the risky activities—made it difficult to intervene. "Without hard evidence that the activities were creating unwarranted risk," trying to clamp down on risk taking would have been a provocative move, Bair suggests. (It would also have ignited a firestorm of controversy: Why were regulators seeking to meddle in a profitable business run by talented professionals?) "In retrospect, it is clear that supervisors were not sufficiently forward-looking in identifying and correcting

imprudent risks," Bair testified at the FCIC hearings. "Current profitability alone is not a sufficient measure of safety and soundness." Indeed, profits—particularly the kind of record profits posted in the six straight years between 2001 and 2006—can be a red flag alerting a vigilant regulator to risky business. Only briefly, in the aftermath of the chaos made worse by the simultaneous failure of incentives, risk management, and regulation, was it philosophically acceptable to talk about preemptive regulation—protective regulation—once more.

Washington and Wall Street have coexisted uneasily for as long as there has been an independent national government and a national financial system. As long as financial markets have existed, what happens within them has consequences not only for the financiers but also for citizens who are far removed from Wall Street and who would be hard-pressed to distinguish a stock from a bond when asked to do so, much less define a derivative. The current crisis has wrecked the national economy of Iceland and caused havoc in German towns; everyone from marketing executives at consumer product firms to managers of geriatric nursing homes has had to rewrite frantically budgets to cope with the financing crisis that ensued. New college graduates, retirees, and entrepreneurs have seen their dreams shattered. Some economists calculate that the cost of the current crisis may reach as much as $4 trillion. That is a high price to pay for the de facto failure of governance, risk management, and regulation. American citizens, regardless of their level of wealth or personal opinions on the merits of regulation or government intervention, will end up paying for the government bailouts of Wall Street institutions and regulatory shortcomings in the form of higher taxes or lower government spending on other projects for years to come.

Deregulatory Fervor and Unintended Consequences

It shouldn't have been this bad. In the wake of the 1929 market crash and the nationwide depression that followed a wave of bank

failures in the 1930s, politicians recognized the impossibility of controlling the fear-and-greed cycle that has governed financial dealings for centuries. People, left to their own devices, will fuel future bubbles, they knew, whether the focus of runaway speculation was tulip bulbs or railroad stocks. But, they reasoned, the federal government could put in place a set of institutions whose function was to take a pin to those bubbles (or even find a way to let the air gently out of them) before they could become so big that when they burst they would wreak havoc on the entire system.

In the 1930s, a battered and disgraced Wall Street had little ability to object to the array of reforms and regulatory measures introduced by Washington. When Congress passed the 1933 Glass-Steagall Act mandating the separation of commercial banks (entities taking deposits from individuals and businesses) from investment banks (those banks engaged in the riskier business of trading or raising capital via the debt and equity markets), even J. P. Morgan's heirs bowed to the inevitable. In September 1935, a clutch of J.P. Morgan office boys pushed eighteen heavy wooden rolltop desks out the doors of 23 Wall Street, the building at the corner of Wall and Broad that the financier had occupied from the day it was built until his death in 1913. They shoved them up a slight incline, past the New York Stock Exchange on their left, to the doors of a newer building at the corner of Wall Street and Broadway. A new investment bank, Morgan Stanley, had been born, in response to Washington's demand for risk reduction.

But Wall Street was never comfortable with the extent to which regulators restricted its collective ability to seek out new sources of business and profits. Every time a financier was blocked from doing something new and creative, he chafed at what felt like senseless and burdensome regulations. With the passage of decades and the disappearance of those who could all too vividly recall the horrors of the crash and the Depression, even rules like Glass-Steagall seemed increasingly unnecessary. With the transformation of Wall Street's business during the 1970s, and in particular as increasingly powerful competitors arose in Europe and Japan, Wall Street's

leaders began viewing regulation as not only something that blocked their firms from earning as much as they could, but something that would lead, inevitably, to the loss of market share to overseas rivals and the erosion of Wall Street's unquestioned dominance of global markets. Banks such as Deutsche Bank and Credit Suisse didn't have to worry about Glass-Steagall, they fretted. They had giant balance sheets, the likes of which Morgan Stanley, Goldman Sachs, and Salomon Brothers could only dream about. Happily for Wall Street, this growing disgruntlement on its part coincided with the rise to power of a group of politicians with a distaste for regulation that, if anything, exceeded that of the financiers.

Ronald Reagan's vision of America harkened back to a golden age of sorts, around the dawn of the twentieth century, when American lives were lived around the town square and the country store, where the Fourth of July was celebrated sedately and joyously with picnics of fried chicken and blueberry pie followed by fireworks after dusk. Free enterprise was part of being a free man or woman, in this worldview, and Reagan had an apparently endless series of witty and damning bons mots about the evils of government intervention. "The nine most terrifying words in the English language are, 'I'm from the government and I'm here to help,' " Reagan quipped on one occasion. As for the government's view of the economy, that was easy to summarize: "If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it." Reagan's view of regulators themselves was equally jaundiced. "The best minds are not in government," he declared. "If any were, business would hire them away."[7] Reagan's philosophy resonated deeply on Wall Street. Freedom, the new president proclaimed, was a core American value. Didn't that include the freedom from regulation for those on Wall Street?

Free market fundamentalists, as George Soros dubbed them, rose to power in the Reagan era but weren't confined to the Republican Party. When the Democrats took control of the White House and (briefly) Congress in 1992, policy toward Wall Street continued to revolve around deregulation, with few interruptions. (Robert Rubin,

who later prodded Citigroup's bankers to take more and more risk at the height of the bubble, was a Goldman Sachs alumnus appointed by President Clinton to run the Treasury Department; not surprisingly, he advocated a hands-off approach to regulating Wall Street.) The free market fundamentalists argued that the managers of Wall Street's financial institutions were the people best suited to understand what was going on and to identify the real risks. And they had incentives to be prudent: if they weren't, investors and analysts would hold them to account. Missing from that analysis were the facts that Wall Street leaders also had an incentive to downplay the risks they identified, that their shareholders had a tendency to view a half-empty cup as two-thirds full, and that analysts were justifiably wary of the career risk associated with slapping a buy rating on any stock, much less on a Wall Street power player.

Increasingly, policy makers and legislators seemed to overlook the fact that an underregulated Wall Street could create havoc that wasn't confined to the financial system itself but stretched well into the broader economy and society. In other words, it wasn't just their own fate for which Wall Street firms were responsible. In the same way that a pharmaceutical company that didn't test its drugs properly (and didn't have an effective FDA overseeing those tests) would not only blow itself up but cause active harm to the general public, so the collapse of a Wall Street firm could have far broader consequences.

History spelled out the message quite clearly. The nineteenth century was punctuated by a regular series of panics on Wall Street: one in 1819, another in 1837, and still another in 1857. The Panic of 1873 (caused by a toxic combination of events that ranged from the railroad bubble to the effort by financier Jay Cooke to corner the gold market and his subsequent bankruptcy) led to a six-year-long national depression; the conflict between labor and management that followed it lasted well into the twentieth century and can be traced back to the decision of President Rutherford Hayes to use troops to break a strike by railroad workers. (Scores were killed.)

The 1873 crash caused bankruptcies across the United States and put an end to post–Civil War Reconstruction in the South; there was no money to continue political and economic reforms, meaning that African Americans in many former slave states were forced to wait another century to exercise their right to vote. The 1873 panic was followed by a boom revolving around more railroad speculation—which in turn produced yet another panic in 1893. That financial and economic crisis caused mayhem in eastern and midwestern manufacturing centers and sent displaced workers drifting westward to populate western cities from Portland to San Diego. One nineteenth-century panic caused the collapse of more than a dozen railroads; a later one was responsible for the demise of some six hundred banking institutions. In all cases, leverage was one of the culprits.[8]

Then came the Panic of 1907, an event that offers some uncanny parallels to the events of a century later: the complete disappearance of liquidity from financial markets, the collapse of one of Wall Street's largest financial institutions (the Knickerbocker Trust Company), the phenomenon of contagion as the crisis rippled through the system from one financial institution to the next, and the unwillingness of New York banks to extend even short-term credit.[9] Only the intervention of J. P. Morgan himself, playing the role of the then nonexistent Federal Reserve, saved the day. Summoning Wall Street's best and brightest to his Wall Street offices, he commanded them to cough up $25 million in the next ten minutes to keep the stock exchange open or watch the financial system itself collapse. Within half an hour of the arrival of the first banker at Morgan's offices, $23.6 million had reached the stock exchange; liquidity had been restored.

Morgan had saved the day, but his actions had created two separate sources of concern that led directly to the creation of a regulatory institution that could fill the role that Morgan had: the Federal Reserve. There were widespread fears that Morgan's power—so dramatically revealed—could be misused. Those who didn't worry about Morgan himself were concerned that after his death (which came in March 1913, months before the Fed's creation)

there would be no other single individual with the same blend of skill, judgment, power, and force of character to perform the same function in the event of future panics. A regulatory agency was the solution that addressed both sets of concerns.

The chain of events that began in the summer of 2007 reminded even die-hard free market fundamentalists that in the midst of financial panics, regulation and regulators had their uses. Henry "Hank" Paulson, the former CEO of Goldman Sachs, had pleaded for years that Wall Street be allowed to regulate itself. Appointed Treasury secretary in 2006, he remained a staunch advocate of free financial markets. "An open, competitive and liberalized financial market can effectively allocate scarce resources in a manner that promotes stability and prosperity far better than governmental intervention," Paulson told an audience at the Shanghai Futures Exchange in the spring of 2007, a speech that was seen by global economists as part of an ongoing campaign by the United States and U.S.-based financial institutions to persuade China to follow their lead at a faster pace.[10] (China had already introduced new products such as foreign-exchange derivatives contracts and expanded its bond market, but it was slower in developing its asset-backed securities market and still imposed constraints on the local activities of U.S. financial institutions.)

Within eighteen months, Paulson was down on one knee in front of Nancy Pelosi in the Oval Office, begging for her help to get Congress to pass an unprecedented bailout package, one that would involve massive government intervention, to save the financial system from disaster. Meanwhile, the effort to preempt global competition had begun to look like an academic exercise. For now, at least, giant financial institutions had to worry more about surviving than about losing market share. And in China, local regulators were learning a lesson that their U.S. counterparts might have absorbed in 1873, 1893, 1907, or 1929. "Financial innovation is a double-edged sword," Fan Wenzhong, deputy head of research at the China Banking Regulatory Commission, said at a September 2008 conference in Beijing. "We can't just concentrate on product innovation and overlook the need to build the financial system."[11]

But by the time Paulson learned that regulators and legislators (however flawed the individuals themselves might be) might have their virtues when it came to serving as a counterweight to the worst excesses of Wall Street's "animal spirits," it was late in the day. The regulatory framework had been established early in the twentieth century as a way to prevent another financial markets panic. But over the last twenty-five years, either the power of regulators to act had been curtailed or those individuals installed at the helm of regulatory agencies were unwilling to act.

Even if the new breed of regulators installed by the deregulatory zealots could bring themselves to admit that something more than just another normal market hiccup was taking shape, their hands-off philosophy left them powerless and paralyzed. Just as bankers used magical thinking to reassure themselves that the heavy winds and choppy seas they saw weren't a category 5 hurricane taking shape, regulators tried to convince themselves that the free market fundamentalists had it right and another panic wasn't on the way—it couldn't be, because an article of their faith was that market discipline would prevent any financial institution from taking silly or ill-considered risks. (Sheila Bair of the FDIC might note after the storm that a belief in self-regulating, self-correcting market was a fallacy; until that had become obvious, however, that view would have been deemed heretical by any in a position to act on it and beef up regulation.) By the time the storm made landfall, it was too late to act.

In just one example, the formal repeal of the Glass-Steagall Act in 1999 (after years of steady erosion) had helped create banking institutions that the Fed and the Treasury Department now realized were too big to be allowed to fail. Bailouts of AIG and the injection of billions of dollars of new capital to maintain institutions that might otherwise have collapsed, such as Citigroup, are part of the price that American taxpayers and businesses will have to pay for failing to protect the money grid. But the consequences of the near collapse of the money grid are liable to be far more dramatic and long-lasting than those of the actual collapse of the electricity grid in the northeastern United States and parts of Canada in the

summer of 2003. The latter event, a daylong blackout, was unpleasant and caused chaos as well as millions of dollars of losses in spoiled food and lost business. But restoring the power grid to full effectiveness is a matter of willpower, capital, and equipment. Restoring the financial grid to health will take longer and cost trillions of dollars. And when it's done, Wall Street, and our relationship with it, will never be the same again.

Unintended Consequences

Perhaps someone should have warned these avid deregulators of the law of unintended consequences. But even in cases where a specific deregulatory measure didn't have unintended consequences (on which more later), the cumulative effect of the deregulatory ethos was such that over time, the idea that it might be appropriate or acceptable to regulate Wall Street became less and less politically acceptable. "If government appoints as regulators those who do not believe in regulation, one is not likely to get strong enforcement," economist Joseph Stiglitz pointed out in his testimony to Congress. Ultimately, those who did believe in regulation and who managed to survive within that kind of system found it difficult to actually regulate. Meanwhile, Congress—even before the financial crisis hit and the Madoff scandal dominated newspaper headlines—had concluded that regulators too often made a hash of their job even when they chose to do it.

It's hard to think of an excuse for the SEC's failure to figure out what Bernard Madoff was up to in his massive Ponzi scheme, especially since at least one concerned individual, financial analyst Harry Markopolos, presented an analysis of the whole scheme to them on a silver platter years before Madoff himself confessed. But perhaps there's an explanation for the agency's apparent inability to act, one that dates back to the events of 2005 that culminated in the SEC's decision to fire Gary Aguirre.

Aguirre, a staff lawyer, had spent months investigating a series of mysterious trades by hedge fund Pequot Capital Management, and

believed that Pequot may have been tipped off to an upcoming merger by John Mack, then CEO of Credit Suisse and a friend of Pequot's founder, Art Samberg. (All the targets of Aguirre's investigation denied any wrongdoing and at first, the SEC dropped the matter without bringing any charges, although a second inquiry, begun in 2008, contributed to Samberg's decision to close his firm the next spring.)

Aguirre wanted to subpoena Mack, then in the running for the CEO's job at Morgan Stanley, to question him about his relationship with Pequot and obtain records of any conversations related to the merger in question. His superiors at the SEC told him to back off, pointing out that Mack had "juice" with top regulators; only months later, days before the end of his probationary period, the SEC fired Aguirre. A Senate investigation later concluded that both Pequot's trades and John Mack's actions were worthy of further investigation, as Aguirre had declared, and that there certainly was a "sufficient basis" for asking Mack some pointed questions under oath. The senators lambasted the SEC for its lack of backbone and particularly for paying "undue deference" to Mack, because of his role as a captain of Wall Street. Instead of seizing the opportunity to investigate the links between Wall Street and the hedge fund industry, the later report concluded, the SEC backed down. And, the senators added, when Aguirre tried to alert the SEC's top brass to the issue, the agency's internal investigators "failed to conduct a serious and credible investigation" of Aguirre's claims.

John Mack would ultimately testify—but the timing was unusual; he would discuss the trades only a few days after the statute of limitations for any potential offenses had lapsed. True, Pequot agreed to pay $28 million to settle charges of insider trading in the spring of 2010 (without admitting or denying any wrongdoing), but that occurred only after the financial crisis had pushed the SEC (under new leadership) to be more proactive. Only weeks after Pequot settled with the SEC, the SEC settled with Aguirre: the latter's wrongful termination lawsuit against the agency was ended with the payment to him of $775,000, representing his full salary since his termination as well as legal fees. In the immediate

aftermath of Aguirre's fruitless efforts to depose John Mack in 2005, followed by his firing only months later, it was clear to anyone still in doubt that trying to rein in Wall Street was likely to be more trouble than it was worth. If trying to put John Mack in the hot seat got Aguirre into hot water, why would any regulator trying to keep his job (or get a new, better-paying one on Wall Street later) pursue allegations about the equally powerful former chairman of the Nasdaq Stock Market, Bernard Madoff? It seemed tantamount to committing professional suicide.

That's the kind of message that the hands-off approach to regulation was sending, explicitly or implicitly, for much of the two decades leading up to the crisis. Regulators may have helped resolve the Long-Term Capital Management debacle, but they didn't help to prevent it. Analysts and short sellers were the first to publicly discuss their concerns about Enron's opaque accounting; a detailed SEC investigation followed, but as short seller Jim Chanos of Kynikos Associates said at the time, "It just gave us all the gory details; it wasn't as if they were catching anything or discovering anything that anyone who had looked at their financial statements didn't already suspect was there. It wasn't regulating and preventing a thing; it was coloring in the picture we already knew."[12] Regulators, Chanos points out, were bolting the barn door long after the horse had fled. Speaking out again in 2009, Chanos argued at the Intelligence Squared debate that "there has not been one major financial fraud in the past 25 years uncovered by the government, outside auditors, or outside counsel. It's always been journalists, whistle-blowers, or short-sellers, or some combination thereof."[13]

Ultimately, the combination of regulation and deregulation created a particularly toxic brand of chaos. In the aftermath of the near collapse of AIG, Congress and other onlookers went hunting for the regulator that should have been scrutinizing the doings at AIG's financial products division. (That London-based unit was the part of the insurance company earning the big fees selling credit default swaps and failing to maintain any capital against potential losses, bringing AIG and the financial system itself so close to collapse that by mid-2009 the government had forked over some

$170 billion to save AIG alone.) They found dozens of potential suspects; in every country where AIG did business—virtually every developed nation and many developing ones as well—there was a regulator responsible for overseeing part of their business. Then, on March 5, 2009, Scott Polakoff, the interim director of the Office of Thrift Supervision and heir to the chain-saw-wielding Gilleran, somewhat sheepishly asked to interrupt a Senate hearing into AIG's near demise to 'fess up. "It's time for OTS to raise their hand and say they have some responsibility and accountability here," Polakoff admitted. "We were deemed an acceptable regulator for both U.S. and domestic and international operations." Florida senator Mel Martinez seemed taken aback. "You [are] the regulator we've been looking for," he marveled. "I think we had assumed there wasn't one." "I'm the one," Polakoff responded. Anyone who had watched as one OTS-regulated institution after another collapsed as a result of poor risk controls might have been forgiven for whispering to himself, "I might have known."

Perverse Incentives

Without strong regulatory agencies in place—entities with the willingness to regulate prudently and the ability and resources to follow through and enforce their regulations—there was little incentive for financial institutions such as Washington Mutual, Countrywide, or AIG to maintain prudent provisions against future losses. The proverbial carrot—the lure of higher earnings—pushed them in the opposite direction, and there seemed now to be no effective stick in the shape of curmudgeonly regulators determined to make them do the right thing.

A 2004 report by the Office of Federal Housing Enterprise Oversight (OFHEO) disclosed significant accounting irregularities at Fannie Mae and Freddie Mac that couldn't fail to raise questions about the judgment of the CEOs of both agencies. Nonetheless, Franklin Raines, CEO of Fannie Mae, responded to a question from a congressman about whether the agency's decision to set aside a

mere 3 percent of its assets against possible future losses—a razor-thin cushion by most standards—by declaring that he felt it was actually too large a sum. The single- and multifamily home mortgages that Fannie Mae owned, Raines testified, were "so riskless that capital for holding them should be under 2 percent." While Raines didn't get any encouragement to slash those reserves further, his comments weren't met with howls of protest from anyone, from regulators to members of Congress. In fact, when Armando Falcon of the OFHEO testified about the accounting irregularities, Barney Frank of the House Financial Services Committee responded by saying, "I don't see anything in your report that raises safeness and soundness problems."[14]

Alan Greenspan, who had led the Federal Reserve for nearly two decades by this time, continued to believe that "enlightened self-interest" would cause Wall Street leaders such as Raines to act prudently. He cherished the illusion that their firms could regulate themselves, in the face of evidence showing him that enthusiastic risk taking was more integral to Wall Street than sober and attentive risk management. Sophisticated risk models and the even more elaborate derivative products from which Wall Street was earning more in profits (at higher profit margins) with every year that passed would do what they were designed to do, Greenspan was convinced. The only requirement was that the "enlightened self-interest of owners and managers of financial institutions [should lead] them to maintain a sufficient buffer against insolvency by actively monitoring their firms' capital and risk positions," he wrote a year after the collapse of Bear Stearns.[15]

Greenspan admits that he made a mistake. But rather than blame regulators for their failure to oversee what was going on, or the institutions for being imprudent, Greenspan directed his fire at the hypercomplex derivative products, which were "too much for even the most sophisticated market players to handle prudently." In other words, he said, there is nothing that any regulator or Wall Street rocket scientist could have done.

Greenspan may have been right, but the truth was that no one tried. Regulators didn't attempt to keep up with the pace of

innovation on Wall Street, the growth in its use of and reliance on leverage, and its growth in size and reach. Even had they wanted to rein in what was going on, their efforts would have been doomed to failure.

There's a good reason why Greenspan is now widely viewed (particularly on Main Street) as one of the chief culprits responsible for the financial crisis. As is the case with most regulators, his errors were ones of omission rather than commission, but they were big ones. If anyone had the ability to realize clearly that Wall Street was motivated more by greed and the fear of losing a fraction of a percentage point of market share to a rival rather than by the fear of being seen to be less than responsible or honorable custodians and users of the financial grid, it was Greenspan. It was he who clung to the conviction that a prolonged period of ultralow interest rates wouldn't harm the financial system, who believed dogmatically in the probity of the financial institutions and their ability to manage their business, who kept the punch flowing long after the partygoers were intoxicated and reeling around half senseless.

Greenspan, dubbed "the Maestro," was perhaps the single individual who had the gravitas and the power to stand up to Congress, the president, and Wall Street CEOs and warn them they were being reckless or shortsighted. Had he chosen to, he could have insisted that legislators transform the OTS into a powerful entity with the will and the ability to regulate the IndyMacs and AIGs. He could have sounded the alarm about inadequate reserves and risky derivatives, as a handful of respected financiers such as George Soros and Warren Buffett were already doing. (Buffett memorably and presciently described derivatives as "weapons of mass financial destruction.") Instead, Greenspan proclaimed in 2004, as the bubble was taking shape, "individual financial institutions [have] become less vulnerable to shocks," while the financial system as a whole was downright robust. And as for those derivatives, the ones that by 2009 he argued had been too much to handle? In 2003 he contended that they were an excellent device for transferring risk from those who couldn't handle it to those who

could. He suggested to the Senate Banking Committee that regulating them would be a mistake.

The derivatives market is perhaps the single largest example of deregulatory zeal on Wall Street. When the regulatory framework that still governed Wall Street in 2007 was created in the 1930s, no one dreamed that these products would even exist. (Getting a 1940s-era policy maker to plan for derivatives was about as rational as suggesting to a Victorian policeman that he send off blood traces found at the scene of a crime to be tested for DNA.) Like all financial innovations, derivatives were a compelling addition to the tools at Wall Street's disposal. A corporate treasurer could use interest rate swaps to manage his company's exposure to interest rates; currency-related derivatives enabled companies that earned a lot of income outside the United States to manage the risk associated with unexpected moves in the value of the dollar. Used that way, derivatives reduced risk for Wall Street's clients.

But these high-octane instruments could also be used as outright bets on the direction or movement of markets, creating more risk for their users. It all came down to how they were being employed. And during the 1980s and 1990s, as derivatives became far more widely used (data from the International Swaps and Derivatives Association, ISDA, showed a jump from about $850 billion in 1985 to $8.5 trillion by 1993), concern that regulators didn't have a clue about how they were being used began to mount. ISDA's membership—which included most of the big Wall Street institutions along with other large and midsized banks—successfully fought off a first effort by the Commodity Futures Trading Commission to bring derivatives under its oversight. By the mid-1990s, when market events pushed regulation back up to the top of the agenda once more, ISDA had helped the industry prepare to fight back. "Market discipline is the best form of discipline there is," Mark Brickell, then head of ISDA, was guaranteed to proclaim, in one way or another, at every ISDA-sponsored event.

But some of these highly structured products now were causing losses on Main Street and attracting the attention of both legislators and regulators. Procter & Gamble and Gibson Greetings were hit

with losses related to derivative-like instruments on their books that their treasurers insisted didn't perform as Wall Street had promised. (It remains up for debate whether the treasurers really didn't understand what they were being sold, or simply claimed not to when their bets later turned bad.) Meanwhile, Orange County had lost some $2 billion on leveraged bond derivatives called inverse floaters and in 1994 became the largest U.S. municipality to declare bankruptcy as a result. Its treasurer had bought the derivatives from Merrill Lynch after first trying to deal with J.P. Morgan. "Under no circumstances should we deal with this client!" concluded J.P. Morgan banker Bill Demchak, returning to New York after a meeting with the treasurer, Robert Citron, having realized just how clueless the bank's potential client was about what derivatives were, what they could and couldn't do, and the risks that were involved.[16]

Even before the losses, alarm bells were ringing. Richard Breeden, once known as an avid deregulator during his days at the helm of the SEC, warned corporate directors about the potential risks of derivatives in a Wall Street Journal editorial. In May 1994, the General Accounting Office (GAO) presented a 195-page report summarizing two years of study of the burgeoning derivatives market to Congress. The GAO—better known as a supporter of free markets than of regulation—concluded that there were "significant gaps and weaknesses" in the way that derivatives were regulated and urged Congress to appoint a federal agency to oversee "the safety and soundness of all major OTC derivatives dealers." A fierce fight followed in Congress and within the broader business community, with many regulators lining up alongside Wall Street, ISDA, and Greenspan. A handful of congressional leaders took up the regulatory battle. When in a hearing on proposed derivatives regulation ISDA's Brickell blasted Representative Jim Leach for treating derivatives differently from other securities, Leach retorted that they were different. They "are new, they are off balance sheet, they are a totally different dimension."[17]

Ultimately the free market fundamentalists prevailed, partly because some former critics saw the light. Gerald Corrigan, during

his days at the helm of the New York branch of the Federal Reserve—the Fed post that gives its holder the closest view of what is going on on Wall Street—had once voiced concern about the newfangled and complex securities. Upon leaving the Fed, Corrigan went to work at Goldman Sachs; soon he was named cochairman of the fledgling Derivatives Policy Group, whose goal was to convince legislators that the bankers themselves were in the best position to both understand these complex instruments and manage their risks. Wendy Gramm, a former CFTC chair (and wife of former senator Phil Gramm, coauthor of the legislation reversing the Depression-era Glass-Steagall Act; she would become infamous as a member of Enron's audit committee), suggested that Washington should "resist the urge … to over-regulate what we just do not understand."[18] Greenspan's confidence in free markets remained unshaken; he continued to assure Congress and the public throughout the 1990s that the market could regulate derivatives usage just as ably as any agency.

As the usage of derivatives continued to grow and spread throughout the financial system, with more and more complex iterations being devised, concern increasingly revolved around the lack of transparency in the market for these instruments. The existence of a stock exchange provides a degree of transparency that helps investors value a company's equity; the very liquid bond market, even in the absence of an exchange, made tracking bond prices relatively straightforward. An investor might quibble over whether the valuation the market was giving to the stocks or bonds was appropriate. But the transparency of the market meant that she could figure out what that valuation was with the click of a mouse.

In contrast, derivatives—which tend to be more customized instruments—don't trade anywhere and for decades didn't clear through any entity that was monitored by a regulator. Anyone requesting the most basic information on the industry—such as the notional value of credit default swaps written—could obtain only informed guesstimates. Brooksley Born, head of the Commodity Futures Trading Commission (CFTC) in the late 1990s, asked Wall Street and other interested parties to comment on ways that

derivatives might be regulated in order to be sure that these increasingly ubiquitous and high-octane instruments didn't threaten the stability of the financial system before regulators were even aware of what was going on.

Within the blink of an eye, the deregulatory gang circled the wagons and began heaping scorn on Born. Even the crisis surrounding Long-Term Capital Management, whose losses were caused in part by the hedge fund's use of derivatives to magnify its bets on the bond market that later went sour, failed to save Born's initiative—or her career. Congress barred the CFTC from wielding any regulatory clout over derivatives for six months; Born resigned in 1999. (Born would be back. In 2009 she received the John F. Kennedy Library Foundation's Profile in Courage Award, presented to the public servants who have made courageous decisions of conscience without regard for the personal or professional consequences, for her efforts to bring the derivatives market under some kind of regulatory oversight. She was also named a commissioner of the FCIC, putting her in a position to shape the debate surrounding future regulation and closely question her former adversaries.) The same year, Greenspan and others (including then Treasury secretary Bob Rubin, who would later become vice chairman at Citigroup, a major player in global derivatives markets) proposed that Congress ban the CFTC from any future meddling in the derivatives universe. It wasn't either necessary or desirable for Congress or anyone else to meddle with derivatives, Greenspan declared firmly on several occasions. All that was needed for the world of derivatives to function smoothly with minimal risk was for it to remain as unfettered as possible; the bankers wouldn't let it get out of hand.

Of course, like so many analyses—the Treasury's report on the shenanigans at the OTS, the UBS shareholders' report, and a chilling SEC survey of what went wrong at Bear Stearns—this chain of events looks more dramatic and alarming when viewed with the benefit of twenty-twenty hindsight. At the time, many Wall Street regulators believed the real threat was not lax regulation but overly oppressive regulation. Creating tough new derivatives rules

wouldn't wipe out the demand for these products overnight, and it certainly wouldn't eliminate the eagerness of the global investment banks to earn fees from structuring and selling them. The impact of regulating derivatives would have been to drive the business offshore and undermine Wall Street's preeminence as a financial center. With every year that passed, this became a more likely scenario, it seemed. In the wake of economic liberalization in China, new businesses were being formed at a rapid clip; the demand for capital was at its height there, and an Asian financial institution could conceivably use success in China to establish itself as the next Citigroup or JPMorgan Chase. Then there was Europe, where the city of London was making determined efforts to compete head-to-head with Wall Street for the title of global financial capital.

As late as 2005 and 2006, those fears seemed even more intense. In the wake of the billions of dollars lost amid the accounting scandals revealed at the beginning of the decade, Congress passed the Sarbanes-Oxley Act. Sarbox, as it is familiarly (but not affectionately) known, tried to address a valid concern: the fact that corporate managers had been able to manipulate their earnings and distort the portrayal of their financial position.

But Sarbox created a financial burden for the publicly traded companies that had to comply with the new law, particularly smaller companies. While the SEC had originally estimated the cost of meeting the new audit and governance rules at around $91,000 per firm, companies reported spending an average of $4.36 million each in 2004 alone, the first year that the rules took effect. Those figures were reported by the Committee on Capital Markets Regulation, which also noted that while half of all IPO proceeds raised in 2000 by companies (U.S. and foreign) selling stock occurred through a transaction on a U.S. exchange, by 2006 that had shrunk to only 5 percent. (It's unclear whether the reason was actually the competitiveness of American capital markets or other factors, such as the reality that a growing number of IPO candidates were non-U.S. companies that preferred to go public on an exchange based in their own country.) Meanwhile, the independent

group noted that private equity funds were growing rapidly, a clear signal that regulation and the costs of complying with regulation were keeping both issuers and investors out of the public markets—at least in the United States.[19] In London, however, the London Stock Exchange's Alternative Investment Market (AIM) was increasingly appealing even to U.S. companies that might have been expected to go public on Nasdaq; it held regular marketing seminars in New York and San Francisco to which were invited investment bankers and promising young private companies.

The London exchange bragged about AIM's "pragmatic and flexible approach to regulation" (which involves the company picking one of a number of approved lawyers, accountants, or other corporate finance professionals to vouch for its bona fides, permitting both the company and the exchange to outsource regulatory issues to these "nomads"). Alarmed by this and other trends (companies were also going public in Amsterdam and Tokyo; U.S. investment banks viewed China and even Europe as higher-growth markets), groups such as the Committee on Capital Markets Regulation increasingly spoke out about the oppressive burden that regulations like Sarbox created for Wall Street. "Let's be frank—people liked London because it was less regulated than New York," says the head of one of the large hedge funds that began building up a presence in the city at the beginning of the new millennium. "If you were a company going public, that was what mattered, period. For hedge funds, there was the extra benefit of the time zone." (From London, hedge funds could trade in Asian markets in the morning, European markets throughout their working day, and U.S. markets in the afternoon and evening.)

The SEC, meanwhile, became the target of a very specific and intensive lobbying effort to reduce the burdens of regulation on the part of Wall Street in the spring of 2004. The big investment banks, led by Goldman Sachs, wanted to increase the amount of leverage they could take onto the balance sheets of their brokerage divisions. If the SEC agreed, the investment banks could stop holding so much capital in reserve against future losses by their brokerage divisions. Instead, that capital could flow up the corporate chain to the parent

company, which could put it to work in ways best calculated to increase ROE and profits—ways that included investments in CDOs and mortgage-backed securities as well as credit derivatives and other complex structured products.

Since the net capital rule had been passed in 1975, investment banks had been required to limit the amount of leverage to $12 in debt for every $1 in equity on their books. They also had to tell regulators and shareholders if they approached that level too closely, and to stop trading if they exceeded it. In practice, that meant that leverage ratio rarely topped 10 to 1. But in a low-interest-rate environment, taking more risk and building up leverage levels was more vital for investment banks trying everything they could to pump up their return on equity. And the SEC seemed to feel that Wall Street was now grown-up enough not to require any adult supervision, that the investment banks were interested enough in their reputations and self-preservation not to do anything stupid. So, after a brief meeting in April 2004, the SEC, under its chairman Christopher Cox, gave the go-ahead to switching to a new monitoring system, one that allowed the firms themselves to establish their own capital levels based on their own computer models. "I keep my fingers crossed for the future," quipped SEC commissioner Roel Campos, voting in favor of the measure.

Indeed, the decision proved to be the equivalent of firing a starter's pistol. The race itself was between the major investment banks, each of which seemed to be eager to claim the title of being the first to pile the largest amount of leverage on its balance sheet —or at least to deploy leverage to maximize return on equity and profits. At Bear Stearns, leverage peaked at around $33 of debt for every $1 of equity, while at one point Merrill Lynch had leverage ratios of 40 to 1. Not surprisingly, the golden years of finance followed the repeal of these net capital laws: by 2006, financial services companies made up nearly a quarter of the U.S. stock market's capitalization, compared to about 15 percent over the previous decades, and those companies earned 43 percent of all the earnings reported by companies in the Standard & Poor's 500 index.

Ironically, the SEC was able publicly to spin this de facto bit of

deregulation as a way to increase its ability to keep an eye on what Wall Street was up to. That's because in exchange for the relaxation of the net capital rule, Wall Street firms agreed to let the SEC scrutinize their balance sheets, an agreement that conveniently dealt with another Wall Street headache—the threat by the European Union to regulate U.S. brokerage units doing business in England, France, and other parts of Europe. The EU authorities pledged not to do so if the SEC promised to regulate the parent entities. John Heine, the SEC spokesman, proclaimed that in fact the new 2004 rules "strengthened oversight of the securities markets, because prior to their adoption, there was no formal regulatory oversight" or liquidity standards for the parent holding company.[20]

That may have been true in theory, but in practice the SEC didn't seem terribly worried about what Wall Street was up to at either the brokerage firm level or the parent company level. Seven people were given the task of examining the finances of the parent companies. Performing that role, scrutinizing the balance sheets of the investment banking industry's largest players, should have given them enough insight into the levels of leverage and risk within the industry. However, they didn't act to rein in that risk taking, whether because they didn't believe it posed a systemic threat to Wall Street or because they lacked the power to address any problems that they spotted. (The contents of the SEC's postmortem on Bear Stearns, which not only clearly spelled out the firm's missteps but also suggested that regulators were aware of those missteps as they occurred, suggests that the latter explanation for inaction was more probable.[21]) Between March 2007, when the first questions were beginning to surface about the subprime crisis, and the autumn of 2008, after the collapse of both Bear Stearns and Lehman Brothers and the sale of Merrill Lynch to Bank of America, the group didn't even have a director to oversee their activities and lobby for action at higher levels within the agency.[22]

If Greenspan was correct in his suggestion that it was the nature of CDOs, derivatives, and other financial products that caused the problem, along with the way financial institutions failed to manage the risks they created, regulators should have admitted their

inability to control that risk. If the various regulatory bodies had simply acknowledged that they couldn't monitor Wall Street anymore, much less prevent investment banks from taking foolish risks, they would have delivered a clear message to legislators and investors alike that the latter would need to step up their own vigilance. Acknowledging that the regulatory system wasn't up to the task of reining in the increasingly complex world of Wall Street would have told other financial system participants to be still more prudent and protect themselves, since the regulators could no longer do it for them.

As it turned out, self-regulation remained the order of the day but ended up making no one happy. It irked Wall Street, which disliked having to pander (as bankers saw it) to regulators. In the eyes of Wall Streeters, most of these officials weren't nearly as smart as the financiers they were overseeing; certainly, investment bankers argued, they didn't understand what Wall Street's risk-taking culture was all about. After all, if the regulators were really competent and capable (or so the Reaganesque argument ran), they would have pursued a career on Wall Street itself, taking those risks and making big bucks, instead of becoming faceless bureaucrats. For their part, regulators were continually frustrated by their inability to get a clear picture of what was going on in the increasingly fragmented financial universe. Chaos seemed the most likely result of the potential information gap.

Most crucially, everyone seemed to want to defer to Wall Street. Politicians relied on Wall Street institutions for campaign donations; regulators such as the OTS relied on the same institutions to maintain their clout and budgetary power. Even today, it is Wall Streeters who have been chosen to oversee the bailout and restructuring plans by government officials.

At first blush, it seemed as if the credit rating agencies had a unique chance to speak their minds. They had acquired the status of quasi-regulatory institutions thanks to Depression-era rules banning banks from owning non-investment-grade bonds; that made agencies providing the now urgently required ratings a de facto part of the Wall Street regulatory apparatus. Ratings agencies didn't

report to Congress or rely on politicians for their budget needs. Ironically, as parts of the shadow banking system (such as securitization) became more important to Wall Street but also more likely to escape the oversight of other regulators, the ratings agencies became more crucial. At the same time, significantly, the nature of financial products became more complex. Only a triple-A rating could compensate for the complexity of the products emerging from the CDO-creation pipeline, enabling Wall Street to earn its fees and book the profits from its transactions.

Alas, the ratings agencies' ability to serve as some kind of guardian of the health of the financial system proved even more fallible than that of the accountants who had blithely overlooked years of financial misstatements by the likes of Enron and WorldCom. Part of the problem lay in the deceptive simplicity of the ratings themselves. The theory was that investors should be able to count on the credit quality of a triple-A asset to ensure that it would sail through any storm and emerge relatively unruffled, except perhaps in the event of a nuclear war or global pandemic. As bond managers liked to say, if a triple-A bond's quality deteriorated suddenly and significantly—enough, say, that it crossed into junk bond territory—then investors would have a hell of a lot more to worry about than what was happening to their portfolios. They'd be stocking up on canned goods and ammunition and heading for the hills. In contrast, a triple-B rating, while still investment-grade, signaled that an investor needed to monitor the transaction more closely. The ability to apply this very simple rating system to the extraordinarily complex world of structured finance was a coup for Wall Street, but it left investors with the perception that this new breed of security was just as easy for everyone to value and judge the risk of as a plain-vanilla bond.

The other problem was and remains the perennial one on Wall Street: the magnitude of the fees available for rating these CDOs and the identity of those footing the bill. Rating agencies may not have had to report to Congress, but they needed to report to their own shareholders. Turning down the opportunity to rate a CDO deal, a transaction that could generate $100,000 in fees for the agency,

would have been just as hard to explain to their own investors as the decision by an investment bank not to structure the potentially lucrative CDO package in the first place. Not surprisingly, given the growing importance of structured finance products that required ratings, the ratings agencies became more deferential to Wall Street institutions, working with them to tweak the design of the product in question. By 2005, about half of Moody's revenues came from the fees it earned for evaluating these and other structured products, and as much as 80 percent of its growth in revenue was coming from the same kinds of complex products. As the assets underlying the CDOs became more risky, the ratings agencies had become so dependent on fees they earned from them that turning down a deal became harder.

Marty Fridson, the veteran bond market analyst, says the real conflicts of interest didn't arise at the ratings agencies until recently, when they began to rate structured products such as CDOs. "For years, people objected in principle to the fact that the issuers selling the bonds paid the agencies for the rating, but in practice, it was rarely a problem," he argues. Information on the bond and the issuer's financial position was readily available to any analyst who wanted to check the accuracy of the agency's rating. And, Fridson points out, at the end of the day, a company that needs capital often has less clout than the rating agency. "The rating agency has an interest in maintaining the integrity of the rating; the issuer has to pay for that rating regardless of what it is, if they want to be able to sell the bonds."

In the world of structured finance, however, if the senior tranche of a CDO didn't get a triple-A rating, investors would be less likely to purchase it and the deal would be pulled. With no deal left to rate, fees could be as much as $500,000 for a straightforward CDO; $850,000 for something more complex, as the FCIC later reported. Multiplied by the growing number of transactions taking place at most major financial institutions on the Street, this was hardly chump change for the rating agencies. "The deal only worked if the top part could get a triple-A rating, and so it was in the agencies' interest to make sure they could do that," Fridson explains. The

balance of power tipped definitely in favor of Wall Street. "No triple-A rating, no deal. No deal, no fee. Even if they'd had all the good intentions in the world, it would have been hard for them to manage that big a conflict of interest," suggests Fridson. "Both sides had a vested interest in getting it right—at least, getting it to the point where it could be sold." After that, it was caveat emptor.

Anyone expecting Moody's to apply the brakes to the runaway train, however, had failed to recognize that some of the same considerations fueling Wall Street's addiction to risk taking were present among the rating agencies as well. In 1998, Moody's had become a publicly traded firm, meaning that its own outside shareholders could now also clamor for higher profitability. Mark Froeba, a former Moody's employee, told the FCIC that prior to that watershed event, "an analyst's worst fear was that we would contribute to the assignment of a rating that was wrong." Later, it became "that he would do something, or she, that would allow him or her to be singled out for jeopardizing Moody's market share." Indeed, Moody's employees reported that their decisions were tracked and second-guessed whenever a deal went to a rival such as Standard & Poor's. Sometimes, the hapless analyst would be told to justify any action that led to losing a deal in a written report to their superiors. Investment banks picked up on this hunger for fees, a hunger they were all too familiar with: analysts who proved too uncooperative or demanding would be told that their bosses would be informed that they were being "unhelpful." "They would threaten you all the time," former Moody's employee Gary Witt told the FCIC.

The hunger for deals may have encouraged the rating agencies to adopt many of the worst habits of the investment banks whose transactions they were—at least theoretically—monitoring. Why create a new, tougher model as mortgage underwriting standards fell? No one in the top echelons at the rating agencies wanted to find reasons to turn away business by offering less than a triple-A rating, and a new model might force them to do just that. Still, even a brief glimpse back through time should have been enough to force them to reconsider. Of all the structured deals put together

since 1980 and rated triple A on their debut, only slightly more than half were able to hang on to that rating for as long as five years, the FCIC discovered. It should have been clear that something was amiss with the initial rating process. And as for downgrades: well, that was a case of too little, too late. True, in 2008, rating agencies downgraded nine out of every ten CDOs in existence—but that happened long after the problems had become apparent and far too late for the downgrade to be the kind of useful "sell" signal to the investors that the rating agencies were supposed to be serving. Some of those investors—those who had scrutinized the rating agencies' processes as well as the deals—had sold by then; others would be caught owning assets that they couldn't sell for even pennies on the dollar.

No one in Washington or among the ranks of the quasi-regulators of the shadow banking system, it seemed, was both willing and able to oversee what was happening on Wall Street. To many, the debate over regulation felt increasingly academic, and little alarm was raised when an occasional regulator admitted that large parts of the financial system escaped not only the regulatory system's control but even its sight. In part, this was because of what Goldman Sachs strategist Abby Joseph Cohen once referred to (in the context of the dot-com years) as the "Cinderella economy"—nothing was ever carried to excess, and the level of market volatility remained low.

Initially, Ben Bernanke, Greenspan's successor as head of the Fed, was as phlegmatic as the Maestro himself. We were, Bernanke declared, living through "the Great Moderation," a period of market tranquility. As long as that lull continued, the gap between the regulators and their ability to monitor and oversee what was happening on Wall Street grew wider. Each Wall Street innovation ensured that the rules governing the Street became more outdated. Even the collapse of corporate giants Enron and WorldCom hadn't rattled confidence in the financial system for long. That financial markets could shake off such gigantic blows made even those worried about a looming subprime credit crisis confident that whatever happened, the financial system itself wouldn't suffer

lasting damage; therefore, the fact that regulatory rules were outdated and agencies underfunded was less troubling.

When the government did respond to crises with new regulations, these tended to be too ad hoc to serve as well-considered responses to the root causes of whatever debacle they were intended to address. Many of them had just as many unintended consequences as deregulation had had. The settlement between regulators and investment banks in the wake of the conflict-of-interest scandals in investment research on Wall Street (finalized in 2002) required firms such as Citigroup and Merrill Lynch to rigorously separate research from investment banking activities. That laudable objective led to research itself being starved of resources; now that analysts couldn't use honest and objective opinions to help make money for the institution (even when those opinions were their own, developed without reference to their institution's financial interests), they were no longer a profit center. That meant that promising analysts ended up working in other areas of finance.

The long-term consequences were damaging for both investors (who had access to less good-quality research on a wide range of stocks) and for smaller companies whose stock prices languished when investment banks cut back their research activities. There is certainly far less publicly available research on one of today's hot new market sectors, green technology, than there was on the Internet in its early days. Then came Sarbanes-Oxley, which imposed costly new burdens on entrepreneurial companies, and which was passed in a matter of days to address the kind of governance problems detected at Enron only months previously.

In the view of some market participants, the need for well-considered and thoughtful regulation of Wall Street risk taking was growing as markets became faster-moving (with trades taking place in milliseconds rather than mere seconds), more global (with the advent of twenty-four-hour-a-day trading), and more interlinked. "Look, we're not known, as a group, for loving regulation for regulation's sake," says the CEO of one large hedge fund. "But someone, somewhere, should have had some kind of oversight of what was going on with Wall Street's balance sheets. And yes, I was

saying so at the time. There should have been some risk-based guidelines on how big those balance sheets were allowed to grow."

On Main Street, there are lots of incentives for most of us to behave prudently. We try to keep some money set aside in cash for a rainy day—enough to cover our mortgage payment for a few months in case we lose our job or need to pay unexpected medical bills. In contrast, Wall Street seemed to be a kind of Wonderland, where normal rules of behavior were irrational. On Wall Street, all the incentives clearly urged financial institutions to believe that there would never be a rainy day and to behave accordingly. Washington succumbed to that way of thinking, whether it was due to Wall Street's lobbying (an appeal to legislators' self-interest) or to its preaching the virtues of self-regulation (an appeal to their idealism). By doing so, Washington seemed to suggest that this kind of magical thinking was just fine. As Niall Ferguson pointed out in the St. Patrick's Day debate, Washington-based institutions, from the SEC to the Fed, were great enablers of the hijinks on Wall Street. True, regulators didn't urge a financial institution to slash capital reserves to the bone—but they didn't protest when that happened. They even adjusted the rules, obligingly permitting the institution to do just that. Or, if the rules weren't changed, regulators such as the OTS quietly looked the other way.

Even after the collapse of Enron highlighted the risks associated with off-balance-sheet activities, Wall Street firms successfully lobbied for a rule that exempted them from consolidating their own offshore vehicles onto their publicly reported balance sheets. Suddenly, structured investment vehicles (SIVs) were being treated differently from off-balance-sheet vehicles at any other corporation. More and more, these SIVs became the place for financial institutions to park what they couldn't hold on their own balance sheets. While the SEC had relaxed rules pertaining to capital for the likes of Merrill Lynch, the Fed maintained tougher standards for the banks that it regulated. But neither the Fed nor any other regulator cared about SIVs, since they didn't show up on the balance sheet, and that balance sheet was what the regulators studied. So Citigroup shuffled lots of its hardest-to-manage securities into SIVs

it had created offshore; when outside investors in the short-term securities used to finance the SIV began to protest, Citigroup pledged to buy back those securities at their full value if they ever ran into trouble—a promise that would come back to haunt the firm in 2007 and 2008.

But Washington's failure to monitor the health of the money grid went beyond its lack of oversight over complex securities and offshore off-balance-sheet transactions. As well as providing too little oversight, Washington was providing far too much credit, thereby permitting and even encouraging the institutions whose well-being was crucial to the health of the financial system to pile on more and more risk.

The lower interest rates fell and the longer they stayed there, the more demand Wall Street found among its investment clients for higher-yielding securities, even those that came with extra risk attached. "The Fed did not take away the punch bowl [of easy money]," says economist Nouriel Roubini, the new generation's "Dr. Doom." Instead, he suggests, the Fed responded by adding "vodka, whiskey, gin and [other] toxic stuff to it."[23] And even as individual members of Congress tried to rein in some of Wall Street's excesses, they failed to realize how their enthusiastic participation in other initiatives was actually fueling them.

Certainly, few members of Congress objected to the principles enshrined in the series of laws they passed designed to encourage home ownership among all strata of American society. "We want everybody in America to own their own home," declared President George W. Bush in 2002 before launching yet another round of initiatives aimed at that end. And yet, as Sheila Bair noted in her FCIC testimony, "There are both opportunity costs and downside risks associated with these policies."

In the name of the overarching virtues of home ownership, subprime loans made their debut. These loans were more and more affordable thanks not only to the creative financing by financial institutions but also to rock-bottom interest rates being maintained by Washington even as the rate at which house prices grew each year suddenly jumped from 7 percent to 17 percent. Even after

Congress had become aware of the accounting problems at both Fannie Mae and Freddie Mac, they were slow to act to rein them in; by the time of their bailout, the two agencies had about $65 in debt for every $1 in assets. Those much-maligned subprime lenders could just claim that they were doing what their president commanded by turning more Americans into homeowners.

"Wall Street is one of the most competitive industries I have ever seen in my life," says Seth Merrin, founder of Liquidnet, who does business with nearly every major Wall Street institution. "If you put three or four of these guys in a room by themselves, within fifteen minutes they'll have some kind of bet going on, even if it's just how long it takes for a raindrop to hit the bottom of the window, and they'll all be yelling and screaming at their raindrop to move faster." These are the same people, Merrin wonders in disbelief, "that regulators expected to be rational and sensible and rein themselves in when the going got really exciting?" Merrin points out that the combination of government legislative policies that encouraged home ownership, fiscal policies that revolved around cheap money, and a deregulatory ethos was an environment designed to fuel ferocious competition between Wall Street institutions, each of which was intent on winning the biggest market share while maintaining the lowest possible capital reserves. "All the regulatory oversight catered to encouraging their self-interest, not to getting them to think about the fear part of fear and greed," he concludes.

The Fallout

Regulation is never perfect; every effort to shape the outcome of what Wall Street does leads to unintended consequences. Jeff Rubin, director of research at Birinyi Associates, a market analysis and investment firm, has studied the way markets work for decades and wonders, for instance, why regulators who oversee Wall Street have been so intent on pushing for ultra-high-speed transactions. "If an institution is investing for the long term, why does it make a

difference that the trader can complete the trade in fifteen seconds instead of thirty seconds, and do it in pennies rather than eighths [of a dollar]?" Studies he and others have done show that speed doesn't necessarily produce a better price, he says.

Rubin believes that many of the changes to the trading rules that have taken place over the last decade as markets have become more complex haven't benefited the entities for whose benefit Wall Street is supposed to exist—long-term investors and the companies who use Wall Street institutions to raise capital from that group of investors. "Those changes help Wall Street institutions like proprietary trading desks and hedge funds make money, not investors or issuers," Rubin declares bluntly. Regulators, he says, have been good at paying attention to the interests of the groups they are supposed to be overseeing but far less skilled at or interested in ensuring that the system their action and inaction produced was in the best interest of that core constituency.

Curiously, some of the beneficiaries of that lax regulation are now aligning themselves with Rubin (no relationship to Bob Rubin of Goldman Sachs, the Treasury Department, and Citigroup) and other critics. While no one has yet uttered the words "They made me do it!" some of the comments about regulators coming from senior figures on Wall Street don't fall far short of that. "Look, the people who were selling this stuff, they are being offered incentives to do it, in an environment where their bosses and the government knew, or could have known, what they were doing," says one top investment bank officer who worked closely with one of the former Wall Street CEOs dragged in to testify to Congress and the FCIC.

The executive is scornful of that process. "Oh, come on, it's for the TV cameras! It's like the car business; when the government is buying the car itself, why should I start worrying that this vehicle is unsafe at any speed? If Fannie and Freddie were buying these CDOs and subprime loans, if the regulators overseeing them and Congress weren't saying, 'Stop a second!' then even if at the back of your mind you say, 'Shit, I wouldn't buy this,' you justify it to yourself. It's your job to do this, you have bills to pay—and everyone, including the government, is telling you it's okay." At the back of

Wall Street's mind, the former banker admits, was the thought that as long as Washington was putting its stamp of approval on the whole housing boom, those financial institutions that helped keep it moving wouldn't be held accountable for their actions; they would have a kind of get-out-of-jail-free card. That reasoning would prove valid for some, if not for those at Bear Stearns and Lehman Brothers.

The hearings by Congress and the FCIC, designed to probe the causes and consequences of the mess on Wall Street, have been great street theater but offered little in the way of hope for the Street's critics. If anything, however, they have showcased what seems like a lack of knowledge among representatives and senators about how Wall Street works, its purpose, and the reasons it came so close to the brink of disaster. Those hearings and the myriad public debates on the causes of the crisis have also shown how ready each group—Washington and Wall Street—is to toss the burden of responsibility to the other. Some held higher hopes for the FCIC. After all, its membership was made up of financially sophisticated individuals who were very familiar with the ways of Wall Street, and several of its members were ready to ask pointed questions of those summoned before its public panels. But even had the final report not been hampered by the inability of the members to reach a nonpartisan consensus on the causes of the crisis, the report—which didn't appear until late January 2011—was far too late to influence the first and likely most significant piece of the reform legislation, the Dodd-Frank Act. At the time of writing, it remains to be seen whether the specific abuses and problems the FCIC panelists identified can be addressed by regulators as they try to implement the changes that Dodd-Frank requires.

Ultimately, both groups are culpable. After all, Washington didn't hold a gun to the head of Chuck Prince or any other investment bank CEO in order to force Wall Street to keep dancing. But regulators and legislators alike, instead of pulling the plug on the jukebox in order to preserve the health of the money grid, looked the other way and allowed the music to keep playing and Wall Street to keep boogying. In some cases, they took actions that

resulted in the volume moving higher and tempting more participants onto the dance floor. The regulators and their overseers in Congress and the White House knew—or should have known—that the nature of those on Wall Street would be to cavort enthusiastically until the last note sounded. They could have insisted that the band play a mournful pavane in order to change the atmosphere. They could have taken away the toxic punch bowl that Roubini describes in order to restore sobriety to the proceedings. At the very least, they could have confiscated the car keys of all the revelers, to ensure that the damage they caused was limited to a few smashed glasses.

When regulators did wake up from their long nap and act, it was too late. They opened the Fed's lending window, in time to rescue Goldman Sachs and Morgan Stanley but too late to save Bear Stearns. By forcing a last-ditch rescue of Bear in the shape of the JPMorgan Chase takeover and bailing out Fannie Mae and Freddie Mac, regulators sent the signal to Richard Fuld at Lehman Brothers and other Wall Street CEOs that bailouts might be available for them, too. Not until the last minute, during a series of marathon meetings over the course of a now famous and stressful weekend in mid-September 2008 at the fortress-like headquarters of the New York Fed, did it become clear just how dire the situation was.

Timothy Geithner, then head of the New York Fed, urged the assembled bankers to try to find a way to finance Lehman's toxic assets, a measure that would have averted a bankruptcy filing and facilitated the company's sale to Barclays or another acquirer as a going concern. The Wall Street senior bankers, summoned at the eleventh hour and fifty-ninth minute, balked. How costly would this bailout be? Certainly far pricier than Long-Term Capital Management had been, at a time when their own balance sheets were under pressure. And why should they help a competitor acquire Lehman? The bankers focused instead on finding a solution to prevent other investment banks from following Lehman down the drain; Geithner tried to refocus the discussion on the immediate problem of Lehman. "You guys have got to try harder," he demanded.[24] Ultimately, however, there was no alternative to

Lehman's collapse; the effort was too little, too late.

Should Washington's legislators and regulators have treated Wall Street the same way that parents of irresponsible teenagers treat their children—setting curfews and restricting access to the family car? Your answer to that question probably depends on the philosophical perspective from which you approach it. But in the wake of the financial crisis and the credit crunch that rippled throughout the broader economy, leaving mayhem in its wake, it has become nearly as difficult to suggest that Wall Street be left to regulate itself as it has always been for parents to let their teenagers follow their instincts, however destructive, in the name of a laissez-faire parenting philosophy. As George Soros—who himself has profited richly from free markets—suggests, "The stability of financial markets is not assured; it has to be actively maintained by authorities."[25]

What happens next is likely to follow the script written in the 1930s, in the wake of the last great systemic crisis. Washington is in the midst of rewriting the rule book according to which Wall Street must live, and building or rebuilding a set of institutions that can enforce those rules. Only when it's evident what form those new rules will assume—a process that may take another five years or more to become clear—will it be possible for Wall Street to move beyond the current range of interim responses and figure out how it will perform its core function for the rest of the twenty-first century.

In order to develop more than simply a Band-Aid solution, Washington and Wall Street will need to join forces and create a kind of accountable capitalism. Like it or not, Wall Street is not the type of business that can be allowed to simply collapse if its members behave foolishly and its investors don't rein them in. That means that somehow legislators and regulators will need to inculcate an awareness of that overarching duty among Wall Streeters, from the Lloyd Blankfeins right down to the greenest junior banker. Without a sense of fiduciary duty, on the part of both Wall Street and its overseers, to the financial system itself—and not just to those who earn short-term profits by participating in that system—there is little reason to be optimistic about Wall Street's

ability to avoid a future catastrophe.

Without free enterprise, there's no reason for Wall Street to exist, just as there's no reason to have cars if you don't have roadways on which to drive. But those roads have to be maintained, and cars have to be driven at safe speeds. Now it's up to a new generation of regulators and financiers to devise a new set of rules of the road for Wall Street, one that will emphasize its role as a utility.

PART III

THE NEW FACE OF WALL STREET

As fate would have it, two of the most illuminating comments on the nature of Wall Street, the reasons for the near-cataclysm and the prospects for its future, weren't made in any of the numerous hearings held by any of the Congressional committees and subcommittees or by the Financial Crisis Inquiry Commission. True, these summoned pundits of all kinds—regulators, legislators, members of the financial industry and academics—and provided them a forum within which they could debate the causes of the financial crisis and throw out their favorite ideas for reforming the system, to ensure that such a crisis could never be repeated. But while many of those trying to delve into what had gone amiss on the Street paid careful attention to these events and to the speeches given by the likes of Lloyd Blankfein and Henry Paulson to groups of all kinds, two throwaway remarks proved far more revelatory. Both were made by senior Wall Street figures—one to a radio talk show audience, the other in response to a question tossed out in the midst of a panel discussion held by financial journalists.

The first of these comments came from Richard Parsons, the lawyer who had previously served as CEO of the company formerly known as AOL Time Warner and who had been named chairman of Citigroup in early 2009. In May of that year, the government had taken a step toward restoring confidence in the financial system by requiring banks to undergo a stress test, running a crisislike scenario to see how well management coped and whether they had the financial strength to survive another liquidity crisis. Perhaps in order to celebrate the fact that the still-struggling Citigroup had passed the test (as had every other institution …), Parsons was a guest on a morning talk show on WNYC, the New York City affiliate of National Public Radio. He chatted amiably with the show's host, Brian Lehrer, about the results of the stress test and the future of New York as a global financial center, his soft, warm voice carrying a tone calculated to reassure and even soothe any Main Street residents listening who might still be fuming about the billions of dollars it had taken to keep Citigroup afloat, and the fact that the government had become the bank's single largest

shareholder.

Parsons's voice stayed calm as he made one of the most significant and revelatory statements about how Wall Street's legacy institutions—the behemoths like Citigroup that had survived the crisis, often with the help of massive injections of government capital—viewed the future. Citigroup, Parsons declared, was committed to weathering the storm. After that, he added almost casually, the bank would feel obliged to "do right by our two major constituencies." Seconds later, he unwittingly showed just how little those on Wall Street had changed their perception of the world and their place in it in light of the events of the last two years. Parsons didn't mention the government as one of those constituencies, or the taxpayers whose dollars had kept his institution afloat. Nor did he mention the financial system as a whole, on which we all rely to function smoothly. Not even the bank's clients—its depositors, borrowers, credit card holders, the companies for which its bankers helped raise capital—were acknowledged as one of those "major constituencies." These, the Citigroup chairman explained, "are our shareholders and our employees."[1]

In other words, the same kind of slavish catering to bonus-hungry employees and profit-hungry investors would come first and foremost on postcrash Wall Street—at least in the opinion of the chairman of one of its largest institutions. Parsons, via a spokesman for the bank, declined to elaborate on his comment or explain why this focus would produce better outcomes for the financial system and for shareholders than it had during the past decade, or why Citigroup would be better able to manage the kind of risks that single-minded approach created than it had been in all-too-recent memory.

John Mack, on the other hand, seemed to have emerged from the mayhem with a very different view of what went wrong—or, at least, a very different view of what was going to be possible on the new Wall Street. He disclosed this new attitude—one that surprised many who know Mack as a hard-driving banker ambitious to propel whichever institution he happens to be heading to the top of the league tables and to maximum levels of profitability—in

what appeared to be an unscripted comment in the midst of a panel convened by Bloomberg News and Vanity Fair to discuss media coverage of the crisis. Mack, weeks away from stepping down as CEO of Morgan Stanley, was in the audience; spotted, panel members urged him to answer a few questions. Soon the discussion shifted to how regulation of Wall Street needed to alter in order to prevent another such crisis in the future. Asked for his thoughts, Mack obliged. "We cannot control ourselves," he told a startled audience. Regulators have to do the job that Wall Streeters can't do for themselves: they "have to step in and control the Street." Mack declared he didn't care that ten or fifteen federal regulators now roamed the hallways at Morgan Stanley, now reborn as a federally regulated banking institution. "I love it," he said. "That kind of scrutiny forces firms to invest in risk management."

Two senior bankers, two events, two throwaway remarks—and two very different and conflicting pictures of Wall Street and the need for change. In Parsons's opinion—one that other bankers would later endorse, describing the crisis as nothing more than a particularly acute version of the kind of regular financial crisis that once happened every few decades—Wall Street could and should get back to business as usual as rapidly as possible. There was little need for change, Parsons implied. In contrast, Mack seemed to believe that without some kind of transformation in both the way Wall Street conceives its role and the way it does business, it might only be a matter of time until firms like Morgan Stanley would either precipitate or contribute to another financial crisis by focusing monomaniacally on what is in their own best interest and paying little heed to the kind of systemic risk their behavior creates.

Certainly, the rebound of the stock and bond markets beginning in the spring of 2009 and the rapid return to financial health of Wall Street's strongest survivors (Goldman Sachs reported profits of $13.4 billion in 2009; JPMorgan Chase would announce that its own earnings had more than doubled since 2008, hitting $11.7 billion) gave those Wall Streeters who had survived the carnage plenty to celebrate. As they enjoyed their bonuses—lavish, even if not quite back to precrash levels—Main Street erupted in outrage.

And the new administration of President Barack Obama took notice. In the early months of 2010, only weeks after the banks began reporting their financial results for 2009, President Obama announced plans for an overhaul of Wall Street. A key feature of this, he said, would be what rapidly became known as the "Volcker Rule," named after former Federal Reserve Chairman Paul Volcker, its architect. In future, the president said, deposit-taking financial institutions wouldn't be allowed to use their capital to treat themselves as their own best customers. No more proprietary trading; no more investing in hedge funds; no more participating in private equity investments as an investor.

The president didn't use the word utility in his bombshell announcement, but he may as well have done so. Only days earlier, investment analysts had voiced excitement about the future earnings potential of the biggest or most powerful Wall Street players—Goldman Sachs and JPMorgan Chase—suddenly switched their focus to calculating how big a hit those institutions would take to their bottom lines if they were forced to act solely as intermediaries and restrained from the lucrative businesses that had generated so much of their income in recent years. Goldman, they calculated, would feel the biggest hit, forfeiting an estimated $4.67 billion of earnings in 2011 if the president's proposals became law.[2] No wonder the squawks of outrage were heard from every corner office on Wall Street, as one CEO after another scrambled to make the case that proprietary trading, hedge funds, and private equity dealmaking hadn't been the cause of the financial crisis.

What Wall Street chose to overlook was the fact that those activities were symptomatic of the real problem. John Mack was absolutely correct in his diagnosis: left to their own devices, Wall Street firms cannot help themselves. They will revert to any and all activities that are in their own best interest, seeking out ways to earn higher returns and recruit the talent able to generate those returns by paying the most lavish bonuses and offering the most lavish perks. Risk management, however, would be seen in the same light as before: not just unprofitable, but eating into profits that otherwise could be paid out to either employees or

shareholders. The last crisis may not have been caused by proprietary trading, but by the attitude on Wall Street that had led to proprietary trading desks, prime brokerages, and "sponsor" groups becoming such powerful players simply because they could generate outsize profits symbolized what was wrong with the system. As long as Wall Street continued to reward itself so lavishly at the same time as it chose to view some of its clients as little more than "counterparties" that should be prepared to look out for themselves in any and all situations, the risk of a repeat of the events of 2007 and 2008 remained high.

The crisis had not—and still has not—reshaped the fundamental attitudes of many of Wall Street's leaders toward the financial systems. While they are responsible for making the money grid work efficiently and safely in the interests of all its beneficiaries, not just themselves or those able to reward them most richly, too many of the leaders think like Parsons: that their responsibility is to their shareholders and their employees. That attitude, coupled with the eagerness of Wall Street to return as rapidly as possible to the status quo ante once the immediate crisis had been averted, served as the catalyst for the president's reform proposals. "My resolve to reform the system is only strengthened when I see a return to old practices," Obama said at the time he proposed the "Volcker Rule."

Just because Wall Street's biggest institutions can construct CDOs and CDO-squared structures, because they can boost leverage levels, because they can structure transactions that even some of their bankers view as risky or dangerous for the investors that the investment banks convince to take the other side of the deal, doesn't mean that they should do so. And that's the problem at the heart of any discussion about the future of Wall Street: there are still too few incentives to say "no" to deals and financial products that shouldn't happen. True, the subprime lending market is largely moribund; financial institutions won't be able to take on nearly as much leverage under new rules set in place by national regulators and transnational groups like the G-20. The products that trigger the next bubble—and the next crash—won't be CDOs, junk bonds, or dot-com stocks. But as long as some players in the financial

markets—perhaps hedge funds, perhaps private equity funds, perhaps some other entities that aren't on our radar screens today in the same way that subprime lenders weren't a factor on Wall Street as recently as the mid-1990s—generate massive amounts of fees for Wall Street institutions and want to undertake high-risk deals, there will be little motivation for those intermediaries to just say no. On the contrary, there will be every reason to go along, because the financial rewards will be there—as will the sense that if they don't grab the opportunity, their rival will. Inevitably, as John Mack realized, financial institutions are programmed to seek out and emphasize the riskiest businesses because that's where the biggest profits can be made. Self-control is simply not part of Wall Street's DNA.

In a pinch, we can muddle along with a dysfunctional health-care system, or even an educational system that isn't doing justice to our country's children. But we can't exist without a robust financial system. The question becomes, what kind of corporate structures, regulation and policy frameworks will encourage Wall Street institutions to behave in the interests of all its stakeholders and in a way that doesn't jeopardize the health of the financial system itself?

The efforts at reform that we've seen to date, many of which I'll address in the remaining chapters, are only a partial solution. The conundrum can't be addressed unless and until we're prepared to start thinking of and treating Wall Street as the utility that it really is. That doesn't mean that its institutions must be government-controlled monopolies—far from it. On the contrary, just as a freewheeling Wall Street turning out subprime CDOs with reckless abandon proved dangerous, I'd suggest that a government-administered financial institution that dutifully loaned more to struggling businesses would be equally hazardous. True, helping a small business obtain a much-needed loan to stay afloat may be more altruistic than creating another subprime CDO just in order to capture the fees, but that doesn't mean it makes more business sense or is less risky. Nor does it mean that Wall Street institutions must accept a regulated rate of return set by the Fed or some other agency, or even limit the size of the bonuses they pay out to their

top-performing employees.

Rather, it means that everyone whose fortunes are tied to Wall Street—from the loftiest banker to the lowliest trader and including investors in firms like Goldman Sachs—must accept that the sole purpose of the financial system isn't to enrich them. To earn those big bonuses, they can't focus obsessively only on capturing outsize profits or on beating Goldman Sachs in the race to maximize return on equity or dominate the investment banking league tables. We must redefine the meaning of success on Wall Street to include more than just profits for Wall Streeters themselves, but reasonable outcomes for those who rely on it: access to capital, a transparent system, and bankers who treat them as valued clients and not simply disposable counterparties. The mantra "caveat emptor" is no way to run a utility.

In the chapters that conclude this book, I'll explore some of the ways the trauma of the financial crisis has already begun to reshape the world of Wall Street. Some firms have vanished; new players are emerging. There's a possibility that entirely new types of players could begin providing intermediary-type services. A quarter-century from now, the list of Wall Street's most powerful firms and individuals may be very different in nature as some of these changes upset the balance of power. Goldman Sachs may no longer be the firm everyone wants to mimic and to outperform. But without some kind of sweeping change, begun either outside or within the financial system, the Street's participants will always be chasing their most successful rival, whatever that firm happens to be. And that ethos is a damaging one, something we can't afford to retain as the "new" Wall Street emerges.

Yes, the Dodd-Frank Act has been passed; the FCIC has rendered its verdict on the causes of the financial crisis. But we're still in the early stages of seeing that new Wall Street take shape, and it's up to all parties concerned to ensure that the system that results is one that serves all their interests, from Goldman Sachs right down to the smallest client of the money grid. The ethos of "chasing Goldman Sachs"—pursuing the maximum level of profits and return on equity, without heed to systemic risk or the interests of all the

stakeholders in the money grid—is a model that must be abandoned in the name of creating a stable and sustainable money grid. Being a winner on Wall Street must mean being more than the firm that manipulates the grid the most successfully, earning the biggest profits in the process because that is all its own shareholders care about. After all, shareholders of the energy giant BP realized in the aftermath of the offshore drilling catastrophe in the Gulf of Mexico in the spring and summer of 2010 that the pursuit of profits wasn't all that mattered. What counted more, it turned out, was maximizing financial returns safely and with an eye toward the environmental consequences of its actions. The same is true of Wall Street, still grappling with the aftermath of its own version of a toxic spill. Perhaps one day it will rediscover and subscribe once more to Jack Morgan's pledge of doing "first-class business in a first-class way."

CHAPTER 8

Wanted: A New Model for Wall Street

Without question, 2010 was an "annus horribilus" for all those at Goldman Sachs. Admittedly, it had begun on an upbeat note, champagne corks popping to celebrate not only the firm's survival but also its startlingly rapid return to profitability in 2009. Even the professional pundits, the investment analysts who scrutinized Goldman Sachs's financial reports in an effort to predict just how well it would do, fell well short of reality in their forecasts. The firm was once again the envy of the rest of Wall Street, reporting $13.39 billion in profits, or $8.20 a share, compared to consensus estimates of $5.19 per share.

But the jubilation wouldn't last long. Even as the analysts were digesting the fine print of the year-end report and revising their earnings estimates upward for 2010, a series of blows began raining down on Goldman Sachs. Until that year, Goldman had seemed immune to the kinds of turbulence that sent its rivals scurrying for cover, while its blue-chip bankers seemed never to make the kind of missteps that caused those rivals to founder. Then came the news that President Obama's planned Wall Street reforms seemed likely to wreak havoc on the kinds of lucrative business that Goldman Sachs dominated and that generated a large proportion of those enviable profits it had just posted. Only weeks later came another, more serious blow: news that a newly ferocious Securities and Exchange Commission had sued the firm. Goldman Sachs, SEC enforcement officials alleged, had deceived its clients in the Abacus CDO transaction by concealing from them the role that John Paulson—the hedge fund manager who was eager to bet against the subprime mortgage securities in the transaction—played in selecting

the specific holdings in the deal. Had investors known that Goldman was bending over backward to cater to Paulson, would they have been as willing to buy in to the deal? The SEC's enforcement division thought not. Goldman's failure to disclose those facts—facts the SEC deemed "material"—rose to the level of fraud, the SEC alleged in its April lawsuit.

The envy of all his Wall Street peers until now, Lloyd Blankfein must have felt like the loneliest man alive at the end of the month as he sat in the hot seat in a Senate hearing room, struggling to explain to his Congressional inquisitors—members of the Senate's Permanent Subcommittee on Investigations—just why he didn't believe that his firm had an obligation to inform clients that it was trying to persuade to invest in subprime CDOs that its own bankers and risk managers were internally referring to the deals as lemons and the transactions as "shitty" or "crap." "Clients don't care about our views," he declared. For the first time in recent memory, Goldman Sachs's name and reputation commanded no respect or deference on the part of the senators; instead, they used the marathon session to challenge Blankfein and some of his senior officials on the basic principles of their business. Sometimes, they hit the nail squarely on the head, as when the junior senator from Montana, Jon Tester, demanded of the Goldman Sachs team assembled in front of him: "Who do you consider yourselves working for—the client or the firm?" That was just one of many questions that the Goldman team battled to avoid answering. "That's a complicated question," replied Dan Sparks, the former head of Goldman's mortgage business.

It didn't take too long for Goldman Sachs to realize that trying to convince the public, members of Congress, and regulators that its actions—selling what one Goldman exec described as "big old lemons" of mortgage securities into deals that could be peddled to its clients, or rather, its counterparties—were acceptable behavior was doomed to failure. True, the firm remained as resolute as ever in public: it had done nothing wrong; it had discharged all its obligations to its counterparty in the Abacus transaction. But even if the firm won battles along the way, a growing number of Goldman

insiders was convinced that it couldn't win the war: it had to settle the case in order to appease its clients, stop the run on its stock that had wiped billions of dollars of market value from its shares in the weeks that had elapsed since the case was filed, and move on to more important issues, like figuring out how it would make money in a new regulatory and market environment.

Already, the lawsuit had overshadowed Goldman's release of another quarter's worth of blockbuster earnings in April; none of the Goldman partners who assembled in June for the firm's annual jamboree wanted to have that state of affairs continue. Sure enough, by July the warring parties had reached a truce of sorts: while Goldman wouldn't acknowledge wrongdoing, much less fraud, it would admit that its disclosure standards weren't all that they could be and the firm would pay a $550 million fine to resolve the case. More significantly, the firm announced that it was already in the midst of a systematic review of its business practices—a tacit admission that these had drifted away from the principles of "long-term greed" espoused by the likes of previous generations of Goldman Sachs leaders. "There was a sense among us all that something, somehow had gone awry and needed to be fixed," says one former Goldman Sachs partner. "The consensus was that we needed to find the path back to the kind of business culture that we had had before; the kind of environment in which it would never have been conceivable for us to sell securities to our clients that we were privately describing as toxic, as lemons, as crap." Goldman Sachs had gone from being Wall Street's most admired and most envied firm to being its most reviled. True, rivals might still covet its profits, but now the sources of those earnings were coming under attack. Goldman couldn't afford to be perceived as the firm that was willing to do deals that a second-tier firm like Bear Stearns—an investment bank that hadn't been able to manage its own risk well enough to ensure its survival!—had turned down for ethical reasons.

But that left everyone with some big questions to address. What would the new Goldman Sachs look like? And would it be the kind of firm that could continue to dominate Wall Street and earn

outsize returns for its investors? Or was the Goldman Sachs era at an end? Would the new rules of the road being drafted in Washington favor new kinds of financial businesses? Would new players try to take advantage of the uncertainty? Would the financial crisis of 2008 and its fallout mark the end of an era or trigger little more than cosmetic changes to the way Wall Street did business? President Obama's objective was clear: he wanted an end to a financial system that had taken "huge, reckless risks in pursuit of quick profits and massive bonuses." But if the old Wall Street was mad, bad, and dangerous to navigate, what kind of new landscape would or should replace it?

Goldman Goes Back to the Drawing Board

Goldman Sachs had spent decades scrambling to become an elite institution and by the 1980s, it had more than achieved that objective. Now, despite everything that had gone wrong, the firm's leaders weren't going to sit around and wait meekly to be told what to do next by a passel of Washington bureaucrats. After all, Goldman bankers were known not just for their aggression but their vision: hadn't their risk management team succeeded in identifying the risks in the credit bubble and acted to prevent the firm's collapse, while wannabe Goldmans had failed? The fact that that very prescience was being held against them in the Abacus case was, in the eyes of those at Goldman Sachs, at least, downright bizarre, but it also signaled that it was time to go back to the drawing board and start reinventing Goldman Sachs before the regulators did it for them.

"It was kind of a crisis for everyone who had worked at Goldman during the big transition, during the time period where we had gone from being a firm that saw a value in principles to one that saw the greatest value in earning the fattest fees possible," says one former partner. Everyone wanted to recapture something of the spirit of the old Goldman Sachs—not the firm that the rest of the world despised because it was believed that Goldman had been

making money at the expense of all the other participants in the financial system while the latter foundered, but the business model that earned outsize profits by being more agile and nimble than anyone else when it came to navigating financial markets and earning an outsize share of the rewards that were there to be captured. "If the firm is going to be what it was, we need to find a way back to the days when 'long-term greed' was what mattered," says the former Goldman partner. "No banker can ever write e-mails like Fabrice Tourre did, showing how cynical he was about what the bank was doing, because there shouldn't be anything to be cynical about." It's not a matter of morality, he adds. "It's just common sense—it's prudence, it's responsibility, it's about all the other things that have gone by the wayside across Wall Street in the last decade or so."

That kind of thinking and the hope of restoring Goldman Sachs to its pinnacle atop Wall Street lay behind the review of business practices that Goldman began in the spring of 2010, while the review—with the implicit promise that Goldman had seen the light and would change its ways—helped to save the firm from the full wrath of the SEC and an even larger fine in the Abacus case. It also contained some unpleasant surprises for Goldman insiders. Particularly dismaying were the results of an independent survey of Goldman's clients, which revealed that many of them had become wary of the investment bank in recent years. To those who were still trying to convince themselves that Goldman had done nothing to violate clients' trust or that could be perceived as doing so, the results were horrifying: too often, a large number of clients said (after being promised anonymity) the investment bank put too much importance on its own interests at the expense of those of the clients. Insiders say they were taken aback by the magnitude and extent of the mistrust and skepticism and that the early survey results were among the factors that convinced Lloyd Blankfein to settle the SEC lawsuit as rapidly as possible. "Just imagine us asking a client to testify on our behalf in that kind of case, and then the dude getting up on a witness stand and saying nope, under oath, I can't swear that there's any reality to the Goldman mystique," says

one Goldman Sachs insider. “That scared the hell out of everyone in the corner office.”

If the Abacus deal symbolized and highlighted what Goldman Sachs and the rest of Wall Street had become—entities that served themselves first to the choicest dishes on the menu and leaving the leftovers for their clients—the business practices review was an opportunity to correct that, at least in the eyes of some of Goldman’s veterans who recalled the days when the investment bank was still a partnership and when there were some deals and some business relationships that the firm shunned as unprincipled, however lucrative they might become. “We just didn’t do every deal—that’s how we got that elite reputation in the first place,” says one Goldman Sachs alumnus. He and others applauded when, in January 2011, the results of the review once again enshrining client interests as paramount were unveiled. “Our experience shows that if we serve our clients well, our own success will follow,” the review declared. The second principle, that the firm’s assets are its people, capital, and reputation, was also a familiar one, albeit with a new twist in recognition of recent events: the review noted that the last of these—reputation—would be the most difficult to restore if it was damaged. Going forward, Goldman pledged, “prior to accepting a role with a client, we will exercise care to ensure that we are able to fulfill our responsibilities to that client. Having assumed a role, we will not undertake activities or accept a new mandate that would prevent us fulfilling those responsibilities.” Providing superior returns to its shareholders ranked third on this list of revised priorities.

But will this mean that Goldman Sachs actually changes the way that it does business, and help shape a new Wall Street? It’s hard to say. While Goldman promises to make its financial statements more “transparent” and easy to understand, it hasn’t laid out a plan of action: it’s still unclear whether or how Goldman will act on these principles in the future. It’s also hard to see how the bank will be able to keep the demands of shareholders for superior returns at number three on that list: after all, Goldman, like other publicly traded corporations, has a fiduciary duty to maximize shareholder

returns. All that matters is that the actions it takes to do so don't put the corporation's survival and well-being at risk. Will shareholders stick around if they believe Goldman Sachs is bending over backward to cater to its clients at their expense—if Goldman walks away from potentially profitable transactions?

Goldman Sachs, like other firms on Wall Street, had lost its way during the previous decade or two. A new kind of business model had evolved, one that led to investment banks establishing a hierarchy of clients, with the so-called dumb money at the bottom. That included, as the Senate and FCIC hearings made clear, institutions like the German bank IKB, which bought the Abacus securities from Goldman Sachs without knowing of John Paulson's full role in the transaction—and without, as Goldman bankers scornfully noted behind the scenes, doing enough due diligence to detect the degree of risk they were taking on in the transaction. (IKB's losses on this and other mortgage-backed securities investments made it one of the first banks to fail in the crisis; bailing it out required a cash infusion of $13 billion by a group of state-owned German banks.) "It's fair to say that the review caused us to think about the missteps we had made," says one Goldmanite. And yet, the review also seemed to duck away from some of the most critical questions. When it came to the issue of conflict of interest—who is Goldman Sachs putting first?—the firm took refuge in weasel words. Conflict of interest, it declared, "does not have a universally accepted meaning."

As Goldman's annus horribilus drew to a close and 2011 dawned, the only certainties were the questions that surrounded the firm and Wall Street as a whole. And the transaction that Goldman Sachs had hoped would give it a new public image—a $1.5 billion capital infusion into one of the most-watched companies of the last few years, the still privately held social networking site Facebook—was supposed to provide the world with evidence that a new, kinder, gentler Goldman Sachs was already taking shape. Goldman Sachs itself wouldn't be the primary beneficiary of the Facebook investment—the kind of pre-IPO financing that historically has paid off with hundred-fold returns in the case of similarly iconic

companies in the past, from Google back to Yahoo! and eBay. Instead, while Goldman Sachs, alongside a Russian investment company, would invest $500 million in Facebook, the bank's real role was the classic one of intermediary: it was responsible for negotiating the terms and conditions of the investment, which would include another $1.5 billion of capital from Goldman's private banking clients. "This is Goldman doing what it does best, adapting to new circumstances and finding a way to make them profitable," says Clayton Rose, a former banker now teaching finance to students at Harvard Business School. Instead of using the firm's own capital to capture all of the potential return, Goldman Sachs, it seemed, had found a way to use its capital to develop a business relationship. "Friending" Facebook earned Goldman Sachs a fee today, a relationship with the company that hopefully would put the bank in the pole position when the race to become lead underwriter for Facebook's IPO got under way, and it would make the affluent clients of Goldman's private wealth management business happy, too, as they'd get a unique opportunity to invest in Facebook, a deal they could brag about today and profit from in the coming years.

In postcrisis Wall Street, this was a sweet deal indeed, one that showed Goldman Sachs at its innovative best. Goldman, like other Wall Street players, needed to identify some clever new ways to make money, with some of their most profitable businesses under attack: if regulators and legislators had their way, there would be no more proprietary trading or hedge fund investments permitted, and even the practice known as marketmaking—which could mean holding positions on a bank's balance sheet for months, making it look uncannily like proprietary trading in the eyes of those predisposed to be critical—was under siege. Add that to the fact that new rules meant keeping higher levels of capital in reserve and using less leverage, and the prospects that firms would resume posting record profits were becoming dimmer by the day. Even the financial markets weren't cooperating. By the summer of 2010, trading volumes across Wall Street had become "painfully slow," as Richard Handler, CEO of Jefferies & Company, complained when

warning investors that the investment bank would post disappointing third-quarter earnings; a growing risk aversion and directionless markets, combined with uncertainty about everything from the global economy to the stability of the financial system, were keeping investors on the sidelines. Even venture capital funds weren't eagerly pushing forward more than a select handful of social networking companies with familiar brand names as IPO candidates for Wall Street's consideration. "It's far easier for us to get these companies acquired for a modest premium, and collect our fees for that, than it is to gamble that one of them might actually get investors excited enough to be worth our time and effort in pushing an IPO through the pipeline," said one banker who works extensively with Silicon Valley startups.

In that climate, the Facebook deal looked like a dream come true, especially as the orders came flooding in—more than $7 billion of them for the $1.5 billion of stock on offer. Then Goldman's success once again became its undoing. Because the deal was being orchestrated by the now notorious bank, and being done for a high-profile firm like Facebook, news of the private placement leaked out into the public domain, along with speculation that Goldman Sachs had reserved the right to hedge its own Facebook holdings, something not available to its clients. Goldman officials denied that, but they couldn't stop the flood of publicity—publicity that isn't permitted as part of a private placement sold to individual investors under the securities laws. The only prudent course of action was to pull back; only non-U.S. private banking clients would be allowed to participate. Goldman's bankers were furious, and so were many of those bankers' wealthy clients who were now shut out of what promised to be one of the most attractive deals of the decade.

The Facebook deal offers hope for Goldman Sachs, at least—hope that it will be able to find new ways to compete and thrive in the new, postcrisis Wall Street. "Firms that previously lived off highly customized transactions that have a high degree of intellectual capital involved, like Goldman Sachs and JPMorgan Chase, will find their businesses and profit margins under serious threat, based

on the way that the new Wall Street is taking shape," argued Rose in early 2011. "They will have to replace those earning with more traditional kinds of revenues, which also tend to have lower profit margins, so that's going to be a real challenge. The business models will have to change." And once again, a premium will be placed on creativity and innovation.

Reinventing Wall Street

In the aftermath of the crisis, and lingering on into early 2011, there were more questions about what the new Wall Street would look like than there were answers. The passage of the financial reform bill known as the Dodd-Frank Act in the summer of 2010 provides a context in which to pose those questions, but this significant package of legislation needs to be implemented and then face legal challenges that will further define what it does and doesn't permit Wall Street to do, before we will begin to understand the full ramifications of the new rules. Some lawyers calculate that will take five years or so; others argue it will be at least a decade.

In the meantime, however, Wall Street has already begun to undergo its own transformation, slowly and almost imperceptibly. Legislative reform and lavish bonus packages may have grabbed headlines throughout 2009 and into 2010, but other forces were already at work. Just as the bankers at Goldman Sachs were pondering what kinds of new transactions might make them money in this new business environment and laying the groundwork for the Facebook deal, even as the firm's leaders battled to put to rest the SEC lawsuit, across Wall Street other firms were asking themselves the same big questions: What does Wall Street do, and what should it do? How does it function, and how should it function? The magnitude of the crisis and the dislocation it produced had been so great that almost anything now seems possible, at least in theory. For the first time in some seventy-five years, since the changes to the financial system that came on the heels of the 1929 crash, Wall Street players have received a glimpse

of entirely new vistas and possibilities. It's almost as if they have just arrived in the Wild West, been shown a map on which all the territory is up for grabs, and been told to go out and stake a claim. Everyone, from the newest member of the tiniest regional brokerage to the most eminent Wall Street veteran, is free to take part in the game of reinventing Wall Street.

Even if angry and aggressive legislators and newly reinvigorated regulators impose new constraints on what some financial system participants can do, many Wall Street veterans still see more opportunity than risk. In some cases, those opportunities may influence how we redefine what Wall Street is and how it functions. Winners can come from anywhere. They can be found among the ranks of the giant financial institutions (including Goldman Sachs); the boutique institutions launched by star bankers that try to replicate what Goldman was two or three decades ago and thus repeat its successful transformation into an elite and astonishingly profitable institution; and even among the midmarket players that end up dominating one particular niche within the investment banking universe, whether it's health care or green energy. At least one giant hedge fund dreams of a future in which it joins the ranks of the intermediaries, becoming an investment bank in its own right as well as an investment firm. Why not?

Some of these businesses dream of becoming the next Goldman Sachs; meanwhile, the actual Goldman Sachs and its peers at the top of the Wall Street power structure are intent on modifying their own business models as much as they need to in order to take advantage of new opportunities and avoid fresh risks, all the while trying to prevent too much change of a kind that might topple them from their perch. "They will fight—ferociously—to recapture any ground that was lost during the storm," says Jimmy Dunne of Sandler O'Neill. "We have a window of opportunity, yes, but it will close, and we'll have to fight just as hard to hang on to whatever we gain."

In place of the magical thinking that dominated Wall Street in the years leading up to the crisis arose a kind of willful amnesia. Surely, leaders of the large legacy institutions like Goldman and

JPMorgan Chase reasoned, the events of 2007 and 2008 were nothing more than a giant nightmare from which they were now awakening? At first, events conspired to support that perspective. Goldman Sachs, whose employees seemed able to spin straw into gold, reported the largest quarterly profit in its history in the summer of 2009, only weeks after repaying $10 billion of government bailout money. By the end of the third quarter of 2009, Goldman and JPMorgan Chase were running neck and neck in the profitability sweepstakes, each having posted profits of around $8 billion.

Of all the firms fighting to reclaim their previous power and prestige, Goldman, as already discussed, had the steepest uphill climb. As its coffers swelled with its fresh profits and employees began spending their bonus checks, populist fury mounted. Even charitable donations didn't help. The level of outrage was reflected in the tone and content of Matt Taibbi's scathing profile of Goldman published in the July 2009 edition of Rolling Stone. Rehashing every conspiracy theory surrounding Goldman, Taibbi concludes (in some of the most memorable prose ever crafted in a work of business journalism) that Goldman is "a great vampire squid, wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money."[1]

Lloyd Blankfein, embarking on a PR crusade to stem the hostility, didn't help matters. Granting an interview to the Times of London, Blankfein tried to emphasize Goldman's crucial role in the financial grid, arguing "we help companies to grow by helping them to raise capital. Companies that grow create wealth. This, in turn, allows people to have jobs that create more growth and more wealth. It's a virtuous cycle." But then, he went on to declare that Goldman Sachs is "very important" and that it serves a "social purpose." Blankfein even told the interviewer that he believes he is "doing God's work."[2] His performance during the Senate hearings, during which he was interrogated on the details of the Abacus transaction and his thoughts on client relationships in general, was even more counterproductive.

Even before the markets made earning outsize profits much

harder in the summer of 2010, Goldman Sachs was finding that it had to keep increasing the amount of risk it was taking in order to stay on top. Throughout 2009, the firm's average daily VaR level rose steadily, following a 20 percent jump in the fisrt quarter. Most of that came from its trading, particularly in the risky bond and currency markets. For most of 2009, the gap between bid and ask prices—known as the spread—remained extraordinarily wide, offering savvy traders the possibility of paying low prices to buy securities they could resell later at a higher price, either because the asset had risen in value or the spread had narrowed. Or, if the trader was executing a transaction for a client, wider spreads justified higher fees. In the second quarter of 2009, Goldman earned more than $100 million revenues on forty-six separate days of trading, according to an SEC filing—a record. Its value at risk shot up in the same period to an average of $245 million daily, from $184 million in the second quarter of the previous year. Goldman's profits drew irritable comments even from Wall Street insiders, concerned that the risks being taken to earn them would once again come back to haunt others who relied on the financial system. "They are making very luxurious returns," said Larry Fink, the founder and CEO of BlackRock and himself a former investment banker, of Goldman's profits. He went on to imply that this came close to profiteering at the expense of the money grid's users, including investment firms such as BlackRock.[3]

Every player cherishes his or her own dream of what the new Streetscape should look like. Some will find that vision harder to realize than others—Citigroup, for instance, will find it hard to reclaim all its past power and prestige. Regulators will have a tough battle trying to force legacy institutions like Goldman Sachs to change the way they think about their business. For others, the task will be simpler. All that is needed for some smaller firms to realize their vision is for Wall Street's giants to continue in disarray and confusion long enough for them to carve out a new and larger role for themselves during the morphing of the money grid. There is every incentive for the rest of Wall Street to continue chasing Goldman Sachs, in part because there is more opportunity than ever

before for some other institution to displace Goldman at the top of the Wall Street hierarchy by being just as smart and attracting less attention and controversy. Chasing Goldman Sachs could take on an entirely new meaning.

Wall Street's Barbell

As the panic that had gripped Wall Street at the height of the crisis in 2008 began to abate the following year, it was replaced with controversy. To avoid a repeat of the crash, what should the "new," postcrisis Wall Street look like? Should it be a completely fresh set of institutions, carved out of the strongest part of the legacy firms and supplemented by the array of midmarket firms and a host of boutique institutions and new players? Or should it be back to business as usual, only with a smaller number of ultralarge players dominating Wall Street?

As early as the autumn of 2008, it was clear that in the first stage of the evolution of a new Streetscape, at least, the financial system would look much like a barbell. At one end was a numerically small number of firms that, thanks to their gargantuan asset base, would likely continue to wield a disproportionate amount of power. These behemoths might be fewer in number than before—Lehman was gone; Bear Stearns, absorbed into JPMorgan Chase; and Merrill Lynch, now forming one division of the suddenly much larger Bank of America—but they would be powerful competitors. These "too big to fail" institutions also emerged as the focus of a controversy: should the government have shielded them from the full brunt of the financial crisis in the name of trying to protect the financial system itself from calamity? And would they continue to be handled with kid gloves because no one wanted to discover firsthand what might happen if they collapsed?

While the lion's share of the business—profits from underwriting stock and bond deals, advising companies on mergers, and providing trading services to clients—still rests in the hands of the giants, there is a lot of interest in what is happening at the other

end of the barbell, inhabited by a cluster of boutiques and specialized investment banks. Some are already established, like Sandler O'Neill or Jefferies; others have only recently been created by star bankers and traders who had decamped from the giant firms either before the crisis or in the wake of the chaos and upheaval. All of them are aware they have more chance than ever before of unseating some of the powerhouse firms and many are building their business plans on one incontestable fact: the distaste for and widespread distrust of "big Wall Street," exemplified by firms like Goldman and Citigroup.

Their potential clients may not subscribe to the kind of conspiracy theories put forth by Taibbi in Rolling Stone, but they do have lingering misgivings about the way those big players regard their clients in the wake of some of the disclosures in the FCIC and congressional hearings. Who wants to be the next IKB, the sucker who is fed a bunch of toxic securities by the next unscrupulous banker? The taint associated with old-model Wall Street is such that brokers and investment advisors who once loved to boast that they belonged to Merrill Lynch's "thundering herd" are now fudging their answers to the question "So, what do you do for a living?" Some are even deserting, setting up independent businesses.

"Some of the changes that we've seen happen in the wake of the crisis aren't likely to be unraveled any time soon, and they are changes that favor the creation of new business models on Wall Street," argues John Costas. He's putting his money where his mouth is. For more than a quarter of a century, Costas worked for some of Wall Street's biggest firms, rising to become head of investment banking at UBS. In the wake of the crisis, he launched the PrinceRidge Group with former colleague Michael Hutchins, a broker-dealer to trade a growing array of fixed-income products. But that's just the beginning of Costas's ambitions. He plans to turn to his advantage both the anger at Wall Street and the reality that the size of the "too big to fail" institutions can't serve all clients well; PrinceRidge, he calculates, is ideally positioned to fill what he believes is a void in the market left behind in the wake of the crisis.

"On a normal day in 2008 and into 2009, about half the market

share [was] up for grabs and the little firms were making ten times more money than they had ever made before," says Costas. He sees no reason that shouldn't continue and delights in the prospect of beating the big guys at their own game. Only weeks after opening its doors in 2009, PrinceRidge was off to a flying start; in 2010, it opened offices in Chicago and Los Angeles. "It's a very unique time, where you can open a business and right away have clients doing business with you." He sees no signs that the market opportunity is shrinking: while in 2006, about 85 percent of the trades that PrinceRidge is targeting were handled by the Wall Street giants, that ratio remains much lower. "Over the next three to five years, fifty percent or so will be up for grabs by firms like ours."

Hedge fund manager Nick Harris* is already seeing the impact of that trend. Harris relies on Wall Street traders to get him in and out of positions in stocks at a second's notice. Beginning in 2008, he realized that some trading desks at the giant Wall Street firms weren't as able or willing to help him put together trades as they once had been—even though Harris manages a few billion dollars in assets. JPMorgan Chase and Barclays (which acquired Lehman's investment banking operations) seemed to have little interest in changing that state of affairs. So when Harris set out to raise another round of capital, he embarked on a simultaneous quest to broaden his trading relationships.

"There's a great opportunity for anyone who is interested to come and grab market share in the trading universe—the Canadian banks, European institutions like BNP Paribas, or the midmarket firms like Jefferies," Harris says. "Anyone with any kind of appetite for risk and the ability to manage it could grab the business away." Previously, Harris had never dealt with trading desks at Jefferies or Key Bank. Now, he say, they "are starting to be more important to us because they are the guys providing the liquidity" in the place of giant institutions like JPMorgan Chase that reason tells him should be better able to do that. Harris now has a long list of those firms and individuals, including a relatively small Texas-based company that helped Harris execute some crucial trades in the stock of a tobacco company. That firm was added to speed dial on his traders'

phones; it took the spot once reserved for Citigroup, Harris says.

Forging a New Reality from Opportunity

Jeffrey McDermott has his own dreams of grabbing market share from the big institutions at the other end of the barbell. Unlike some other refugees from the Wall Street giants, McDermott initially thought he might launch a private equity firm when he left UBS in 2007. But raising capital as the credit bubble lurched toward its end proved difficult; McDermott switched his focus to a more distinct and more compelling business idea, and one he felt had a better chance of thriving: a boutique investment bank dedicated to advising and raising capital for clean technology and other green businesses.

"From the point of view of the economy and society as a whole, it was pretty clear to me that climate change and global sustainability were going to continue to be big areas of interest and investment for a while," McDermott explains. He calculated that, as had been the case in the dot-com revolution, smaller companies would likely lead the way. But with Wall Street's big firms caught up in the battle to return to their old business model and engaged in fighting off Washington's reform proposals, firms like Goldman Sachs weren't likely to be interested in any but the top 0.01 percent of those businesses, leaving, McDermott estimates, about three hundred companies in this arena "underbanked." Again, the upheaval had created a void—one that McDermott is filling with his new firm, Greentech Capital Advisors. He almost chuckles with glee discussing the magnitude of the opportunity, one that his years spent dealing with Fortune 500 clients at UBS prepared him to fill. "This whole industry has only grown up in the last (few) years, so there's no embedded firm with specialized knowledge and a competitive advantage. It's all new intellectual capital, and I'm in on the ground floor."

It remains to be seen whether players like Costas and McDermott can translate their early advantage into a lasting and sustainable

business edge. Dick Bove, an investment banking analyst who himself now works for a smaller firm, Rochdale Securities, argues that the big firms are likely to lose market share to the top new entrants. "The risk is on the side of JPMorgan Chase and the other big players," he says. "There's a space at the top of the investment banking world, where firms like Lehman, Bear, and Merrill Lynch once were—and yes, Goldman too, before it and Morgan Stanley became banks. That's the space that is up for grabs and it remains to be seen whether a new hybrid model—a firm more diversified than a traditional boutique, but that isn't driven by the need to post big returns on equity—will emerge and grab that, or whether it will be divided up between the big guys and the small, specialized boutiques."

Certainly, the boutiques showed no signs of standing still—on the contrary, they buzzed with excitement and a sense of opportunity. For years and sometimes decades, boutiques like Greenhill & Co. (founded by Robert Greenhill, former rainmaker at Morgan Stanley) had worked quietly but very profitably on the margins of Wall Street. With moderate fixed costs—they didn't run giant trading desks or have big underwriting or distribution businesses to fund—they had no giant debt load and while they hadn't been as locked into the pursuit of return on equity, they had done very well at the game nonetheless. (In 2006, when Goldman Sachs reported a 33 percent return on equity, becoming the envy of all the big Wall Street institutions, Greenhill generated an ROE of 56.3, rising to 82 percent in 2007.) It seemed to offer convincing evidence that trying to mimic Goldman Sachs was not the only way to become extremely wealthy on Wall Street. Greenhill never branched out beyond its core area of expertise and so, even at the height of the market meltdown in November of 2008, it managed to attract an extra $80 million in capital from investors eager to back one Wall Street business that seemed to know what it was doing. (It took only hours to raise the money; Bob Greenhill later bragged to Fred Joseph that he could have raised twice as much.)

The capital would come in handy, since Greenhill was taking advantage of the chaos to recruit discontented top bankers from

across Wall Street. From Merrill, Lehman, Citigroup, and Morgan Stanley, the bankers flocked to Greenhill and other boutiques, suddenly realizing that this was the kind of place he or she had always yearned to work. "It was obvious from the start that we didn't have to make the kind of tradeoffs—we weren't trading, we weren't lending, we were being hired for our expertise," says one banker who made the move in 2009. Greenhill acquired a Chicago office, and then opened one in Los Angeles as well, then expanded its roster of activities in London. The new bankers brought big deals with them: Greenhill advised Roche on its $46.8 billion battle for control of biotech giant Genentech. Not only were the boutiques avoiding the giant writedowns, but they were getting seats at some of the best deals in town: advising on InBev's $52 billion purchase of Anheuser-Bush; Pfizer's $68 billion bid for Wyeth; and the $58 billion merger of mining giants BHP Billiton and Rio Tinto. By mid-2009, their share of the merger advisory market had hit 15 percent—and that of the giants was down.

Some of the boutique bankers were focused not on chasing Goldman Sachs but rather on finding a way to reinvent the "old" Goldman Sachs for the twenty-first century. Ken Moelis, a veteran of such feisty second-tier institutions as Drexel Burnham Lambert and Donaldson, Lufkin & Jenrette, was one of these. Moelis became a power player at UBS, from which he walked away only weeks before the Swiss bank realized the full magnitude of its subprime lending problems. (Moelis wasn't involved in that CDO business.) Having turned UBS into a viable rival to Morgan Stanley and Goldman Sachs, Moelis figured he would repeat the feat—but this time for his own benefit. Now it would be Moelis & Co. that went head-to-head with Goldman Sachs.

At a Los Angeles dinner celebrating the new firm's launch, Moelis delivered a brief motivational speech to the small team of veteran bankers he had convinced to join him. It was clear that he saw the fledgling investment bank as something more than just another one of a cluster of boutiques. "I hope this is the beginning of something that, a hundred years from now, people will look back on and say, 'That's when it started.' " Moelis later recalled saying. In fact, he

thought it was the kind of moment that deserved to be preserved in the kind of old black-and-white photographs that had hung on the walls of the firms where Moelis had learned his trade and now set out to beat; the photograph featuring Messrs Goldman and Sachs, for example.[4]

Within twenty-four hours of opening his doors, Moelis had made the magnitude of his ambition clear, parlaying a long-standing professional relationship with Stephen Bollenbach, the CEO of Hilton Hotels, into a $13 million fee for Moelis & Co. in exchange for the new firm's assistance advising Hilton on the hotel chain's pending purchase by Blackstone. More deals followed and to be sure he was prepared for anything, he poached a forty-person team of restructuring bankers from Jefferies & Co. to handle what he expected would be a wave of bankruptcy-related workouts.

Even firms that had previously abandoned the investment banking and market-making parts of the financial services business seemed to take a new interest in their potential in the postcrisis environment. Sanford C. Bernstein & Co., noted for the caliber of its investment research, announced in December 2009 that it had recruited Thomas Morrison, a former Bank of America investment banker, to launch a new division that would focus on underwriting securities transactions for clients. This was a part of the business that Bernstein (now a division of asset management company, Alliance Bernstein Holding L.P.) had abandoned previously, amid controversy surrounding the potential for conflicts of interest between its research and the demands of serving corporate finance clients. Faced with the size of the opportunity that had arisen, those concerns now took a backseat.

The presence of these new rivals is an additional threat to the established banks, at a time when they already feel under siege by government policy changes. Some have let their frustration and vulnerability show, as when UBS filed a lawsuit against Jefferies & Company, claiming that the latter had been "surreptitiously planning" a raid on the former's banking talent before it poached a team of star health-care bankers. UBS had lost a lot: in the last four years, the team and its leader, Benjamin Lorello, had earned more

than $1 billion in fees for UBS. Given that the ties between a top banker and his clients tended to be stronger than those between the clients and whatever institution that banker happened to be working for (with the possible exception, of course, of Goldman Sachs), the suit showed just how concerned UBS was that its brand name not be further damaged by such defections.

The Future of the Behemoths

Wall Street's giant firms may feel threatened, but they aren't dinosaurs. Nor will they simply slink away into the night. For starters, many of them still have access to one of the scarcest resources on Wall Street postcrisis: capital. Underwriting deals is fine; advising on mergers is a great business. But to be a powerhouse player requires capital—and the talent to deploy it in such a way as to make money at every turn. "To stay in the game, you need capital," points out one Goldman Sachs banker. "Do you think that we just take an order to sell so many shares of General Electric [but] don't execute it until we find someone else who's willing to buy [the shares] at that price?" Nonsense, he says. Being an intermediary these days means knowing what price to pay for a big block of stock a client wants to sell, being willing to keep some, most, or all of those shares on the firm's own balance sheet ("warehousing" it, in Wall Street parlance) until a buyer can be found for it at a high enough price, and managing the risk associated with that position. That kind of market-making requires a big balance sheet as well as trading talent: two assets the typical boutique doesn't possess. "They're just too small," the banker says of the boutiques. "The phrase I hear is 'too small to thrive.' I don't know about that, but they'll be thriving in their own little corner of the world, not expanding into ours."

Whether that dismissive perspective is accurate or not isn't the point. Rather, the issue is that none of the rivals has a clear monopoly on the winning Wall Street model. Size has its advantages: being nimble and opportunistic will benefit other firms.

Even some of the firms that have struggled in the wake of the crisis have a chance at emerging in the winners' corner, once they are recapitalized and efficiently managed.

Still, by the time the dust settled it was clear that one of the large firms had a chance of beating Goldman Sachs at its own game. After years spent stuck beneath Goldman, Morgan Stanley and even Citigroup in the league tables and thus in Wall Street's pecking order, JPMorgan Chase was emerging as the dealmaker that its rivals were starting to envy by the summer of 2009. Of every $100 of fees companies paid to Wall Street banks for underwriting stock sales, JPMorgan Chase collected $15, while Goldman Sachs pocketed only $10. JPMorgan Chase vaulted from sixth to first place in the much-watched underwriting league tables since 2005, when it had earned only $5 of every $100 of fees. It was already a powerhouse player in the debt and loan markets, and its bankers were faring well in the battle to advise on mergers and acquisitions, helped by the bank's ability to make loans in support of these deals. (The battle between Goldman and JPMorgan for primacy continued into 2011.)

Moreover, the bank had relatively few legacy issues to deal with; whether by accident or design, its CEO, Jamie Dimon, had steered clear of the subprime mess; he had been tapped to acquire both Bear Stearns and Washington Mutual—deals which dramatically increased the bank's size and clout—because of its balance sheet strength. Almost overnight, Dimon became a kind of Wall Street superhero, one of the only Wall Street leaders to emerge untainted from the fiasco. At the firm's annual meeting in 2009, Dimon was thanked at least twice by shareholders for his leadership and was able to promise in return the prospect of a higher dividend.

The biggest banks face one giant obstacle, however: the raft of new regulations that I'll discuss in the next chapter, many of which will make it more difficult for them to take the kind of big risks that generate outsize profits. There is certainly a need for some kind of restraint: within a year of the crash, even the losers among the big banks were behaving as if they were winners and once again seeking ways to take risks that, if left unchecked as they had been

before, could create fresh havoc within the financial system. Citigroup, for instance, despite still having the government as its single largest shareholder after it had come closer than most other survivors to utter collapse, was mulling plans to revamp and relaunch its alternative-investments division before the first reform proposals announced by President Obama raised questions about its ability to do so. How risky might that have been? Well, one of the bank's former hedge funds had been liquidated in the wake of the crisis and had returned only 3 cents on every dollar investors had put into it—not a track record to inspire confidence in either the immediate managers or the bank officials overseeing the division. Happily, investors agreed that they weren't willing to climb back aboard this particular bandwagon: while Citi had hoped to raise $2.5 billion by 2010, at the end of 2009, it had received investor commitments for a mere $150 million. Perhaps investors will impose a kind of discipline on Citigroup's management that even near-bankruptcy failed to do? At least, that is possible for as long as those investors remain fearful. When memories of the crisis are less vivid, when greed returns and regulators become less vigilant, the system will once again be at risk.

For now, at least, everyone remains intent on ensuring there is no repetition of the events of 2008. "The regulators are hell-bent on not having this happen again," says Leon Cooperman, the former Goldman Sachs partner who currently heads a large hedge fund group. How can he be so certain? The very fact that they insisted that Goldman—along with Morgan Stanley—become a banking institution and subject itself to tighter levels of regulatory scrutiny. "When I was a partner at Goldman Sachs, we would sit around the partners' dining room and talk about how we never, ever wanted to become a bank; that the banks were too regulated, that the returns were much less in that business and what have you." And yet, that's precisely the path Goldman's leaders chose in September 2008. "You can rest assured that [they] became banks not because they wanted to, but because the government made it clear to them that was what was going to happen," Cooperman opines.

Even before the administration unveiled what would become the

Dodd-Frank Act in 2010, it was clear that regulators and policy makers wouldn't put up with Wall Street firms taking as much risk as they once had. Becoming bank holding companies meant that Goldman and Morgan Stanley came under the scrutiny of a new set of regulators and faced more restrictions on the amount of leverage they could deploy in the quest for profit. The Dodd-Frank Act, when it was passed in the summer of 2010, complicated matters further, putting another sizeable obstacle in the path of Wall Street institutions hoping to return to being profit-generating machines for the benefit of their shareholders and employees, as Citigroup's Parsons envisaged. If they can't pursue some of their most profitable business lines, and can't use leverage, then what?

"By and large, you can't make large sums of money without taking risks," comments Franklin Allen, finance professor at the Wharton School of Business. "The more money you make, the indication is that you probably took a lot of risk to do it.... And I think that's part of the problem."[5] Wall Street CEOs don't want to attract the suspicion of regulators by becoming extraordinarily profitable; at the same time, at some firms that have been slower to reembrace risk taking in the wake of the crisis, rumblings of discontent have been heard.

Morgan Stanley—the firm that forced out a former CEO, Phil Purcell, for being too reluctant to take risk—is now a much more conservative place to work, thanks to its new CEO, James Gorman. Before leaving that office, however, John Mack—who had insisted that Wall Street couldn't be trusted to govern itself—hired one hundred new risk managers. And yet bankers weren't happy that Morgan Stanley was taking longer to bounce back than archrival Goldman Sachs, meaning that bonuses would likely remain smaller. Some executives claimed that it wouldn't be long before the firm would be standing "shoulder to shoulder" with Goldman again, at least in terms of profitability and market share.[6]

But Wall Street is going to have to work harder and battle new kinds of rivals to earn the kinds of profits to which it had become accustomed in the first few years of the new century. The CDO machine is dead; the buyout funds are likely to be even more hard-

nosed when it comes to negotiating fees for advising them on acquisitions or underwriting IPOs of their portfolio companies. If the Dodd-Frank Act turns out to mean in practice what it appears to mean in principle, then Wall Street's institutions will be forced to rely on more plain-vanilla transactions to generate profits. That will be a good thing for the stability of the system—at least until Wall Street figures out a way to bypass the spirit of the rules while still adhering to them technically, and make money by marketing some new strategy or product or using some financial engineering technique that we can't even conceive of today.

The incentive exists to do just that, because those plain-vanilla transactions—the ones that are essential to the smooth functioning of the money grid—generate smaller fees, meaning profits will be thinner on the ground and shareholders increasingly dissatisfied. Goldman Sachs got a taste of that in the summer of 2010, when its return on equity dipped to a worryingly low 9.5 percent, a far cry from the 20 percent that Goldman leaders had always considered the base case and the 10 percent that is considered essential for a financial institution to prevent its existing shareholders from fleeing. If lower ROEs become the norm, Goldman and its rivals may yet—gasp—end up looking like a real utility.

Tug-of-War

The incentives for Wall Street to return to its past practices are all in place; the question that remains to be answered is what factors will rein in a repeat of that behavior. Regulators may place their faith in their ability to craft new rules but others, as I'll discuss in the next chapter, believe that a cultural transformation is required. But perhaps it will be the arrival of an entirely new kind of competitor that convinces Wall Street to keep its risk taking in check and focus on its core business. What if those firms that had been Wall Street's biggest clients over the last decade—hedge funds and buyout firms—now became its rivals? What if they began to try to serve as their own intermediaries and dispense with at least

some of the services of Wall Street's traditional money grid operators? Could a firm such as Blackstone replace Goldman Sachs and beat it at its own game?

It may sound outlandish, but buyout fund manager Jake Martin, who has been helping to structure financial transactions for a specialist buyout firm for nearly two decades, believes he and his peers have all the skills that are required. "I think it's quite possible that some of these large and very diversified buyout firms could bypass institutions like Citigroup altogether and sell bond deals for their portfolio companies directly to the buy side," Martin remarks. A firm such as KKR knows who the logical investors are for the debt it wants to issue to finance the purchase of, say, a medical devices company. "They have the same knowledge and skills as Citigroup—their ranks are full of bankers." Battered legacy institutions aren't attractive banks to work with, Martin adds. "At some point, it will be KKR and not Citigroup knocking on the door of other investors. They'll say, 'Hi, we're here to get you to buy a piece of this bond or loan deal, which we've taken a big piece of ourselves.' They'll be part investor and part banker, and the change will occur relatively seamlessly."

KKR is already taking baby steps in that direction. Back in 2007, it recruited Citigroup banker Craig Farr to build an in-house investment banking division, KKR Capital Markets, to serve the firm's own portfolio companies and give the buyout group more control over the whole investment banking process. In 2009, KKR Capital Markets signed an unusual pact with Fidelity, giving the investment giant exclusive access to KKR's share of any of its portfolio companies in the wake of an IPO or other public issue. This gives KKR an exit strategy for its holdings, and Fidelity the option to pick up some stock in any businesses that its money managers find intriguing without having to compete for them on the open market. Even more intriguing to many was the decision by Farr and KKR to provide the struggling Eastman Kodak with a cash infusion in 2009, a transaction that gives it the option to acquire a 17 percent stake in the firm down the road as well as two board seats—an unusual transaction for a buyout firm that prefers to own

a portfolio company outright. “Who knows where they could take this?” says one investment banker. “It’s not inconceivable that they could begin providing at least advisory services for a fee to Kodak now, and maybe develop more businesses for which they traditionally had to go to Wall Street. This is not a time to rule out anything.”

Martin’s own firm, which he didn’t want to name publicly, is already investigating ways to be its own banker. One option is to raise a new fund that would invest in bonds issued not only by its own portfolio companies (it already does that) but for other businesses as well. Instead of turning to Citigroup, the CEOs of those companies could cut out the middleman and come straight to Martin’s firm for capital. “Why do we need to have Citigroup as an intermediary?” Martin wonders, a small smile playing around his mouth. The smile broadens. “We can be our own intermediary; we have the know-how, the contacts. The technology exists to help us. And we have the kind of capital that we can put into these deals in a way that Citigroup obviously wasn’t able to manage to do sustainably.” In the postcrisis era, when Goldman Sachs’s brand name can be tarnished and an upstart bank like Jefferies can recruit a team of star bankers, why shouldn’t a KKR or a Blackstone transform itself into Wall Street power player? “If we do our own due diligence and say we’re putting our own money in alongside those of others, wouldn’t that be a selling point?” Martin demands. “I’ve got to believe it. After all, while Citi would only be interested in selling it on to the next guy, we’d be there for the long haul.”

Buyout funds may be pondering this kind of move, but at least one hedge fund began pursuing such a strategy in the immediate aftermath of the crisis. By late October of 2008, Ken Griffin, the founder of Citadel Investment Group, one of the world’s largest and most influential hedge fund empires, was preparing to take advantage of the carnage he was witnessing. True, Citadel’s own funds were being hit by losses, but Griffin saw these as being short-term hiccups. He was looking ahead to the day he believed Citadel would emerge as a new kind of player on Wall Street. The firm’s trading and market-making activities meant that it already

commanded as much as 4 percent of all trading volumes worldwide on any given day. Now Griffin figured he could put his firm on the same level as JPMorgan Chase or Goldman Sachs, and himself on the same level as Lloyd Blankfein or Jamie Dimon by leveraging that clout and market knowledge and becoming an investment bank in its own right.

Griffin confided his plans to Rohit D'Souza and Todd Kaplan, two Merrill Lynch alumni. Citadel's market-making division, a business that both offers to buy stocks, bonds, and other securities at a bid price and maintains an inventory of them to sell at the posted ask price, was the key. "It was clear to all of us early on in these discussions that the market-making business could serve as a hub for a new kind of investment bank," Kaplan recalls. "We started out by discussing what might be possible, and it quickly evolved into us working on a full-fledged business plan, on the way to add client-facing bankers to that existing model." Before the end of the year, Griffin, Kaplan, and D'Souza were all convinced: Citadel had a chance of becoming one of the great investment banks on Wall Street, they agreed. So what if it was technically still a hedge fund?

All three believed that the only way to try to launch a viable competitor to the existing investment banks, with their still-impressive (if battered) brand names, was to return to Wall Street's roots. Kaplan's vision was of an investment bank that would serve as an intermediary, not a principal; one that earned fees rather than using its own balance sheet to generating a return on equity. No more chasing Goldman Sachs, he decided. "I watched the big firms lose their way when it came to client service, and I don't want that to happen again." Whereas the classic investment banks had been sustained by the stream of revenues coming from high-margin trading operations up until Mayday in 1975, this twenty-first-century reincarnation of that model would be financed by the high-volume market-making business. (It didn't hurt that Citadel itself was making some $1 billion a year from the newfangled high-frequency trading platform it had built, a way to make even more money from rapid-fire computerized trading.) It was just a new twist on an old theme, some Wall Street veterans suggested as the

details began to leak out in the summer of 2009. But the one thing that stunned everyone was that the initiative was coming not from someone such as Costas or Moelis but from a hedge fund. From a hedge fund in Chicago to boot.

"I just don't see it," says Roy Smith, a finance professor at New York University and a former partner at Goldman Sachs. "How do they imagine they can achieve overnight what it took firms like Goldman more than a century to build?" Those who had studied Griffin as he built up a $15 billion hedge fund empire in less than two decades didn't want to underestimate him. "If he sees an opportunity, it's there," says one former senior colleague. Even though D'Souza and Kaplan had both bowed out by early 2010, the New York–based business was still growing and already working on trades for other hedge funds—something naysayers said could never happen—and had won mandates to advise corporate clients, including a bankrupt casino operator. Griffin sees himself not as chasing Goldman Sachs but rather as becoming Goldman Sachs. "I do believe in the next five years we will have created one of the great sales and trading operations" on Wall Street, he said in an interview.[7] And they will be able to do so, Kaplan argues, because returning to business as usual is neither possible nor wise for Wall Street as a whole. "This is a whole new ballgame."

Regardless of whether Citadel succeeds with its plan to graft an investment bank atop a hedge fund, Kaplan has come to believe that simply trying to emulate the Street's biggest and most successful firms was at the root of the crisis. Wall Street's institutions should have pondered whether or not they had a real competitive advantage in the businesses they were entering, he says, as well as a real understanding of the risks as well as the potential for those businesses to boost their ROE. "The need to make a return on the balance sheet was all-important, but then the balance sheet became the tail wagging the dog," Kaplan says. But while he believes a more classic model is the way of the future, he had trouble recruiting bankers who shared that vision, despite widespread layoffs across Wall Street. His in-box rapidly filled with résumés from displaced bankers with blue-chip pedigrees, few of

whom "get it," he explained. "When guys I talked to about a job asked me what our ROE target is, I had to explain we're not going to be managing the business that way."

Perhaps the biggest question about Wall Street today isn't the shape of the winning institutions of the future, but whether or not its denizens will ever manage to internalize that ethos. Certainly, government policies and new regulations won't succeed in swaying Wall Street's hearts and minds.

CHAPTER 9

Chasing Goldman Sachs?

A blizzard was blanketing the East Coast of the United States with snow on the day in late January 2011 that Phil Angelides and five of his nine fellow members of the Financial Crisis Inquiry Commission filed into a small conference room in Washington, D.C., to announce their findings. More than a year after beginning their inquiry—and months after the first package of financial reforms had become the law of the land in the shape of the Dodd-Frank Act—Angelides brandished the 545-page paperbound report in his left hand, pronouncing it to be the result of an exhaustive investigation into a financial system that had altered beyond recognition over the course of three decades until it was one that was no longer capable of discerning the course of action that was in the best interests of all the system's stakeholders. "The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks," he said. "Theirs was a big miss, not a stumble. A crisis of this magnitude need not have occurred. To paraphrase Shakespeare, the fault lies not in the stars, but in us."[1]

The six members who had signed off on the report and now appeared before journalists to defend it argued that the crisis had been avoidable. Giant failures among regulators were accompanied by massive missteps and ethical shortcomings on the part of Wall Street itself, they declared. The financial system, they concluded, had become "a highway where there were neither speed limits nor neatly painted lines" and on which Wall Street firms had been conducting a giant game of chicken in the high-speed Porsches purchased with their lavish bonuses.[2] Group think dominated, a

majority of the FCIC members had recognized: instead of questioning what their rivals were doing, Wall Street firms blindly mimicked them in hopes of generating a few extra pennies a share in earnings each quarter. “A crisis of this magnitude cannot be the work of a few bad actors,” they proclaimed scornfully, dashing the hopes of those who had tried to pin the crisis on a handful of rogue mortgage lenders and their accomplices at now-defunct financial institutions rather than conclude that there was a systemic problem that needed to be addressed.[3]

But it wasn’t the blizzard that kept the other four members of the FCIC from attending the press conference. In fact, while Angelides and five other panelists (including former CFTC chair Brooksley Born) made their case for Wall Street’s culpability in the financial crisis, their report sparked not one but two separate formal dissents by the other members of their group—including disagreement over even including the phrase “Wall Street” in their conclusions.

Many critics of Wall Street had hoped that the FCIC would produce the contemporary equivalent of what became known as the Pecora Report, named for its primary author and chief counsel of the post-1929-crash investigation, Ferdinand Pecora. But while Pecora’s findings were so damning that he won the title of “the hellhound of Wall Street” for his relentless pursuit of the culprits who had undermined the integrity of the financial system, the FCIC was hampered from the start by the kind of sharp divisions of opinion of the kind discussed in chapter 7. Ultimately, these couldn’t be reconciled: some FCIC members could not or would not accept the idea that Wall Street was a prime mover in the near-cataclysm of 2008. Republican members fought, ultimately unsuccessfully, to have the words deregulation and shadow banking system removed from the report as catalysts for the crisis; in their eyes, the problem was tied to the role of Fannie Mae and Freddie Mac that encouraged reckless risk taking by mortgage lenders, as well as related government policies.

In order to reform the financial system—or any kind of system—you have to reach a broad agreement on what’s wrong with it and what needs fixing before you start tinkering in an attempt to fix the

problem. As the ferocious behind-the-scenes arguments between members of the FCIC showed, no such agreement seemed possible. While the Pecora hearings of 1933 and 1934 not only offered tremendous public drama but also generated widespread public support for sweeping new securities laws—including the Glass-Steagall Act that mandated the separation of commercial and investment banks—the FCIC hearings passed with relatively little commotion. As for the idea that the FCIC's conclusions might pave the way for thoughtful consideration of what kinds of reforms might be necessary for the financial system to continue functioning smoothly into the twenty-first century, well, the divisions among its members were enough to put that to rest.

Perhaps some of the skullduggery that was unveiled by the FCIC—Angelides told reporters that he has referred several names to law enforcement—will result in criminal charges. Perhaps, just perhaps, some of those charges will stick and someone will be found criminally liable for part of the crisis. But without any kind of consensus on what caused the financial crisis, the odds of reaching agreement on what to do to prevent a recurrence were sharply diminished. Now, with the crash in the earliest stages of becoming part of Wall Street's past history rather than its current reality, the odds that another crisis will rock the financial system to its core are creeping higher once again.

Back to the Brink?

The subtitle of this book, How the Masters of the Universe Melted Wall Street Down … and Why They'll Take Us to the Brink Again, warns of what happened when Wall Street couldn't govern itself and regulators weren't capable of reining in the Street's worst instincts … as well as what will happen if we don't find a way to do so in future. Optimists wondered why on earth that would happen again, given how close the whole system had come to complete collapse in 2008. "I think that some of the lessons will stick with us for quite a while, particularly as long as the leaders

who had to make the decisions about survival and who came within hours of filing for bankruptcy are at the helm and are in a position to see future problems in the early stages, before they become too big to control or contain," says one senior Wall Street veteran familiar with the thinking of leaders like Lloyd Blankfein and Jamie Dimon.

What optimists overlook is the fact that the conundrum at the heart of the way Wall Street works remains unchanged. As has been true for at least the last three decades, the pressure is on every bank and investment bank to identify and squeeze the last drop of profit out of each successive new product or strategy in order to maintain returns on equity at acceptable levels. Simply doing well isn't enough if one or more of your rivals is doing better. And there remain few incentives to ask the "risk question" along the way, to inquire, what happens if we all have it wrong?

Nor are there, as yet, any incentives for firms like Citigroup or Morgan Stanley to put the priority on running the money grid safely and efficiently in the interests of all stakeholders, not simply themselves and their shareholders, even though there is no evidence that the two objectives are completely incompatible. For now, CEOs at Wall Street firms may have been scared straight, but the system in which they operate and that doles out rewards to the overachievers among them and the punishments to those who lag behind is still the one that contributed to the crisis. So what is to stop a Wall Street firm from once again focusing almost monomaniacally on what is in its best interest, seeking out ways to earn even higher returns and recruit the top talent and offer the most enticing perks, paying little heed to the consequences?

Clayton Rose, a former investment banker who now guides students at the Harvard Business School through case studies of crisis and failure on Wall Street, is one of many veterans of the Street who worries that the reforms to date have been too cosmetic to effect real change. "There is a natural tendency to forget and to let self-interest rule the day," Rose says. When Long-Term Capital Management collapsed in 1998, requiring Wall Street firms to chip in $3 billion to "ring fence" that problem, "we thought it was the

end of the world," Rose recalls, "Now, that sum looks like tipping money, and the problem looks, in hindsight, completely containable."

Anyone looking for clues as to why Wall Street tends to self-destruct periodically, in large part due to its own foolishness, could do worse than pay attention to some of the details of the LTCM rescue package. Investment banks were asked to chip in $250 million each to save LTCM and thus the financial system; the fear was that a chaotic collapse of the hedge fund would pull its counterparties—the Wall Street firms that had done business with it—into the abyss one after another due to the magnitude and complexity of the counterparty relationships associated with its derivatives markets dealings. One after another, the big Wall Street firms agreed to participate in the bailout, with the sole exception of Jimmy Cayne of Bear Stearns, who flat-out refused. Merrill Lynch's then-CEO, David Komansky, demanded to know what Cayne thought he was doing. "When did we become partners?" a furious Cayne shot back.[4]

That attitude was still one of Wall Street's biggest problems a decade later, when then-Treasury Secretary Hank Paulson tried to drive home to Wall Street's leadership the message that they had a common interest that transcended their individual corporate self-interests during the fateful weekend in September 2008 that determined the fate of Lehman Brothers and Merrill Lynch. According to accounts of the meetings that took place at the Federal Reserve's headquarters in lower Manhattan, the assembled bankers pressed Paulson to structure a bailout for Lehman. For his part, Paulson tried to get them to shoulder some of the responsibility for what all were finally prepared to acknowledge was a systemic failure, and thus play a role in preventing a collapse that could have systemic ramifications. "You have a responsibility to the marketplace," Paulson told them.[5]

But once more, they declined to acknowledge that collective responsibility—whether they couldn't agree that they had a common responsibility in the first place (the concept that Cayne had so adamantly rejected in 1998) or whether they couldn't act on

it because of their own internal woes is unclear—and nothing happened. Lehman filed for bankruptcy protection, and the intermediary function at the heart of the money grid came within hours of not just freezing but collapsing altogether. "It's impossible to understate the sense of fear people in that room felt—they were going into the unknown," says one former top banker familiar with the weekend's events. He went on to compare it to the fear among scientists at Los Alamos just before the atomic bomb was tested for the first time in the early summer of 1945. "For all these guys knew, they were going to set fire to the earth's atmosphere when they set off the first nuke, and some of us wondered if we'd blast our financial system back to the days of the horse and buggy and the quill pen," the former banker says. "As it turns out, after Lehman, the government stepped in and did everything it could to make sure we never had to find out."

That attitude on the part of Wall Street—me first, me foremost, and only me—remains a problem today. They may have a common interest in fending off regulation or other outside interference, but Wall Street's firms have always seen a rival's woes as their opportunity—and vice versa. During the boom years, all of them had chased Goldman Sachs with zeal, thinking of little more than grabbing the biggest possible share of whatever fee-generating business was available, without considering the risk created to the system by the fact that they and their peers were all doing the same thing at the same time. Each firm on Wall Street put its own interests ahead of those of the system and paid attention to what its rivals were doing only insofar as those activities affected its own ability to grab market share and profits. (They certainly weren't thinking of the impact of so many firms following the same business strategy might do to the sustainability of that strategy, their business model, or the system itself.) The question continues to haunt some on Wall Street as well as many regulators who have used the events of 2008 to think more broadly about what went amiss—not just the proximate causes (why were so many subprime loans issued and repackaged into CDOs?) but more complex and far-reaching ones. Why was it that no one, even among those who

perceived the risks, thought to holler “danger”?

The Utility and Fiduciary Duties

To whom or what do the institutions at the heart of the money grid owe their primary loyalty? Should they have acted as partners to save the system, even at the last moment? Or, by 2008, was that kind of action so unimaginable that it had become impracticable? Without understanding how the denizens of Wall Street react to those questions, it’s impossible to address the logical corollary: Will anything stop Wall Street from returning to behaving recklessly once the crisis is past, even with more restrictive rules and regulations governing its behavior? What happens once the government is no longer peering over the shoulders of financial institutions that are now larger and more systemically important than ever—that have become, in popular parlance, “too big to fail”?

Unfortunately, in the absence of major changes to the DNA of these giant legacy institutions and their inhabitants, the question isn’t whether but when, as John Mack tacitly admitted in his cri de coeur. These firms have strong incentives to return to business as usual, and little motivates them to seek out a new business model, even if that new path might put less stress on the system as a whole. True, the advent of the Dodd-Frank Act means that regulators are now required to implement its provisions, a process that will mean finding ways to constrain some kinds of behavior on Wall Street. But regulation isn’t a panacea.

Even if Dodd-Frank did a perfect job of identifying the risks to the financial system—a claim that almost no one is trying to make—the legislation contains, as several members of Congress have pointed out, multiple unintended consequences for each one of its 2,500-plus pages. No one, for instance, wants Wall Street to curtail the “good” kind of risk taking that the money grid requires in order to fulfill its role in the economy—that would backfire, creating a system dysfunctional in a different way. Classic utilities such as gas

and electric companies may be economically and socially useful, but they aren't very profitable. One reason many on Wall Street recoil at their industry being characterized as fulfilling a utilitylike function is the fact that utilities' profits are typically overseen and its fees approved by regulators fearful that businesses running effective monopolies will take advantage of their customers.

Wall Street doesn't need to worry about being allowed to earn only a regulated rate of return, like their counterparts in other utilitylike businesses. To date, policy makers of all stripes acknowledge that Wall Street isn't a typical utility even if it exists to fulfill a social good of some kind, and that treating it as if it were a power or water utility might prove counterproductive. That is why they have so far tilted in the direction of letting the industry regulate itself, constrained only by the rules passed and overseen by organizations such as the Securities and Exchange Commission and the Office of Thrift Supervision. The problem is that as the financial system became more complex and more oligopolistic—by 2000, the ten largest banks held 40 percent of all commercial banks' insured deposits, double the level recorded in 1980—those organizations had become less rigorous in their enforcement of whatever rules existed. Meanwhile, the institutions themselves were paying attention to an altogether different set of incentives.

Unless you work for or invest in a power company, you can probably go through your entire life without becoming familiar with the phrase regulated rate of return. Similarly, unless you happen to be a corporate governance activist, a securities lawyer, or a corporate director, odds are that you've heard the phrase fiduciary duty only in passing and dismissed it as one of those bits of jargon that is just academic. That's only half true. While it is jargon, understanding the real meaning of the phrase is essential to grasping what happened on Wall Street and why it may happen again. The concept is straightforward enough: the idea that an individual or group has an overwhelming duty to another group that overrides every other possible interest, including self-interest. It's the same kind of relationship that a lawyer owes to his client, the kind that pops up during television crime shows when a lawyer

is put in an impossible bind when he can't publicly disclose information that would solve a murder because that information was entrusted to him in confidence by a client.

That is the level of duty that every director of every corporation owes to the company's shareholders. Every decision that a director makes must—legally—be in the best interests of those shareholders; that extends to the selection of the company's CEO. The CEO and the company's employees, in turn, are bound by the same obligation. The smaller the number of shareholders and the greater the extent to which those shareholders are the same individuals who serve as managers and employees—as is often the case in a startup company or in a private partnership—the more likely it is that everyone's interests will coincide. When a Wall Street firm is run by a CEO who is also a major shareholder—not just a shareholder but one who owns an outsize slice of the business—the odds are greater that that individual will be hyper-vigilant about the kind of risks and the nature of risks the company is taking. The greater the extent to which the people taking the risks identify emotionally with the company whose future they are putting at risk, the more they are likely to second-guess themselves. As investment banker John Costas has already noted, "The partners' capital was on the line; we thought about the long-term implications of all the business we pursued; we knew that our long-term profits depended on being responsible stewards of our capital in the short term." If a potential source of new profits seemed too risky over the long haul, Costas says, the partner had an incentive and even a duty to speak up and the ability to make his voice count, as one of those shareholders in whose interests the company was legally required to function. It was that kind of context that enabled Goldman Sachs to describe itself—with a straight face—as being "long-term greedy."

But what happened if the Wall Street firm's major investors weren't the firm's partners, those charged with its day-to-day operations? Even at those financial institutions where employees were, collectively at least, major owners—Lehman Brothers among them—the culture had changed over time. Few investors saw

themselves as long-term holders of any company, even the one they worked for at a given point in time. With the freedom to sell their stock in their publicly traded companies whenever they chose came an intensified focus on short-term profits. Even when restrictions were imposed on their ability to sell, many investment bankers found ways to hedge the risk that the value of their company's stock might decline; it was simple prudence. Accustomed to putting such strategies in place for their clients, doing so for themselves was a far simpler matter than trying to withstand the pressure to take on additional risk. Hedging gave them a way to have their cake and devour it at the same time: investment bankers could pursue the maximum profits possible (and thus the maximum possible bonus) and still limit their own losses to some extent. That helped them cope with the demands of their outside investors, all of whom seemed to have the clout to win an audience with an investment bank's CEO or chief financial officer—or even its directors—and influence decisions on how much risk to take in a way that a mere employee rarely could.

The very nature of Wall Street institutions as publicly traded companies has emerged as one of the chief problems, something that is perhaps a bigger issue in determining the health of the Street than the specific businesses targeted by the Dodd-Frank Act. If Wall Street firms came to rely heavily on proprietary trading, allocating big chunks of capital to create hedge funds and private equity funds, and seeking to develop increasingly complex and opaque derivatives, it is because these are the products and services that command the highest rates of return. Being accountable to a large number of outside shareholders came to be seen on Wall Street as a justification for pursuing the most profitable businesses, at all costs—and for chasing Goldman Sachs. In exchange for acquiring a larger and more stable capital base—the rationale for going public—investment banks found themselves with a new kind of burden. "The culture at Goldman Sachs began to change, almost to the day we finally completed the IPO," says one former Goldman partner. "More and more the discussion around new business opportunities wasn't about weighing the merits, risks, and profitability of the

business, but just about the profitability. There was still room to argue, but every day it seemed as if that was more futile."

Before Brad Hintz moved to Alliance Bernstein and began to track Wall Street's investment banks from the perspective of a research analyst, his job had been to communicate to investors that Morgan Stanley (in whose investor relations group he toiled) was doing everything it could to maximize profits and the all-important return on equity. As profits and outsize ROE levels became harder to earn, that message was simply that Morgan Stanley pledged to deliver "superior" returns. Increasingly, outside shareholders hearing this pledge defined the bank's fiduciary duty to them as earning and distributing the largest profits possible in the shortest possible time frame.

The pattern was the same across Wall Street. Each fiscal quarter, bankers at publicly traded investment banks scrambled to beat their own results of the previous three months to keep investors happy. And those big investors themselves—managers of pension funds, hedge funds, and mutual funds—weren't shy about making known their demands for ever-higher rates of growth in profits and ROE. One former Citigroup executive says, "That just didn't happen within a private firm. The pressures were there, sure, but there was more of a likelihood that someone worried about the long-term impact of a short-term move in market share could get a hearing and be heeded."

Other corporate scandals have rocked the United States in recent years, many of them involving managers who violated the trust of shareholders in the pursuit of personal profit. Some have revolved around the sale of faulty products; others, fraudulent accounting schemes. Ironically, no such betrayal can be cited as a cause of the financial crisis. Rather, as Leo Strine, vice chancellor of the Delaware Court of Chancery (a place where a great number of shareholder lawsuits are filed and adjudicated), points out in one of the most damning postmortems yet published on the Wall Street crisis, directors and managers were, if anything, too responsive to demands from their investors.

"The more pressure business leaders are under to deliver high

returns, the greater the danger that they will violate the law and shift costs to society," Strine concludes.[6] As of this writing, no one has been convicted of any criminal offense in connection with the crisis, a state of affairs that Oscar-winning documentary maker Charles Ferguson publicly deplored, to tremendous applause from the audience, when accepting his Academy Award for Inside Job, a film about the near-meltdown. It may be, as Strine cautions, that on today's Wall Street, firms "are free to engage in behavior that is socially costly without violating" the letter of the law.

To give the bankers at firms such as Merrill Lynch and Lehman Brothers their due, they don't seem to have set out with the explicit goal of destroying their firms. Rather, they lacked the imagination or intellect to realize what could happen down the road, or the skill to protect themselves and their firms from the fallout. But even if they had consciously behaved foolishly, a savvy lawyer could still argue—legitimately—that they were acting in the fiduciary interest of their investors. As long as those investors continue to believe that a firm's board and management are pursuing their best interests when they embark on strategies to maximize short-term profits—even at the expense of prudence—that is what those Wall Streeters will do. Missing from this equation is the kind of ethos that Dennis Weatherstone, former chairman and CEO of the firm then known as J.P. Morgan & Co., once tried to instill in the aggressive bankers under his dominion.

Weatherstone saw clearly the risk that one weak player within the system could destabilize Wall Street as a whole. Even if Morgan managed its own risk prudently, that couldn't insulate it from a firestorm, he realized. His realization was sparked by the rapid growth of the derivatives market, involving complex customized products; left to grow unchecked, Weatherstone feared what might follow since the system was only as strong as its weakest link. "If you are driving along the motorway in a smart Maserati and see an old car belching fumes, it's no good just driving on," Weatherstone told J.P. Morgan's young derivatives bankers in the early 1990s, according to Gillian Tett's chronicle of the bank's adventures in the derivatives world. Those fumes might signal a problem with the car

that could become a problem for everyone else on the highway. "If that old car crashes, it could wipe out the Maserati, too."[7]

But words of wisdom from such elder statesmen fell on ears that became increasingly deaf with the passage of years. As it became harder to make money by sticking to low-risk lines of business and plain-vanilla transactions on behalf of clients, the pressure to venture further into riskier trades involving the bank's own capital mounted. Often, that dovetailed with the clients' interests. For instance, proprietary trading was simply an outgrowth of market-making; the process of allocating the institution's capital to buying and selling big blocks of securities on behalf of clients. Those clients wanted the traders with whom they dealt to assume the business and financial risk of holding securities on the trading-desk balance sheet until needed by a client; they didn't want to be told they'd have to wait until the trading desk could line up a list of clients willing to take on the other side of the transaction. A bank that dithered about using its own balance sheet would lose business to rivals—the intolerable scenario. These days, no Wall Street firm can function only as a pure intermediary, veterans insist.

Some firms—notably Goldman Sachs—proved extremely adept at deploying their own balance sheets to maximum advantage. Others, faced with the harsh reality that raking in enough in profits to keep their shareholders happy via traditional intermediary businesses was no longer possible, concluded they would have to follow Goldman's lead. And they'd need to seek out other sources of large profits—even if those profits came accompanied by large risks—in order to stand a chance of offering their own investors a return on equity that came close to what Goldman Sachs could deliver. That's what Merrill Lynch and Citigroup were doing when they set up their CDO creation machines: taking risk to maximize shareholder value. The only consideration that would have weighed more heavily than that fiduciary duty would have been an outright and explicit ban on their involvement in the CDO business—a kind of blanket prohibition that remains unlikely today. Certainly, it was utopian to expect them to voluntarily refrain from taking on those risks, since that meant relinquishing the business—and the fees—to

their rivals. That would have been foolish on a personal level, especially once Phil Purcell's ouster from the helm of Morgan Stanley in a shareholder-led coup reminded every other Wall Street CEO of the career risk they were running by not pursuing the maximum possible profit.

What manager or board member, forced to choose between the possibility and even the probability of earning profits for investors in exchange for taking on some risk and the certainty of losing those profits to a rival by focusing too much on the possible risk would, in the absence of some flashing warning lights, decide to walk away from a deal? How could they feel they were on sound legal footing? "There was evidence that these businesses were profitable; there was no evidence that they were built on quicksand," argues one lawyer who represents one large legacy institution. "When there is no evidence of any E. coli or other tainted food, should a restaurant stop serving its customers steak or hamburgers" simply because history has shown that beef can be infected with the E. coli bacterium?

Certainly, John Mack didn't see the risks he was taking on so eagerly when he succeeded Purcell as CEO of Morgan Stanley. Some of Mack's earliest meetings were with the managers of hedge funds that were generating a growing proportion of Wall Street's revenues and profits. His mission was to reassure those managers that even though Purcell had favored sticking to the old vision of Wall Street as an intermediary, Mack had no problem with Morgan helping out its hedge fund clients by serving as a counterparty and taking balance sheet risk. As Charles Gasparino chronicled in The Sellout, his narrative of the meltdown, one of those with whom Mack met was Stanley Druckenmiller, manager of Duquesne Capital and a former colleague of the legendary George Soros. Morgan Stanley had what it took to replicate Goldman's trading prowess, Mack told Druckenmiller. "The old agency model is gone, and it's never coming back," Mack added. "The proprietary model is here to stay."[8]

As long as fiduciary duty remains a paramount consideration for Wall Street institutions, how possible is it to even think about

reforming the world in which these firms operate? The former Citigroup executive laughs at the paradox that creates. "Well, that's the 64-trillion-dollar-question. You'd like to think that the banks' directors and top managers would see that their fiduciary duty would stretch to include the well-being of the financial system as a whole, since without a Wall Street, who cares who's on top of the heap? But then, where is the evidence that that is happening?" Henry Kaufman, the onetime Salomon Brothers economist who won the nickname "Dr. Doom" for predicting the painful surge in interest rates in the 1970s and early 1980s, fears that there is only one logical outcome, even in the wake of the crisis. "Incentives to leverage [and risk taking] always will overshadow prudent judgments."[9]

The late Fred Joseph agreed with that assessment. "It's a bit inevitable, because that's human nature at work," he argued. "At least, it's the risk we all run, and hopefully we learn over time not to let our animal spirits run away with us. But it happens." Another Wall Street veteran, Peter Solomon, suggested to the FCIC that they at least revisit the merits of old-style Wall Street structures like the separation between risk-taking businesses and consumer-oriented ones (formerly mandated by the Glass-Steagall Act) or the private partnerships, as a way to limit the extent to which risk taking becomes destructive. "Our firm is a throwback to the era of the early 1960s when investment banks functioned as agents and fiduciaries advising their corporate clients," he said. (The italics are mine.) "We do not act as principals or take proprietary positions. We do not trade and we do not lend." That model, he suggested, has its advantages.

Perhaps the biggest problem of all is that by now, the current way of thinking about their business has been encoded in Wall Street's DNA. Once a Wall Street institution begins thinking of a 10 percent return on equity as unsustainably low and 20 percent as an acceptable number; once it accepts a certain set of growth and profitability targets as reasonable, it changes the definition of what is normal and what is excessively risky. Once it becomes accustomed to using a large balance sheet to help generate those

profits, once it relies on "financial ingenuity" to generate income, then it ceases to place as much value on the businesses that it once viewed as core to its raison d'être. And it becomes as hard for it to change its modus operandi as it is for a supertanker to change course on a dime.

Policing the System

Wall Street's instincts are pushing it in one direction, one that leads it back to the brink of the abyss as the need to earn profits pushes firms to take larger and larger risks. "Déjà vu is just around the corner," argues Leo Tilman, a risk management specialist. Back in September 2009, a year after the crisis peaked, Tilman reflected on what might lie ahead and predicted, accurately, that "calming markets and competitive pressures of fully commoditized financial businesses will compress margins and fees" once again.[10] (Within nine months, Wall Street's earnings would be visibly under pressure, albeit for slightly different reasons, such as client risk aversion.) Tilman predicts the vicious cycle will resume, with Wall Street's intermediaries taking risks they don't always understand and that they are rarely able to manage.

After decades working on Wall Street, Ralph Schlosstein, the CEO of boutique investment bank Evercore, has formulated a theory for what happens on Wall Street. In a normal year, the broad U.S. economy grows at a nominal pace—one that includes the rate of inflation—of about 5 to 6 percent. Yet somehow, as Schlosstein points out, investment banks consistently have managed to earn returns of between 17 percent and 20 percent on their shareholders' equity. In other words, their ROE has been anywhere from 11 to 15 percentage points higher than the rate of the growth of the economy. "If you're in a business generating that much more in returns than is being provided by the economy, you either have to find a way to give the excess capital you are making back to your shareholders [through dividends or stock buybacks] or you figure out some way to [use and ultimately] lose that extra capital by

involving yourself in some new business," Schlosstein says. Wall Street, he believes, has proven itself a master of the latter. "We lost money in the energy markets, in the emerging markets, in junk bonds, and now by securitizing subprime assets."

That this has been possible for so long is a result of two separate and converging trends on Wall Street. The first is the culture of Wall Street, described earlier in this chapter, and its increasing emphasis on generating the maximum rate of return for its shareholders on a short-term basis. The second is the kind of laissez-faire behavior on the part of those regulatory agencies whose mandate it was to rein in these institutions when they crossed the line and began to imperil the health of the system as a whole. Had it been possible for a Wall Street CEO to forgo a source of potential profits he believed to be too risky without jeopardizing his career; had Wall Street's culture been less of a "beat-thy-neighbor-at-his-own-game" affair and instead one where bankers worried that risk were taken seriously rather than escorted to the front doorstep of their companies, an investment bank might have been a less exciting but more stable place to work. But that isn't the case. So, in order to stop Wall Street from repeating its errors, we have two options, one of which seems impossibly complex; the other, deceptively straightforward.

The seemingly straightforward one is also the most appealing on a visceral level, especially to legislators who have to go back and face furious constituents at the polls: just slap more rules on the industry and throw the book at anyone who steps out of line. It's one that has attracted supporters from the White House (a furious President Obama made his first sweeping regulatory reform proposals in early 2010 in the immediate aftermath of the 2009 Wall Street bonus system) to, oddly enough, Wall Street itself. "Regulators have to be much more involved" in keeping an eye on what his firm and its rivals are getting up to, John Mack declared at the same time he made his astonishing plea for those same regulators to just jump in and stop him from behaving recklessly.

That was quite a statement, given that Mack, like his fellow Wall Street leaders, more traditionally has been an advocate of less

regulation, or, indeed, self-regulation. Nonetheless, it's a school of thought that, in one form or another had been gaining traction even before the president first introduced the proposals that would take formal shape as the Dodd-Frank Act, if only because it manages to shift the burden of responsibility from Wall Street altogether. "When you are sitting within one of these institutions, it's hard to even grapple with the concept of systemic risk," says Evercore's Schlosstein. "You are so focused on your own institution and how it is doing relative to its peers that it's hard to take enough of a step back to see the whole picture."

He grapples for the right analogy, one that will illustrate the kind of risk that is involved and the need for someone beyond Wall Street to shoulder the responsibility. "Imagine," he says, "that there's a wall, and on one side of it is someone with a giant canister of gasoline. On the other side of it is a guy with a giant match. Neither of them can see the other or know that the other is doing something that places them both at risk." A regulator, Schlosstein explains, is the only person in a position to not only see what both of these individuals are doing but also understand whether the gasoline is being stored safely so that no lit matches will cause it to explode, or whether the person on the other side of the wall is playing with his matches in a way likely to cause a conflagration.

"In banking, we train people to react to a problem by finding a way to make money out of it," Schlosstein points out. That's what hedge fund manager John Paulson did when he became a billionaire after identifying the weaknesses in the mortgage and CDO markets and finding ways to exploit them in the financial markets. He believed that subprime lending, poor structuring of CDOs, excessive leverage, and inadequate capital were about to wreak havoc on Wall Street, but his instinct wasn't to warn Lehman or Bear Stearns or to shout his findings from the rooftops. Rather, Paulson set out to sell short the securities he believed would suffer most in the crisis, just as, in the depths of the crisis, he became an active buyer of stock in big "legacy" financial institutions, betting that the survivors would rebound. That bet has paid off, too. Paulson, like any other short-term investor, is risk-agnostic—as long

as the risks he take pay off, he's happy to be at the party in any capacity.

Mack and Schlosstein are right when they argue that more active and more thoughtful regulation of the money grid is needed to stop a repeat of the events of 2007 and 2008. But for all the lavish praise President Obama and others heaped on the Dodd-Frank Act when it was passed in the summer of 2010, that package of proposed reforms—all 2,500 pages of it—is no panacea. Harvey Pitt, former head of the Securities and Exchange Commission and now the CEO of a Washington-based consulting company, Kalorama Partners LLC, argues that there are three fundamental flaws with the legislation, aside from all the unintended consequences that we can't yet quantify or even identify.

Firstly, the new law doesn't require any entity whose dealings could have a big impact on the financial markets to provide an ongoing stream of data on their operations to regulators, so that the latter can monitor risk. (A new body of federal regulators can monitor or unwind any systematically important financial firm, but that's not the same thing, Pitt points out.) "We've got a problem today in that we regulate people by looking at what they were born as, rather than what they have become over time, and that leaves a lot of regulators without enough knowledge of how the firms they monitor actually can impact the financial markets," Pitt says.

Not to mention the fact that—at least hypothetically—should Goldman Sachs one day decide that it's fed up with having federal banking regulators peering over its shoulders and second-guessing all its decisions when it isn't even a "real" deposit-taking bank, the firm could opt to bid farewell to its banking license and reinvent itself as something else, thus escaping from some of the regulatory scrutiny now following it. That may not be likely or even probable in the current climate, but it's not impossible, particularly a few years down the road.

Then, as regulators are already aware, there is the fact that new kinds of entities, such as hedge funds, can have a disproportionate impact on the health of financial markets and yet go largely unregulated. Several years elapsed between the LTCM implosion in

1998 and the first successful effort to get the biggest hedge funds to begin disclosing even rudimentary details of their operations to regulators.

That's not all, Pitt says. Once regulators have that information or the raw data, it needs to be properly analyzed and shared efficiently with other agencies, "so that regulators and those in the markets themselves can factor it into their decision making." Finally, he says that some kind of circuit breaker mechanism needs to be put into place that will get government regulators "to stop, look, and listen to what is going on and prevent the trend from continuing and magnifying until we can understand what it is that is really taking place and identify any systemic threats." These three ingredients, if combined, would have contributed to regulatory reform creating a nimble system able to respond to financial market crises as they are building, rather than after they have begun to claim casualties, he believes. "Together, these would give us some level of comfort that the next crisis will be manageable."

Rather than being nimble and flexible—the ideal, in the eyes of Harvey Pitt and many of his former regulators—the reforms enshrined in the Dodd-Frank Act tend to be more static rules. The bill as a whole, argues Allan Meltzer, professor of political economy at Carnegie Mellon University "is a terrible bill. Yes, it corrects a lot of problems that are of some importance to someone, but it doesn't correct real causes of the crises" such as the "too big to fail" issue and the moral hazard that accompanies it, he says. Static rules tend to be those created solely in response to the last crisis, such as Glass-Steagall in 1933, which responded to the problems of risk-taking by deposit-taking financial institutions by requiring the rigid separation of the two kinds of institutions into investment and commercial banks. That did help to stabilize the financial system—until it didn't anymore. Under siege for the last half of its sixty-six-year existence, Glass-Steagall ultimately wasn't flexible enough to respond to the changing realities of the banking system—specifically, the need of financial institutions to consolidate in order to become more efficient in a globalized, fast-moving, and capital intensive business.

The Dodd-Frank Act does address some important issues. It provides for the creation of a systemic regulator and creates a Financial Stability Oversight Council that will possess sweeping powers to investigate any potential risk to the health and well-being of the financial system. It intensifies the oversight of hedge funds and introduces the "Volcker Rule," which imposes limits on the degree to which a financial institution can use its own balance sheet to take bets in the hopes of boosting its own earnings. In other words, the Act aims to limit the extent to which a bank can treat itself as its own best customer, by refusing to allow it to allocate more than a sliver of its assets to hedge funds or private equity funds, or indulge in proprietary trading to any significant extent. The Act tries to ramp up oversight of the over-the-counter derivatives business and also provides for the creation of a consumer protection agency charged specifically with ensuring that ordinary individuals aren't abused by the financial institutions in the fine print of credit card deals, mortgage loans, or other financial products.

The ideas behind these and the other detailed reforms spelled out in the fine print of the legislation officially known as the Dodd-Frank Wall Street Reform and Consumer Protection Act are often laudable. But there are countless obstacles that litter their future path. Firstly, they must be implemented; specific policies need to be designed by the agencies charged with carrying out the reforms. We have already seen in the fierceness with which parts of the market battled specific provisions that were later dropped or watered down in the Act, that Wall Street won't sit by waiting to abide humbly by whatever new rules Congress and regulators choose to devise. As always, they intend to have a voice in shaping those rules, and they had some early successes—removing car loans from the oversight of the new Consumer Financial Protection Agency, for instance. While banks will only be allowed to dabble in derivatives for the benefit of their own bottom line if they are hedging positions already on their books (such as Treasury bonds), there are loopholes which could permit them to set up separate divisions that would still be able to undertake those trades. There's

no mention of Fannie Mae and Freddie Mac, the two government-sponsored entities that have been on life support since the crisis and which fueled the mortgage bubble by allowing and encouraging their balance sheets to swell with new home loans.

"For every provision of the bill that tries to stop Wall Street from doing something it has been doing, there are several loopholes and even more ways for me to challenge the law," says one financial services lawyer who brags about having become wealthy by challenging the provisions of Glass-Steagall and who anticipates a similarly lucrative future chipping away at elements of Dodd-Frank that his clients find restrictive. One area that will certainly be the focus of a lot of scrutiny is the debate over what actually constitutes "proprietary" trading. There is likely to be a sharp difference of opinion among some regulators, who view the extensive market-making operations of Goldman Sachs, for instance (which can involve holding large positions of all kinds of securities on the firm's trading books for significant periods of time) as proprietary trading, even as Goldman's executives insist it's all about catering to their clients. No wonder the Dodd-Frank Act "lends itself to being called the lawyers' full employment act of 2010," as Harvey Pitt gloomily dubbed it.

An effective regulatory system is one that is dynamic. As well as having rules that restrict the worst kinds of risk taking as well as illegal or abusive behavior by the industry being regulated, the regulatory system must be able to spot trends as they take shape and determine whether they might pose a real danger to the health of the financial system or even just to the well-being of a single systemically important player; it must be able to react in an appropriate fashion, rapidly enough to make a difference. An effective regulatory system is one that functions as a counterweight of sorts to Wall Street's "animal spirits." When a bubble of any kind arises, particularly when a new kind of business starts generating a disproportionate amount of profits for Wall Street, regulators must be able to understand what is going on and to react appropriately.

Consider for a moment two entirely different kinds of regulatory failure by Alan Greenspan, the once-revered Fed chairman who was

idolized so much by financiers that a rumor he was ill or dead was able to rock financial markets during his reign in the 1990s. In late 1996, Greenspan correctly identified that a bubble was taking shape in speculative dot-com stocks and warned of it publicly, referring to "irrational exuberance" on the part of market participants. But it took more than three years for that bubble to burst, during which time it grew to extreme levels and claimed many more victims. What might have happened had Greenspan gone beyond "jawboning" and instead had summoned the CEOs of the major financial institutions involved in the emerging bubble to a meeting and told them he didn't want them to underwrite excessively speculative companies and that if they persisted, they should be prepared to contribute a share of the fees they were earning to an investor protection fund? Flash forward to 2006, a period in which the credit bubble was already well in place—a bubble that this time Greenspan didn't appear even to notice. What would have happened had such a revered figure even decided to speak out and voice concerns about mortgage fraud and excessive leverage on Wall Street?

In both cases, all that would have been required to make Wall Street CEOs sit up and take notice would have been a gentle hint that someone like Alan Greenspan—a figure with unparalleled power and the gravitas of a Warren Buffett—was worried about what was happening. That kind of finger, applied in the right place at the right time, may have steered the financial system out of harm's way whether by causing Wall Street's leaders to act themselves or prodding them to pay some heed to the concerns of in-house naysayers like Lou Gelman at Morgan Stanley during the dot-com era (who had watched his role morph from that of gatekeeper to the capital markets to one he compared to being a croupier at a Vegas casino) or Mike Gelband at Lehman Brothers, who tried repeatedly to win a hearing from his bosses on his concerns regarding the firm's exposure to real estate.

Good regulators think countercyclically. When they see the boom taking shape, they worry about the bust that could follow. Just as a good utility regulator makes sure that a Consolidated Edison power

plant has enough generating capacity to serve the citizens of Manhattan on the hottest summer days—that it can cope with a week or two of every citizen running his air conditioner at maximum power twenty-four hours a day without a blackout—so a good financial regulator will make sure that the institutions it oversees have their own version of excess capacity in the form of large capital reserves. Those can't be fixed, simply defined as a function of the type of bank it is or even by how much risk now-discredited models tell us the institution is running with its capital. Rather, capital adequacy standards need to adjust with the institution, so that a bank that suddenly starts paying outsize bonuses to employees in a new business segment that could potentially put at risk a lot of the institution's capital is required to set aside more of that capital to guard against such potential losses, even if nothing else has changed. If that new business line suddenly begins to generate a third of the company's revenues or profits, that might trigger additional regulatory scrutiny and possibly additional capital requirements.

The idea, says Sheila Bair, the head of the FDIC, is to make the kinds of business strategies that proved so destructive in the first decade of the new millennium so unappealing and costly that Wall Street firms will shun them on their own, without being required to do so, or at least manage them more carefully in the future. "One way to address large interconnected institutions [those deemed too big to fail] is to make it expensive to be one," Bair suggested to the FCIC. She proposed that giant banks should be required to contribute to a fund that could be drawn on to finance the breakup of a systemically important firm that starts to fail, arguing that such a proactive approach would be better for taxpayers than an after-the-fact emergency capital infusion or bailout. It also gives a firm a financial incentive to avoid failure in the first place.

The more risky a bank's business model—the more it relies on proprietary trading or structured finance, like CDOs or derivatives—the higher its "insurance" payment would be, Bair proposed. She went further still, suggesting that the "too big to fail" institutions should be required to draw up a kind of corporate living will that

would include a plan for their own liquidation in the event of insolvency. Again, the intent of proposals like these is to require those on Wall Street to ask the "what if" questions that too often get shoved to the bottom of their agendas.

A lot of attention has been devoted globally to the issue of capital standards. This is crucial: had financial institutions not eroded (sometimes deliberately, in order to magnify rates of return on equity) their capital bases in the years running up to the crisis, far fewer banks would have failed, required bailouts, or even wobbled, experts agree. Prior to the crisis, the average large global financial institution had set aside about 2 percent to 3 percent of their capital in the form of common stock as assets that could not be used or invested, that had to sit on the bank's books ready to plug a balance sheet hole. Under proposal G-20, which policy makers put forward last autumn, that level will rise to 7 percent or so and regulators will have the flexibility to tell the institutions they oversee to boost that by another few percentage points should they detect another credit bubble in the making. The fact that regulators of the nations in which the major financial centers of today are located are all collaborating to devise an appropriate capital standard means that it will be harder in the future—at least as far as can be determined today—for banks wishing to cut their capital reserves to the bone to simply shift their businesses to another regulatory jurisdiction, or to argue that they need permission to set aside less capital in order to compete with rivals in other jurisdictions.

Good regulations are those that will cause an institution being regulated to stop and ponder the nature of the business that it is pursuing; to second-guess itself; to ask itself tough questions, such as, "If I am wrong about this, what is the worst that can happen and am I prepared as I can be for that and for whatever consequences follow?" The hallmark of a poorly conceived regulation is one that has all and sundry devising ways to outwit it before it has even been passed into law, such as the elements of the Dodd-Frank Act that try to regulate the derivatives business. The goal was to get many of these instruments traded on an exchange or at least cleared

through some kind of intermediary organization, a step that would make it simpler for market participants and regulators to identify potential risk. That's a laudable objective. But lawmakers wanted to exempt some players from this oversight. Farmers, mining companies, and others use relatively straightforward kinds of commodity-based derivatives to hedge their day-to-day business risks rather than to speculate. A farmer, for instance, may lock in a price for his soybean crop long before he harvests it by selling soybean futures; that eliminates the risk he will see his income plunge before he can harvest as the market reacts to the prospect of a bumper crop.

As long as those who are exempt from that law really aren't speculating and they have an economic purpose for their actions, that's fine. But quite apart from the possibility that exempt players would suddenly be given carte blanche to do whatever they want, without the kind of supervision other market participants face (and ignoring the fact that some of them, like the world's giant energy or mining companies, are big enough players to merit monitoring), there is a big additional risk. What is to stop Steve Cohen at SAC Capital, for instance, from opening a division of his hedge fund empire devoted to oil and glass exploration and production? Once established, with the exemption given, would the rules prevent the hedge fund from routing all kinds of derivatives transactions through this new division?

It's hard to see how the trade-offs and compromises necessary to pass regulatory reforms like the Dodd-Frank Act will result in a series of new regulations and regulatory bodies that are capable of meeting the extraordinary demands that will be placed on them in the years ahead. It isn't a matter of the perfect being the enemy of the good; rather, the question is whether the good can ever be good enough. Even in the best possible situation—one where the new rules themselves are good—the success of regulators will hinge on their ability to attract and retain the best talent and thus be able to enforce those rules. In other words, agencies like the SEC—in an era of government-budget cutbacks and renewed partisan hostility to regulation—needs to begin chasing Goldman Sachs on its own turf.

To be effective, regulators need to be as aggressive and as knowledgeable as the best Wall Street bankers. Too often, the savviest regulators are lured away from the SEC and other agencies to work at the financial institutions they once regulated—the fox that once guarded the henhouse has been recruited to devise strategies for future raiding parties. What regulator will be willing to take a hard-line stance against the big financial institutions, while being aware that down the road, in order to repay her student loans and put her children through private school and college, she may be approaching those same organizations in hopes of landing a much more lucrative job? For the money grid to function in the interests of all its stakeholders, regulators who ensure the rules are being applied in the best interests of the system deserve to be rewarded lavishly for containing risk, just as bankers and traders are for running those risks or helping their clients manage them.

Chasing Goldman Sachs?

At the end of the day, the question boils down to whether Wall Street's reckless risk taking can be constrained by force alone, in the same way that criminal psychologists believe a serial killer is doomed to repeat his behavior unless confined to a maximum-security prison for life or sentenced to death. That seems to be what John Mack was suggesting when he declared "we can't control ourselves," and what the rhetoric that accompanied the financial reform proposals has implied. When Charles Prince put forth the same case, he did so somewhat more poetically, arguing that as long as the music kept playing, he had to keep dancing and keep pace with everyone else.

But isn't it ever possible for someone on Wall Street to break step and decide to sit out the dance? And if not, why not? And if not, what can we, collectively, do to make that possible? While we can use the regulatory system to shield us and Wall Street from the latter's worst instincts and protect the money grid, surely we are all better off in the long run if Wall Street can develop its own modus

operandi for managing risk and corraling "animal spirits."

It's impossible—and undesirable—to remove greed as a factor in the way that Wall Street thinks and operates. Even John Mack, for all his newfound zeal for reform, believes that isn't a good idea. "We cannot and should not take risk out of the system—that's what drives the engine of our capitalist economy," Mack told the FCIC commissioners during their inquiry. But perhaps it is possible to devise ways in which greed can be displaced as the sole deciding factor. Instead of playing yesterday's game, chasing Goldman Sachs in the hope of earning the highest possible profits, could financial institutions shift their focus to emulating the best characteristics of Goldman Sachs?

Doing so would require Wall Street leaders to ponder the reasons that Goldman Sachs became the firm that everyone else on Wall Street envied—why it always seemed able to be ahead of the curve whether it was a matter of identifying promising new businesses or avoiding new sources of risk. The mystique predates the tenure of ex-Goldmanites Robert Rubin and Hank Paulson at the helm of the Treasury Department, giving the firm perceived "insider" status in Washington. Long before it had the easy access to cheap government capital that turbo-charged its earnings power and attracted controversy in the aftermath of the crisis, it was earning a higher rate of return and paying out heftier bonuses than its rivals, year after year, with fewer missteps.

In the late 1990s, when other firms decided that catering to the man in the street or the retail investor was the wave of the future and set out to either build or acquire retail brokerage networks, Goldman Sachs dismissed the idea. Goldman wasn't Merrill Lynch; that wasn't its core business. It was a firm that worked with institutional clients—big pension funds, mutual funds, or companies in search of capital—and a handful of ultrawealthy individuals and families, but not Joe Sixpack. That wasn't a business it knew, and it came with a set of risks the Goldmanites didn't feel sure that they could manage. Sure enough, within a few years, the Internet craze was over and several of the firms that had made massive investments in developing a broad retail presence were forced to

retrench or refocus. Goldman had never jumped on that bandwagon, and it let the next one pass it by as well. When firms such as Merrill Lynch were snapping up mortgage-origination companies in order to secure as much proprietary deal flow as possible for their CDO-creation machines, Goldman Sachs once again decided to stick to its knitting—even when it was criticized by shareholders for not chasing this possible source of profits.

But Goldman didn't stop at not jumping into the CDO business with both feet; it spotted the risks far earlier than most of its peers, and devised ways to limit its losses and to even profit from what it expected would be a downturn, even though those strategies landed it in hot water later on. Over the course of a two-and-a-half-hour meeting on December 14, 2006, that has now become part of Wall Street's folklore, chief financial officer David Viniar met with key members of Goldman's mortgage underwriting team, its risk managers and its traders, and emerged with the conviction that this was indeed a bubble, and one that needed to be shorted. Goldman reduced or removed the amount of credit it was willing to extend to mortgage originators. It established short positions in the credit and derivatives markets that would boost its profits if the real estate market began to crumble, and it began to sell off its own holdings of mortgage-backed securities, both subprime and investment-grade, in transactions like the Abacus deal.[11]

Goldman Sachs and its employees are no saints, as the Financial Times noted when it named Lloyd Blankfein its Man of the Year in 2009. The firms that bought the CDOs they had structured and sold were clients—Goldman was their counterparty and didn't owe them any fiduciary duty. As Blankfein told his interrogators within Congress, these were mainly professional investors who could look out for themselves. That's not an argument that will boost the public's perception of Goldman Sachs, but while the investment bank may have been in morally muddy territory, it was doing just what its obligations to its shareholders required it to do, not bending over backward to disclose more to clients about these transactions than it believed was absolutely required by law. Did anyone really expect a Wall Street firm to suffer from a sudden

attack of altruism? Or expect Goldman Sachs to warn the world about Viniar's conclusions? After all, John Paulson didn't issue a press release when he established his own positions. It was up to Goldman's clients to look at the same set of facts—they were there for anyone alert and astute enough to spot them—draw the same conclusions, and take the same measures. Most didn't, as history would quickly demonstrate.

What is worth chasing about Goldman Sachs isn't its rate of return; what is worth replicating isn't its outsized bonus pool. Rather, what the rest of Wall Street can learn from Goldman Sachs is that strategic thinking and planning of the kind that Viniar and his team displayed in the runup to the crisis pays off—and can pay off disproportionately well when done by some of the smartest people on Wall Street. "Trying to simply mimic Goldman Sachs is likely to lead to disaster," says Evercore's Schlosstein. Rather, he and others suggest mimicking elements of their strategy.

That, says another former senior Wall Street figure, is harder than it sounds. "When I talked to people who worked for me, I would ask them to come and tell me what their strategy was going to be for next year; how they were going to change the business and adapt to the changes that they found," he recalls of his first years overseeing a business division. "Don't tell me you're going to run faster than everyone else, shoot straighter, and win. Because that is not ever what works on Wall Street, not ever." The harsh reality of life on the Street, he adds, is that few people look ahead very far and think strategically; even fewer try to combine that analysis with a hardheaded evaluation of their own competitive strengths and weaknesses. "There may be a lot of very smart people on the Street, but they are always playing yesterday's game or today's game, not thinking about tomorrow," he says. "They are not thinking about how the markets are changing, how they might change in the future, how they can organize today to prepare for that."

The result is that when change happens, Wall Street scrambles to cope, just as it did when new technology wreaked havoc on its business model and just as it did when Mayday removed—overnight—the stable source of trading fees that made that business model

sustainable. “Because they are clever and smart, these Wall Street guys from the better firms, they develop a solution and survive,” the banker-turned-consultant says. “But it’s not done in such a way that they plan ahead and try to control the outcome and position themselves to win. It’s not that Wall Street discourages strategic planning; it just doesn’t reward it. It’s all about what is this year’s performance, or how did your group do last quarter? It’s about maximizing this year’s bonus, and worrying about next year when it happens.” To the banker, a chess player, it’s like the difference between a game of poker and a game of chess. At poker, he says, what happens in one hand doesn’t affect the outcome of future hands—that’s a function of the cards he is dealt. Chess, in contrast, is a game of strategy, where each move limits future options or creates fresh opportunities. “It doesn’t surprise me that the guys on the Street tend to play poker more often than chess,” he comments drily.

A handful of Wall Street players do appear to be pursuing business in the Goldman Sachs style. In the autumn of 2009, in a move that received almost no attention from the financial press, the firm founded by star banker Robert Greenhill, Greenhill & Co., calmly announced that it would spin off its proprietary private equity investment division, Greenhill Capital Partners. At least one firm, it seemed, had decided that trying to emulate Goldman Sachs by becoming bigger and more diversified and doing more proprietary deals wasn’t the only path to success on Wall Street. Greenhill was thinking strategically, and had decided to play to his own firm’s strengths: advising clients on mergers and other strategic moves. “The scale of the opportunity,” Greenhill declared, “merits our undivided attention.” This, Greenhill had decided, was where his firm could capture higher profits, where the skill of his bankers could make a difference.

As every innovative new product that Wall Street devises becomes commoditized and while access to capital is, in normal market environments, already a commodity, skill is the one thing offered on Wall Street that is likely to continue commanding a premium fee. It is skill that helps Goldman Sachs earn a substantial

return on its shareholders' equity, and that will help it navigate financial markets that have been more tricky since the summer of 2010. Skill, like strategic thinking, can be acquired and honed, but not imitated or chased. Nor can strategic planning. Clayton Rose says that Greenhill's move was not only a reflection of the boutique institution's clear understanding of its skills but also a recognition of its weaknesses. These insights can only come from strategic thought. "Smaller players [like Greenhill], in this environment, don't enjoy a competitive advantage in terms of access to credit or deal flow for their private equity or merchant banking businesses," says Rose. "So they don't have the ability to outperform their larger investment banking peers in this area" on an ongoing basis.

If you can't beat them, why chase them at all? That's a question that we have too rarely asked Wall Street firms or, it seems, that they have too rarely tried to ask themselves. The firms that now dominate the money grid—JPMorgan Chase and Goldman Sachs—do so because they have a culture that puts a priority on risk management, and part of that risk management process involves asking tough questions of oneself. Some of the firms that chased Goldman Sachs without a real understanding of what made its model work—as opposed to what kinds of businesses helped it generate big profits—are now gone, or absorbed into other institutions.

So far, too few Wall Street firms have tried to answer the question of why they're chasing Goldman Sachs, much less the broader question of what Goldman Sachs represents. Some of those who have done so have come up with the wrong answer, judging by Dick Parsons's throwaway comment about Citigroup's priorities; others don't see any reason to undertake that exercise at all. When these firms are once again on stable footing, will they resume chasing Goldman Sachs—or JPMorgan Chase, if that firm succeeds in unseating Goldman and emerges as the model to emulate on Wall Street? Will smaller rivals try to replicate what Goldman Sachs has done, rather than carve out their own path to success based on their own strategic analysis of the opportunities and challenges and their own strengths and weaknesses?

"There is significantly more capital on the books of Wall Street's banks than is needed for them to fulfill their core role of providing liquidity to investors," says Evercore's Schlosstein, alluding to one of the basic utility functions at the heart of the money grid. As long as that is the case, he adds, there will remain an incentive for parts of those firms to take outsized risks and to behave as if they are running a casino rather than a utility. "Something needs to provide Wall Street with a wake-up call and remind it that shocks like those of 1998 and 2008 will not be aberrant events as long as the risk-taking culture remains so central," Schlosstein argues. "Memories fade faster on Wall Street than on Main Street."

But Main Street's need for Wall Street is the reason that Wall Street still exists. The one certainty is that, regardless of which particular institutions or investment banking models endure and triumph over the next decade, its functions must remain intact. Unless we want to return to the days when we had to save for decades to buy a house, couldn't buy furniture for that new home until we had saved the cash, and had to keep our savings in a bank account paying us less in interest than the rate of inflation (or, worse still, buried in the backyard or in our mattresses), we all have a healthy interest in ensuring that Wall Street functions smoothly, just as we have an interest in being sure that when we flick a switch, the light comes on, or that clean water flows through our taps.

That means we have a vested interest in ensuring that Wall Street begins to adopt some kind of long-term strategic planning, that it collectively stops trying to chase Goldman Sachs and instead starts trying to emulate the best features of the Goldman Sachs model. At the same time, all the financial institutions that collectively make up the money grid—including Goldman Sachs itself—must accept that as long as they collect the profits from running the grid, they must be prepared to pay the price when things go awry. A system in which the intermediaries profit or are cushioned from the full impact of any disasters while those at either end suffer outsize losses is not one that is sustainable.

Going forward, all of those who have an interest in the survival of

the money grid that is Wall Street must decide collectively what kinds of actions and compromises are necessary to ensure that the grid and its functions remain healthy and vibrant over the long haul. Otherwise, we risk a systemic meltdown that could make us look back on the events of 2008 almost wistfully. Ultimately, we will get the Wall Street that we deserve.

GLOSSARY

Active/Passive investing: An investor may actively choose what stocks or bonds to add to a portfolio, or can opt to put money into an index fund or exchange-traded fund that simply tries to replicate the composition and performance of an index. The latter is referred to as passive investing, and die-hard advocates believe that since few managers can reliably outperform an index (after fees) over the long term, it's always the better option for investors.

Alpha: The ultimate big-game hunt on Wall Street is the quest for "alpha." Technically, it's a return that can't be explained by what's going on in the market. So if the S&P 500 is up 10 percent and a manager posts a 15 percent return, that extra 5 percent is, theoretically at least, pure alpha. The problem is that the more you look for alpha, the harder it is to find, just like your missing car keys. Some folks argue that it's less like big game and more like looking for the dodo bird—in other words, it has been hunted into extinction by all the hedge funds.

Arbitrage: The process of taking advantage of small price differences between the same kind of investment in different markets.

Asset allocation: The process of dividing a portfolio among all the possible asset classes or types of investments, with return objectives and risk and volatility concerns in mind. A basic asset allocation involves stocks, bonds, and cash; it can also include other asset classes, such as real estate and commodities, and subdivide an asset class into subcategories with different characteristics—for instance, emerging market stocks, growth stocks, value stocks, small cap stocks.

Asset-backed securities: Bonds that are based on some kind of

income-generating asset—a mortgage, credit card receivables, or even a rock star's royalties. The income a bond investor receives is the cash flow from that asset, translated into an annual interest rate.

Back office: The behind-the-scenes operations necessary to the smooth functioning of any business, financial institutions included. Typical backoffice operations include clearing, information technology, human resources, and risk management.

Beta: The return that is offered by a market index, such as the Standard & Poor's 500 Index. (See alpha.)

Black Swan: An event that most market participants dismiss as so unlikely to occur as to be almost improbable. The events of 2008 reminded everyone that just because such events may not be visible most of the time doesn't mean they can be safely ignored. (See tail.)

Bonds: A bond investor is lending money to a company (or a government) for a fixed period of time and usually at a fixed rate of interest, which is why these are also referred to as fixed-income securities. A bond is a liability—investors are creditors, who are entitled to a stream of income but don't have any ownership interest in the entity issuing the bonds unless that issuer defaults, or stops paying the interest. In that case, bondholders may force the issuer into bankruptcy and seize the assets posted as collateral for the bonds. Bonds tend to earn lower rates of return for investors than stocks, but to offer less risk.

Capital: The lifeblood of any business, capital is the amount of cash, investments, and other assets on its books. To be well capitalized, a business's assets and liabilities (its debt, amounts owing to others) need to be in balance. But banks detest holding large capital reserves on their books; even though it's important to protect their balance sheets from losses on loans (see default).

every dollar set aside is a dollar that isn't working to boost revenues and profits. Part of Wall Street's problem in 2008 was lack of access to long-term capital at a time when the value of other assets on its balance sheet was eroding, after Wall Street firms themselves had pared their capital levels to the bone.

Capital markets: Those financial markets that are used to help raise capital for corporations or other entities (including the U.S. Treasury), or in which the securities created to finance the companies' need for capital change hands on stock markets or via over-the-counter networks, are collectively referred to as the "capital markets."

Career risk: A wry term coined by those on Wall Street to express the kind of non-financial risk they run by making a decision that others see as risky. For instance, someone running a mutual fund was far more likely to run "career risk" by putting money into an unproven dot-com stock than by investing in a blue-chip company—even if the outcome proved identical. One catchphrase embodying this idea was "No one ever got fired for buying [shares in] IBM."

CDO/CLO: A security that is made up of a pool of other securities, and that is then divided into tranches or slices that have different risk and return characteristics. A CDO, or collateralized debt obligation, is made up of debt securities, such as mortgages or car loans, while a CLO, or collateralized loan obligation, is a pool of loans.

Clearing: When a buyer and a seller of stocks, bonds, or other securities come to terms, there's a back-office process that follows, in which the owner of the securities transfers them to the purchaser in exchange for the money agreed on. The process results in what's known as the "settlement" of the trade.

Collateral: The security posted by a borrower that can be seized by

a creditor if the borrower defaults on a loan. In a mortgage, the collateral is the house that is being mortgaged, for instance.

Convertible: Not all securities sold on Wall Street are straightforward debt (in which the investor gets the right only to agreed-on interest payments over the life of the security and repayment of the principal. Some are hybrid securities, known as convertible bonds or convertible preferred stocks. These start their life looking like fixed-income securities, offering the investor a steady stream of income, but can be converted later on into stock.

Correlation: A way of describing the likelihood of event A being followed by event B, expressed in numerical terms. A perfect correlation means that if one thing happens, another is almost certain to happen as well, either at the same time or in short order. Investors use correlation to understand what the risk is that a hike in interest rates will cause not only a selloff in the bond market but also in the stock market—and which parts of the stock market might be less correlated to interest-rate jumps and thus a safer place to seek shelter. In the midst of the financial crisis in 2008, nearly all assets were tightly correlated, falling in tandem, even many of those that had historically displayed much lower levels of correlation. (See diversification.)

Counterparty: Literally, the individual or entity taking the opposite side of a trade or transaction. When you buy a house, your counterparty is the seller. It's an arm's-length kind of relationship, in contrast to the word client, which implies an ongoing relationship that includes an element of trust.

Covenant: The terms and conditions under which a loan is granted or that are specified in a debt security. A borrower may be legally obligated to keep a certain level of assets or cash flow relative to the value of the loan, for instance. Violating a covenant—even if the borrower has kept up with payments—can put that borrower

into default.

Credit: The origin is credere, Latin for “to believe”; and credit signifies the belief that a borrower will be able and willing to repay what has been loaned. To extend credit is not only to make capital available (at a certain rate of return) but to signify confidence in the borrower.

Credit default swap: Developed in the 1990s as a way for banks and other financial institutions to reduce their exposure to credit risk (the risk that a borrower can’t repay his loan, see default). The pressure was on banks to keep less and less capital in reserve to guard against defaults. Like any swap, the CDS seeks to move a set of risks from someone who doesn’t want them to someone who sees a profit in them. A bank might buy credit default swaps to protect against loan losses—with the counterparty paying up in the event of a loss, but collecting a fee immediately in exchange for that longer-term insurance. For banks, it was a great way to reduce exposure to some kinds of commercial loans without damaging client relationships—they could extend a moderately risky loan, keep the customer happy—and then use a credit default swap to reduce the risk of that loan. The original credit derivatives involved single-company credit risk; credit default swaps packaged together multiple corporate credits.

Default: When a debtor—a company that has issued debt securities or taken out a loan—ceases to make regular interest payments to the lender as provided for in the loan agreement or under the terms of the debt security, that entity is deemed to be in default. As a company’s cash reserves decline and its finances come under pressure, the risk of default rises, usually triggering a slump in the price of both its shares (which could be worthless if default presages a bankruptcy filing) and any debt securities. Cash flow is the major warning sign of a looming default.

Derivative: A security whose value is linked to, or derived from,

that of an underlying asset. For instance, gold futures contracts are tied to the value of gold bullion; stock options are linked to the value of a stock, and move in response to any stock price change. They are contracts on myriad financial products, which can be as straightforward as gold and crude oil futures, or as complicated as customized swaps involving obscure currencies. Farmers and mining companies can use derivatives to hedge their risk, selling forward their future production and locking in a guaranteed price. But speculators can also use derivatives—both exchange traded and customized—to bet on what they think the financial markets will do.

Diversification: The process of spreading assets around many different kinds of investments; much research has shown that diversification can lead to higher investment returns and limit risk.

Due diligence: Don't trust; verify—that's the mantra of the financial markets. And due diligence is the process of checking a company's books for hints as to how strong its business really is, looking for any unexpected hiccups or errors in judgment. It's the process usually undertaken by an acquirer before purchasing a business, in the same way that a homebuyer will ask a structural engineer or other expert to check that a house they want to buy doesn't have termite damage or other flaws before they complete the transaction. In the stock market, due diligence by investors can mean checking regulatory filings and other financial disclosures, talking to people in the same line of business as the target company, interviewing executives, etc.

Futures: Contracts between a buyer and a seller (purchased/sold on an exchange) in which a buyer promises to pay a fixed sum for a fixed quantity of a certain asset at a date in the future. (Hence the moniker.) These began as a way for farmers to hedge the uncertainty of crop prices—they could sell wheat that was still growing months before it would be harvested, locking in a price.

Futures started as a way to trade commodities, but today include contracts on interest rates movements, currencies, and many other kinds of assets and are now used by investors with no interest in taking delivery of a bushel of soybeans or barrel of oil to speculate on the future movements of those commodities.

Glass-Steagall: The 1933 law that mandated the separation of commercial banking (banks that take deposits and make loans to "ordinary" individuals) and investment banking (a riskier and more volatile business involving trading and underwriting). Passed in the wake of the 1929 Crash and the banking crisis that followed, the idea was to create an environment where the backbone of the financial world would be sheltered from similar storms in the future. But long before it was eventually overturned, Glass-Steagall was eroded by decisions such as that by the Federal Reserve in 1990 that enabled banks to resume trading securities.

Hedge fund: Go anywhere, invest in anything, but bring back an eye-popping performance. That's the theory that underpins the existence of the hedge funds. Very few of these funds were structured as "hedges"—to minimize risk. The moniker seems to have more to do with the use of short-selling, one hedging technique that can also be used to generate profits. Over the years —multi-strategy. And as the landscape became more crowded, there were fewer unexploited opportunities. These are private partnerships, lightly regulated, that typically offer their managers the opportunity to profit from their investment skill by rewarding them with not only a management fee but a percentage of the profits.

Hedging: An investment strategy used to manage an existing risk. If someone works for Microsoft and owns a lot of Microsoft stock, he or she might use options to hedge against a decline in Microsoft's stock price, for instance.

Illiquidity: An environment in which it's nearly impossible to get

market prices on the securities in a portfolio because there is little or no trading in those securities, and so it becomes extraordinarily difficult to determine the value of a portfolio. (See liquidity.)

Incentive fees: The fee that a manager of a hedge fund or buyout fund collects if they hit a certain rate of return. In a typical structure, the manager might get 2 percent to manage the assets, but pocket 20 percent of any profits as an incentive to do well.

Index: A collection of securities brought together because they reflect a certain kind of asset class or category and can be used as a shorthand way of describing the performance of that group of securities. For instance, the Standard & Poor's 500-Index is a proxy or reflection of the performance of the largest U.S. publicly traded corporations of all kinds. Various products can be structured to allow investors to profit from moves in an index, from index funds and ETFs to swaps.

Institutional investor: The opposite of a retail investor (see below), an institutional investor is an entity or an individual responsible for managing large pools of capital that don't belong to him or her personally. An institutional investor can be a mutual fund manager, or in charge of running a college endowment or pension fund's assets. They are the investors who, due to the billions of dollars they control, dictate the direction and velocity of the financial markets.

IPO: This stands for initial public offering—i.e., the first time that stock in a particular company has been sold to general investors via a large-scale transaction. Up until this point, financing is deemed to be "private"—a handful of institutions or individuals known to the company have been approached to provide funding. An IPO is an opportunity for those early investors to reduce their holdings by selling them at a profit. An IPO typically means that the new stock will now be traded on a stock

exchange, and its shares, available for purchase by anyone at all with the money and the interest in acquiring them.

Junk/high-yield bond: When a company's credit rating is low, it has to pay higher rates of interest in order to issue debt because the risk of default is seen to be higher. Hence, these companies issue what investors might describe as "high yield" bonds, a polite description that refers to the level of interest payments, or "junk" bonds, referring to the credit quality.

League table: The lists published periodically—every quarter, every year—showing the market share of banks and investment banks in key areas such as stock and bond underwriting and merger advisory mandates. Financial institutions measure their market share and relative performance using these rankings.

Leverage: Basically, this means borrowed money. When you buy a house and take on a mortgage to finance it, you're using leverage. On Wall Street, leverage is most frequently used to turn a trade that on its own is only slightly profitable into one that becomes much more lucrative. If you have $10 but can borrow $90, you now have $100 to invest. If you make $1,000 with that $100, you have a much larger profit—you only have to return that $90 (plus whatever interest rate you paid). You really used only $10 to generate $1,000, so your actual rate of return is far higher.

Leverage ratio: Ratio of how much a financial institution (or other entity) has borrowed for every dollar of equity on its balance sheet.

Limited partner: An investor in a private equity, venture, or hedge fund (in Wall Street terminology, at least).

Liquidity: The lifeblood of any business or individual. You may feel rich if you own a Picasso painting, but if that's all you own, you don't have the "liquidity" required to pay your mortgage or buy

groceries. Liquidity measures how much cash you have on hand or readily accessible, in an emergency. Even solid businesses can succumb to a liquidity crunch if panic makes it impossible for them to access capital or sell assets to finance operations—transactions that could readily have been accomplished in a normal environment.

Loan losses: The amount of capital set to one side to protect a financial institution against losses on the loans it has made to its clients.

"Long": Stock market jargon for owning a security outright and betting that its price will climb. If you buy 100 shares of Microsoft, you are "long" the stock and hoping that its value will rise.

Margin: The process of borrowing money to buy securities and using those securities as collateral for the loan. Margin is often offered by brokers to creditworthy clients. But borrowers can face margin calls if the securities they have bought on margin fall in value, pushing down the value of the loan's collateral.

Mark-to-market accounting: The process of adjusting the value at which securities are held on the balance sheet of a bank or an investment bank based on the price others are willing to pay for them. That's a straightforward task when it involves stocks, since the price is openly revealed by the stock exchange on which a stock trades. It's trickier when it involves private companies or "over the counter" securities for which no public market exists. (See over the counter.) "Marks" can fluctuate dramatically, depending on the willingness of buyers to invest; sometimes the market that owners think is there doesn't exist at that price at all. Marking to market is an important discipline because it identifies any gaps between the value someone applies to an asset and its real market value, but only when those doing it find ways to value those hard-to-value assets (like subprime CDOs in the midst

of a market selloff).

Market-making: At its purest, market-making involves a financial institution bringing together two investors that separately want to take the opposite view with respect to a particular security or investment idea; the institution serves as matchmaker and facilitator, collecting a fee for being the intermediary that helps to price and execute the transaction. In practice, market-making can be murkier; a bank can buy assets from a client and keep them on its own books for some time. Is that proprietary trading (see proprietary trading) or market-making? It all depends on who is making that assessment. Certainly the bank can claim it is simply facilitating a client's desire to execute a transaction and taking the other side of that trade until a counterparty can be found. But that's not always the full picture.

Maturity: In financial markets, this term is used to indicate the life span of a security such as a bond, futures or options contract, or other structured product. A bond that matures within twenty years has a long maturity; one coming due within the next year has a short maturity.

Models: Designed by highly skilled computer geeks, these were used as the basis for managing risk and predicting reward. Quantitative investors, for instance, used models to screen for stocks they believed had characteristics to outperform; risk managers used models to try to predict future losses in the event of such events as sudden interest rate increases, a boost in the price of oil, or other factors that might affect the value of a portfolio or trading book. The problem is that many models rely on assumptions gleaned from data; they can thus be tweaked to produce a desired result or have flaws that only show up in times of crisis.

Moral hazard: When someone perceives that there may be no negative consequences for taking risks, they are likely to take

more or greater risks. That implicit "get out of jail free" card is dubbed moral hazard; critics charged that government bailouts create a moral hazard for the rest of the financial system by altering behavior and attitudes to risk.

Mutual fund: A pool of capital offered by a management company (such as Fidelity or T. Rowe Price) available to any investor. An investor can buy or sell at any time over the course of a day, making mutual funds liquid. They can be broad (for example, investing in U.S. stocks) or narrow (investing only in European technology companies).

Off-balance sheet: The process of shifting assets and liabilities off a company's own balance sheet and onto that of another entity, sometimes a subsidiary of the company. Doing this can free up capital and make a company's own balance sheet—and debt and leverage levels—look more healthy.

Options: The right, but not the obligation, to purchase a security at a specified price and a specified date in the future.

Over the counter: While most stocks are traded on an exchange, many other securities change hands only via a network of traders or dealers, what is referred to as "over the counter." Some of these OTC markets are very liquid, such as government bond markets, as the trading is heavy and frequent, with many participants. Other securities, however, are much more exotic or customized, have only a few natural buyers or sellers, and therefore can't be readily bought or sold. (See liquidity.) Some never trade at all. An illiquid OTC security can be very difficult to price. Even if a liquid market was present a month ago, events can cause that liquidity to dry up rapidly and, in contrast to the stock market, there are no players required to continually "make" a market in a given security.

Par: A term used in the pricing of bonds and other fixed income-

style securities, this refers to the value of the assets being sold at the time of their sale. For instance, a $100 bond that is sold for its full face value, $100, is said to be sold or priced "at par." In some cases, bonds are sold above or below par at the time of issuance, but more often the move away from par value comes in the secondary market and is a reaction to the move in interest rates (a rise in interest rates often pushes the value of already-issued bonds offering interest payments below the new, higher level lower in price) as well as the credit quality of the issuer. A bond trading at 75 cents on the dollar, for instance, is trading "below par."

PIK, or payment in kind: A twist on interest payments offered by cash-strapped businesses. Instead of making interest payments in cash, they might offer them in more debt or stock. It's a riskier investment as instead of pocketing cash, the investor is agreeing to accept a security whose future value may be uncertain.

Plain vanilla: Jargon; a slang phrase used to describe a very straightforward security or transaction. The original swaps contracts were "plain vanilla"; many credit default products of the 2005–2008 period were anything but.

Price: As in every other market, it's something that buyers and sellers haggle over daily and varies depending on the appetite of the buyers for whatever kind of security or asset is being put up for sale, as well as the amount available.

Private equity fund: Based on the theory that public financial markets don't always fairly reflect the full value of a business, private equity funds use borrowed funds to buy businesses and overhaul them. The goal is to find ways to enhance or make more apparent the real value and then sell them to the public via an IPO, or to another corporation in a "strategic" merger.

Proprietary trading: This is the phrase used to describe the growing

trend of banks and investment banks to set aside a portion of their own capital for their own traders to deploy as they see fit in pursuit of profits. Most of their other businesses involve the financial institution serving as an intermediary, helping buyers meet sellers. In proprietary trading, the bank itself becomes one of the parties to the transaction, rather than just facilitating it. During the 1990s and into the first decade of the twenty-first century, this became an important source of both profits and market intelligence for many institutions.

Quants: Quantitative investors rely on data and models to tell them what investments are most likely to outperform in any given market situation. Quants are usually very skilled in building computer-generated models and related fields; often referred to as "rocket scientists," some have, indeed, used their mathematics and physics skills working for NASA and other organizations.

Rating agency: When investors don't have the resources to do their own due diligence or don't want to invest the time and energy required to understand the risks of a security, a rating agency is a fallback. In the runup to the crisis of 2008, however, too many investors had placed too much reliance on those ratings—and the rating agencies had compromised their standards in order to pull in fees and enrich themselves. Rating agencies have had a privileged role on Wall Street, thanks to regulations requiring institutional investors to buy "rated" bonds.

Repo market: By 2007, investment banks used the repo market to fund half of their assets, obtaining short-term capital from big institutional investors who are willing to entrust them with that capital because the investment banks put up collateral in exchange. The problem was that the risk associated with those assets began to climb in the months leading up to the crisis; eventually, repo lenders insisted on bigger discounts and ultimately dug in their heels and refused to lend, even overnight, against assets that couldn't be valued and that were highly

volatile. A crisis of confidence produced a liquidity crunch. This was the late-twentieth-century version of a run on the (investment) bank.

Retail investor: An ordinary individual saving for his or her own retirement or other goals; not someone who is managing money on behalf of others as a professional.

Returns: The size of the profit an investor makes on their investment, usually expressed in percentage terms. For instance, buying a stock at $10 that then climbs to $12 within six months would mean a six-month return of 20 percent.

Return on equity: This figure, known as an ROE, tells investors how skillfully and effectively a company's management team is employing the capital they have invested to generate profits. It is a particularly significant metric for anyone trying to understand how well a financial services company is doing in absolute and relative terms.

Risk: When we cross a road, we run the risk that we'll be hit by a car, trip over a curb, bang into another pedestrian, or have the bottom fall out of a bag of groceries. The risks confronting financial-market participants are equally varied, and far harder to track. They are also linked. (See correlation.) Some risks that financial-market participants must bear in mind are price risk, volatility risk, economic risk, operational risk, credit risk, and counterparty risk.

Risk-adjusted return: If two investors each earn 15 percent on their portfolios over the course of the year, who is doing a better job? One way to answer that question is to figure out how much risk they are taking to earn that 15 percent; the investor taking less risk is earning a higher risk-adjusted rate of return. There are many different ways of calculating this kind of figure and some element of risk-adjusted returns has crept into the evaluation of

most kinds of investment funds.

Risk management: The process of understanding and seeking to limit or reduce the magnitude and nature of risks being run by any entity. Increasingly, on Wall Street, this involved using derivatives to break up risk and package it out among more different institutions—the theory was that such a spreading out of risk would minimize any shock to a particular institution.

SEC: The Securities and Exchange Commission, established in the 1930s to ensure that public securities markets function efficiently. Companies are required to disclose earnings and other material facts; the SEC is charged with guarding against insider trading and other wrongdoing.

Securities: A way of referring to the whole panoply of financial assets—stocks, bonds, loans, et cetera.

Securitization: The process of taking a loan and turning it into a security that can be traded by packaging it together with many other loans of a similar kind, then selling ownership stakes in the entire loan pool. Securitization started with mortgages, then moved on to car loans, credit card receivables, even rock star royalties.

Shadow banking system: Entities that make up the shadow banking system don't take deposits, like a traditional bank (e.g., Citigroup or JPMorgan Chase), and include investment banks, hedge funds, and mortgage lenders, as well as money market funds and other nonbank financial players. They serve the same intermediary role but are more lightly regulated.

Short-selling: To bet against a company's stock or other security is said to be selling it short. Instead of buying a stock and holding it outright, a skeptical investor borrows the stock from an institution that owns it. then sells those securities. She is now on

the hook: at some point, she will have to repurchase the stock and return it to the institution that lent it to her and meanwhile she is paying a fee for borrowing it. For the transaction to be profitable, the stock must fall. The lower it tumbles, the cheaper it will be for her to buy back and replace—the difference between the price she sold it at and the price she buys it back at is her profit. If she gets it wrong, the loss is potentially unlimited, one reason why many brokerages limit the amount of short-selling a client can do and require short-sellers to demonstrate a degree of market knowledge.

Spread: The difference between the yield on one asset—say, a Treasury bond—and another, such as a junk bond. The wider the spread, the riskier the higher-yielding asset is said to be.

Stocks: Purchasing stock in a company gives an investor an ownership interest in the business, in contrast to a bond. While companies can pay dividends on their stocks, investors typically make most of their return in stocks from capital appreciation: the growth in the value of the stock.

Stress test: A process in which the managers of a financial institution run "what if?" scenarios and gauge their organization's ability to respond and even survive anything from a computer-systems crash to a massive and unexpected change in interest rates, market valuations, or other factors. Playing around with scenarios can highlight previously unknown or underrated sources of risk.

Structured finance: The process of and the players involved in developing often complex, new kinds of securities to transfer risk from one player to another.

Structured Investment Vehicles (SIVs): Off-balance sheet entities in which financial institutions could hold securities as long as those positions were financed with very short-term debt—debt that had

less than a year before maturity. Ostensibly these were independent vehicles, but as banks began to fill them up with mortgage-backed securities, the question was whether banks could afford to let them collapse.

Swap: Earliest of the derivatives; contracts between two parties (see counterparty) enabling them to swap one risk for another. Swaps made their debut in the interest rate (bond) markets and the currency exchange markets amid tremendous volatility of the 1980s. A company with floating-rate debt and fearful of a jump in interest rates could pay a fee to a banker who would structure a "swap" enabling them to exchange that floating rate for fixed debt. In exchange for some kind of premium, the counterparty would take on the interest rate risk. The counterparty (often a financial institution) would then seek to hedge (or offset) its own risk associated with that trade.

Synthetic security: An index is a synthetic structure—it is designed to represent something else. You can't buy the S&P 500 Index, for instance, although you can buy one share of each of the five hundred companies. Similarly, a synthetic CDO is a CDO designed and structured to mimic the performance of real assets. These securities may mimic returns but offer features that aren't available to investors in those underlying assets. Most synthetic securities are private placements, not readily available to the average investor.

Systemic risk: The risk that the entire financial system will come tumbling down. Because it has never really occurred—although it has been prevented, sometimes narrowly, on many occasions—this risk tends to be underestimated in practice, and is hard to measure and guard against.

Tail: Imagine a bell curve, with a big bump in the middle and lines falling to be almost flat at each end. Those end points are the "tails." In most financial markets, the big bump in the middle is

where most outcomes occur—the greatest probability of a change in the price of a stock will be found here. Let's say that for 364 days of the year, a stock's price never moves more than 3 percent. That's the big bump in the middle. Over on the tail are those other moves, the outliers. Over there is the one day in a year when it trades only 1 percent, or a whopping 15 percent. The more unlikely the move, the more unprecedented, the lower its probability and the further its location out on the tail. But over time, people grew complacent about those low-probability events, or "Black Swans"—just as they were about to burst upon the market in 2008.

Too big to fail: Shorthand for the idea that some financial institutions have become simply too large and interconnected—and too vital to the economy—to collapse and file for bankruptcy without wreaking havoc on the entire financial system. Accordingly, the theory runs, the managers of these banks can be tempted to take on more risk simply because they believe that the government will be forced to bail them out if they hit the rocks. (See moral hazard.)

Tranche: Literally, a slice; in practice it refers to a slice of a deal, whether a new financing, a CDO, or a loan, etc. A tranche tends to have specific risk and return characteristics relative to other tranches of the same transaction.

Transparency: The degree to which risk and return can be easily gauged and information about an investment can be readily obtained. The large-cap U.S. stock market is said to be highly transparent.

Underwriting: The process of bringing a security to market.

Underwriting fees: The percentage of the total sum raised in the sale of stock, bonds, or other securities that is allocated to the underwriters as a fee for their efforts. This varies with the size of

the transaction and its difficulty. Stock transactions of little-known startup companies typically command a 7 percent fee; someone selling bonds for a Fortune 500 company will get significantly less than 1 percent. Junk bond fees might fall somewhere in the middle.

Value/Valuation: It's always in the eyes of the beholder. A value investor is in quest of a stock or bond that is trading beneath what she believes to be its actual value and that she believes will rise in price until the valuation is "fair."

VaR: Value at Risk—Can be used by buyers to convince themselves that they were taking much less risk than was in fact the case; it is a backward-looking measure. Built around probability theory, the goal was to look across the entire panoply of a financial institution's operations and come up with a single number reflecting how much it might lose over a defined period (typically the next twenty-four hours) with a certain probability or level of certainty, say 95 percent. Bank executives viewed the number as a kind of worst-case scenario; a jump in VaR would serve as a warning signal that the bank was suddenly risking more of its capital. VaR was alluring (it could measure risk in every kind of financial asset by looking at its pricing history, however complex or straightforward) but also deceptive, because it relied on history and put a lot of emphasis on more recent history. (It also ignored the risk of what would happen the remaining 5 percent of the time; see tail, Black Swan.) So the further back in time that extreme price swings receded, the less likely they were to affect the VaR calculation. The weaknesses of relying on simplistic VaR measures became clear in 2008—often too late. VaR's greatest utility was, and remains, as a starting point for a broader discussion of risk.

Venture capital: Startup capital for fledgling companies where the potential risk of failure greatly outstrips the prospects for success. Perhaps 20 percent of a venture fund's portfolio companies will

generate big returns; another 10 percent may go belly-up. In return for much-needed capital, validation in the eyes of the market, help with the business plan, and marketing, etc., the VC investor gets great terms and can have a lot of say in how the business is run.

Vulture investor: An investor who likes to pick over the carcass of a truly dreadful investment, in hopes of finding a smidgen of value.

Yield: A function of a security's price and whatever kind of income stream (coupon or dividend) it offers the investor. For instance, buying a bond that has a 7 percent annual interest payment at $100 or at $95 will give an investor two different yields; the latter investor pays less and thus collects a higher yield. Price and yield always move in opposite directions, and yield is a function of how much an investor values a preset rate of return.

NOTES

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— CHASING —
GOLDMAN SACHS

HOW THE MASTERS OF THE UNIVERSE MELTED WALL STREET DOWN . . . AND WHY THEY'LL TAKE US TO THE BRINK AGAIN

SUZANNE McGEE

13 BANKERS

The Wall Street Takeover and the Next Financial Meltdown

SIMON JOHNSON AND JAMES KWAK

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TO OUR FAMILIES

They were careless people, Tom and Daisy—they smashed up things and creatures and then retreated back into their money or their vast carelessness, or whatever it was that kept them together, and let other people clean up the mess they had made.

—F. Scott Fitzgerald, *The Great Gatsby*[1]

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INTRODUCTION
13 Bankers

> My administration is the only thing between you and the pitchforks.
>
> —Barack Obama, March 27, 2009[1]

Friday, March 27, 2009, was a lovely day in Washington, D.C.—but not for the global economy. The U.S. stock market had fallen 40 percent in just seven months, while the U.S. economy had lost 4.1 million jobs.[2] Total world output was shrinking for the first time since World War II.[3]

Despite three government bailouts, Citigroup stock was trading below $3 per share, about 95 percent down from its peak; stock in Bank of America, which had received two bailouts, had lost 85 percent of its value. The public was furious at the recent news that American International Group, which had been rescued by commitments of up to $180 billion in taxpayer money, was paying $165 million in bonuses to executives and traders at the division that had nearly caused the company to collapse the previous September. The Obama administration's proposals to stop the bleeding, initially panned in February, were still receiving a lukewarm response in the press and the markets. Prominent economists were calling for certain major banks to be taken over by the government and restructured. Wall Street's way of life was under threat.

That Friday in March, thirteen bankers—the CEOs of thirteen of the country's largest financial institutions—gathered at the White House to meet with President Barack Obama.[*] "Help me help you," the president urged the group. Meeting with reporters later, they toed the party line. White House press secretary Robert Gibbs summarized the president's message: "Everybody has to pitch in. We're all in this together." "I'm of the feeling that we're all in this together," echoed Vikram Pandit, CEO of Citigroup. Wells Fargo CEO John Stumpf repeated the mantra: "The basic message is, we're all in this together."[5]

What did that mean, "we're all in this together"? It was clear that the thirteen bankers needed the government. Only massive government intervention, in the form of direct investments of taxpayer money, government guarantees for multiple markets, practically unlimited emergency lending by the Federal Reserve, and historically low interest rates, had prevented their banks from following Bear Stearns, Lehman Brothers, Merrill Lynch, Washington Mutual, and Wachovia into bankruptcy or acquisition in extremis. But why did the government need the bankers?

Any modern economy needs a financial system, not only to process payments, but also to transform savings in one part of the economy into productive investment in another part of the economy. However, the Obama administration had decided, like the George W. Bush and Bill Clinton administrations before it, that it needed *this* financial system—a system dominated by the thirteen bankers who came to the White House in March. Their banks used huge balance sheets to place bets in brand-new financial markets, stirring together complex derivatives with exotic mortgages in a toxic brew that ultimately poisoned the global economy. In the process, they grew so large that their potential failure threatened the stability of the entire system, giving them a unique degree of leverage over the government. Despite the central role of these banks in causing the financial crisis and the recession, Barack Obama and his advisers decided that these were the banks the country's economic prosperity depended on. And so they dug in to defend Wall Street against the popular anger that was sweeping the country—the "pitchforks" that Obama referred to in the March 27 meeting.[6]

To his credit, Obama was trying to take advantage of the Wall Street crisis to wring concessions from the bankers—notably, he wanted them to scale back the bonuses that enraged the public and to support his administration's plan to overhaul regulation of the financial system. But as the spring and summer wore on, it became increasingly clear that he had failed to win their cooperation. As the megabanks, led by JPMorgan Chase and Goldman Sachs, reported record or near-record profits (and matching bonus pools), the industry rolled out its heavy artillery to fight the relatively moderate reforms proposed by the administration, taking particular aim at the measures intended to protect unwary consumers from being blown up by expensive and risky mortgages, credit cards, and bank accounts. In September, when Obama gave a major speech at Federal Hall in New York asking Wall Street to support significant reforms, not a single CEO of a major bank bothered to show up.[7] If Wall Street was going to change, Obama would have to use (political) force.

Why did this happen? Why did even the near-collapse of the financial system, and its desperate rescue by two reluctant administrations, fail to give the government any real leverage over the major banks?

By March 2009, the Wall Street banks were not just any interest group. Over the past thirty years, they had become one of the wealthiest industries in the history of the American economy, and one of the most powerful political forces in Washington. Financial sector money poured into the campaign war chests of congressional representatives. Investment bankers and their allies assumed top positions in the White House and the Treasury Department. Most important, as banking became more

complicated, more prestigious, and more lucrative, the *ideology* of Wall Street—that unfettered innovation and unregulated financial markets were good for America and the world—became the consensus position in Washington on both sides of the political aisle. Campaign contributions and the revolving door between the private sector and government service gave Wall Street banks influence in Washington, but their ultimate victory lay in shifting the conventional wisdom in their favor, to the point where their lobbyists' talking points seemed self-evident to congressmen and administration officials. Of course, when cracks appeared in the consensus, such as in the aftermath of the financial crisis, the banks could still roll out their conventional weaponry—campaign money and lobbyists; but because of their ideological power, many of their battles were won in advance.

The political influence of Wall Street helped create the laissez-faire environment in which the big banks became bigger and riskier, until by 2008 the threat of their failure could hold the rest of the economy hostage. That political influence also meant that when the government did rescue the financial system, it did so on terms that were favorable to the banks. What "we're all in this together" really meant was that the major banks were already entrenched at the heart of the political system, and the government had decided it needed the banks at least as much as the banks needed the government. So long as the political establishment remained captive to the idea that America needs big, sophisticated, risk-seeking, highly profitable banks, they had the upper hand in any negotiation. Politicians may come and go, but Goldman Sachs remains.

The Wall Street banks are the new American oligarchy—a group that gains political power because of its economic power, and then uses that political power for its own benefit. Runaway profits and bonuses in the financial sector were transmuted into political power through campaign contributions and the attraction of the revolving door. But those profits and bonuses also bolstered the credibility and influence of Wall Street; in an era of free market capitalism triumphant, an industry that was making so much money had to be good, and people who were making so much money had to know what they were talking about. Money and ideology were mutually reinforcing.

This is not the first time that a powerful economic elite has risen to political prominence. In the late nineteenth century, the giant industrial trusts—many of them financed by banker and industrialist J. P. Morgan—dominated the U.S. economy with the support of their allies in Washington, until President Theodore Roosevelt first used the antitrust laws to break them up. Even earlier, at the dawn of the republic, Thomas Jefferson warned against the political threat posed by the Bank of the United States.

In the United States, we like to think that oligarchies are a problem that other countries have. The term came into prominence with the consolidation of wealth and power by a handful of Russian businessmen in the mid-1990s; it applies equally well to other emerging market countries where well-connected business leaders trade cash and political support for favors from the government. But the fact that our American oligarchy operates not by bribery or blackmail, but by the soft power of access and ideology, makes it no less powerful. We may have the most advanced political system in the world, but we also have its most advanced oligarchy.

In 1998, the United States was in the seventh year of an economic boom. Inflation was holding steady between 2 and 3 percent, kept down by the twin forces of technology and globalization. Alan Greenspan, probably the most respected economist in the world, thought the latest technology revolution would allow sustained economic growth with low inflation: "Computer and telecommunication based technologies are truly revolutionizing the way we produce goods and services. This has imparted a substantially increased degree of flexibility into the workplace, which in conjunction with just-in-time inventory strategies and increased availability of products from around the world, has kept costs in check through increased productivity."[8] Prospects for the American economy had rarely seemed better.

But Brooksley Born was worried.[9] She was head of the Commodity Futures Trading Commission (CFTC), the agency responsible for financial contracts known as derivatives. In particular, she was worried about the fast-growing, lightly regulated market for over-the-counter (OTC) derivatives—customized contracts in which two parties placed bets on the movement of prices for other assets, such as currencies, stocks, or bonds. Although Born's agency had jurisdiction over certain derivatives that were traded on exchanges, it was unclear if anyone had the authority to oversee the booming market for custom derivatives.

In 1998, derivatives were the hottest frontier of the financial services industry. Traders and salesmen would boast about "ripping the face off" their clients—structuring and selling complicated deals that clients did not understand but that generated huge profits for the bank that was brokering the trade.[10] Even if the business might be bad for their clients, the top Wall Street banks could not resist, because their derivatives desks were generating ever-increasing shares of their profits while putting up little of the banks' own capital.[*] The global market for custom derivatives had grown to over $70 trillion in face value (and over $2.5 trillion in market value)[†] from almost nothing a decade before.[11]

The derivatives industry had fought off the threat of regulation once before. In 1994, major losses on derivatives trades made by Orange County, California, and Procter & Gamble and other companies led to a congressional investigation and numerous lawsuits. The suits uncovered, among other things, that derivatives salesmen were lying to clients, and uncovered the iconic

quote of the era, made by a Bankers Trust employee: "Lure people into that calm and then just totally f____'em."[12] Facing potential congressional legislation, the industry and its lobbying group fought back, aided by its friends within the government. The threat of regulation was averted, and the industry went back to inventing ever more complex derivatives to maintain its profit margins. By 1997, the derivatives business even had the protection of Greenspan, who said: "[T]he need for U.S. government regulation of derivatives instruments and markets should be carefully re-examined. The application of the Commodity Exchange Act to off-exchange transactions between institutions seems wholly unnecessary—private market regulation appears to be achieving public policy objectives quite effectively and efficiently."[13] In other words, the government should keep its hands off the derivatives market, and society would benefit.

But Born was not convinced. She worried that lack of oversight allowed the proliferation of fraud, and lack of transparency made it difficult to see what risks might be building in this metastasizing sector. She proposed to issue a "concept paper" that would raise the question of whether derivatives regulation should be strengthened. Even this step provoked furious opposition, not only from Wall Street but also from the economic heavyweights of the federal government—Greenspan, Treasury Secretary (and former Goldman Sachs chair) Robert Rubin, and Deputy Treasury Secretary Larry Summers. At one point, Summers placed a call to Born. As recalled by Michael Greenberger, one of Born's lieutenants, Summers said, "I have thirteen bankers in my office, and they say if you go forward with this you will cause the worst financial crisis since World War II."[14]

Ultimately, Summers, Rubin, Greenspan, and the financial industry won. Born issued the concept paper in May, which did not cause a financial crisis. But Congress responded in October by passing a moratorium prohibiting her agency from regulating custom derivatives.[15] In 1999, the President's Working Group on Financial Markets—including Summers, Greenspan, SEC chair Arthur Levitt, and new CFTC chair William Rainer—recommended that custom derivatives be exempted from federal regulation. This recommendation became part of the Commodity Futures Modernization Act, which President Clinton signed into law in December 2000.

We don't know which thirteen bankers were meeting with the deputy treasury secretary when he called Brooksley Born; nor do we know if it was actually twelve or fourteen bankers, or if they were in his office at the time, or if Summers was actually convinced by them—more likely he came to his own conclusions, which happened to agree with theirs. (Summers did not comment for the *Washington Post* story that reported the phone call.) Nor does it matter.

What we do know is that by 1998, when it came to questions of modern finance and financial regulation, Wall Street executives and lobbyists had many sympathetic ears in government, and important policymakers were inclined to follow their advice. Finance had become a complex, highly quantitative field that only the Wall Street bankers and their backers in academia (including multiple Nobel Prize winners) had mastered, and people who questioned them could be dismissed as ignorant Luddites. No conspiracy was necessary. Even Summers, a brilliant and notoriously skeptical academic economist (later to become treasury secretary and eventually President Obama's chief economic counselor), was won over by the siren song of financial innovation and deregulation. By 1998, it was part of the worldview of the Washington elite that what was good for Wall Street was good for America.

The aftermath is well known. Although Born's concept paper did not cause a financial crisis, the failure to regulate not only derivatives, but many other financial innovations, made possible a decade-long financial frenzy that ultimately created the worst financial crisis and deepest recession the world has endured since World War II.

Free from the threat of regulation, OTC derivatives grew to over $680 trillion in face value and over $20 trillion in market value by 2008. Credit default swaps, which were too rare to be measured in 1998, grew to over $50 trillion in face value and over $3 trillion in market value by 2008, contributing to the inflation of the housing bubble;[16] when that bubble burst, the collapse in the value of securities based on the housing market triggered the financial crisis. The U.S. economy contracted by 4 percent, financial institutions took over one trillion dollars of losses, and the United States and other governments bailed out their banking sectors with rescue packages worth either hundreds of billions or trillions of dollars, depending on how you count them.[17]

Brooksley Born was defeated by the new financial oligarchy, symbolized by the thirteen bank CEOs who gathered at the White House in March 2009 and the "thirteen bankers" who lobbied Larry Summers in 1998. The major banks gained the wealth and prestige necessary to enter the halls of power and sway the opinions of the political establishment, and then cashed in that influence for policies—of which derivatives nonregulation was only one example—that helped them double and redouble their wealth while bringing the economy to the edge of a cliff, from which it had to be pulled back with taxpayer money.

The choices the federal government made in rescuing the banking sector in 2008 and 2009 also have significant implications for American society and the global economy today. Not only did the government choose to rescue the financial system—a decision few would question—but it chose to do so by extending a blank check to the largest, most powerful banks in their moment of greatest need. The government chose *not* to impose conditions that could reform the industry or even to replace the management of large failed banks. It chose to stick with the bankers it had.

In the dark days of late 2008—when Lehman Brothers vanished, Merrill Lynch was acquired, AIG was taken over by the government, Washington Mutual and Wachovia collapsed, Goldman Sachs and Morgan Stanley fled for safety by morphing into "bank holding companies," and Citigroup and Bank of America teetered on the edge before being bailed out—the conventional wisdom was that the financial crisis spelled the end of an era of excessive risk-taking and fabulous profits. Instead, we can now see that the largest, most powerful banks came out of the crisis even larger and more powerful. When Wall Street was on its knees, Washington came to its rescue—not because of personal favors to a handful of powerful bankers, but because of a belief in a certain kind of financial sector so strong that not even the ugly revelations of the financial crisis could uproot it.

That belief was reinforced by the fact that, when the crisis hit, both the Bush and Obama administrations were largely manned by people who either came from Wall Street or had put in place the policies favored by Wall Street. Because of these long-term relationships between Wall Street and Washington, there was little serious consideration during the crisis of the possibility that a different kind of financial system might be possible—despite the exhortations of prominent economists such as Paul Krugman, Joseph Stiglitz, and many others. There was no serious attempt to break up the big banks or reform financial regulation while it was possible—when the banks were weak, at the height of the crisis. Reform was put off until after the most powerful banks had grown even bigger, returned to profitability, and regained their political clout. This strategy ran counter to the approach the U.S. Treasury Department had honed during emerging market financial crises in the 1990s, when leading officials urged crisis-stricken countries to address structural problems quickly and directly.

As we write this, Congress looks likely to adopt some type of banking reform, but it is unlikely to have much bite. The measures proposed by the Obama administration placed some new constraints on Wall Street, but left intact the preeminence and power of a handful of megabanks; and even these proposals faced opposition from the financial lobby on Capitol Hill. The reform bill will probably bring about some improvements, such as better protection for consumers against abusive practices by financial institutions. But the core problem—massive, powerful banks that are both "too big to fail" and powerful enough to tilt the political landscape in their favor—will remain as Wall Street returns to business as usual.

By all appearances, the major banks—at least the ones that survived intact—were the big winners of the financial crisis. JPMorgan Chase, Bank of America, and Wells Fargo bought up failing rivals to become even bigger. The largest banks increased their market shares in everything from issuing credit cards to issuing new stock for companies.[18] Goldman Sachs reported record profits and, through September 2009, had already set aside over $500,000 per employee for compensation.[19] Lloyd Blankfein, CEO of Goldman Sachs, was named Person of the Year by the *Financial Times*.[20]

The implications for America and the world are clear. Our big banks have only gotten bigger. In 1983, Citibank, America's largest bank, had $114 billion in assets, or 3.2 percent of U.S. gross domestic product (GDP, the most common measure of the size of an economy). By 2007, nine financial institutions were bigger relative to the U.S. economy than Citibank had been in 1983.[21] At the time of the White House meeting, Bank of America's assets were 16.4 percent of GDP, followed by JPMorgan Chase at 14.7 percent and Citigroup at 12.9 percent.[22] A vague expectation that the government would bail them out in a crisis has been transformed into a virtual certainty, lowering their funding costs relative to their smaller competitors. The incentive structures created by high leverage (shifting risk from shareholders and employees onto creditors and, ultimately, taxpayers) and huge one-sided bonuses (great in good years and good in bad years) have not changed. The basic, massive subsidy scheme remains unchanged: when times are good, the banks keep the upside as executive and trader compensation; when times are bad and potential crisis looms, the government picks up the bill.

If the basic conditions of the financial system are the same, then the outcome will be the same, even if the details differ. The conditions that created the financial crisis and global recession of 2007–2009 will bring about another crisis, sooner or later. Like the last crisis, the next one will cause millions of people to lose their jobs, houses, or educational opportunities; it will require a large transfer of wealth from taxpayers to the financial sector; and it will increase government debt, requiring higher taxes in the future. The effects of the next meltdown could be milder than the last one; but with a banking system that is even more highly concentrated and that has a rock-solid government guarantee in place, they could also be worse.

The alternative is to reform the financial system now, to put in place a modern analog to the banking regulations of the 1930s that protected the financial system well for over fifty years. A central pillar of this reform must be breaking up the megabanks that dominate our financial system and have the ability to hold our entire economy hostage. This is the challenge that faces the Obama administration today. It is not a question of finance or economics. It is ultimately a question of politics—whether the long march of Wall Street on Washington can be halted and reversed. Given the close financial, personal, and ideological ties between these two centers of power, that will not happen overnight.

We have been here before. The confrontation between concentrated financial power and democratically elected government is as old as the American republic. History shows that finance can be made safe again. But it will be quite a fight.

* The CEOs and their banks were Ken Chenault, American Express; Ken Lewis, Bank of America; Robert Kelly, Bank of New York Mellon; Vikram Pandit, Citigroup; John Koskinen, Freddie Mac; Lloyd Blankfein, Goldman Sachs; Jamie Dimon, JPMorgan Chase; John Mack, Morgan Stanley; Rick Waddell, Northern Trust; James Rohr, PNC; Ronald

Logue, State Street; Richard Davis, US Bank; and John Stumpf, Wells Fargo. There were also two representatives of industry organizations at the meeting.[4]

* Because the accounting treatment of derivatives was unclear, the amount of capital that banks had to set aside for their derivatives positions was generally disproportionately low compared to the amount of risk they were taking on. Because they could generate higher profits with less capital, their "return on equity" was higher.

† Derivatives are essentially zero-sum transactions. The face value, or notional value, of a derivative is the basis on which the value of the transaction is calculated. For example, in an interest rate swap, the payments made by the two parties are calculated as interest rates (percentages) on the notional value; the amount of money that changes hands is much lower than the notional value. The market value of a derivative contract is calculated by the Bank for International Settlements as the current value of the contract to the party that is "in the money"—in other words, the amount of money that would change hands in order to close out the contract at this moment.

1
THOMAS JEFFERSON AND THE FINANCIAL ARISTOCRACY

> Great corporations exist only because they are created and safeguarded by our institutions; and it is therefore our right and our duty to see that they work in harmony with these institutions.
>
> —Theodore Roosevelt, State of the Union message, December 3, 1901[1]

Suspicion of large, powerful banks is as old as the United States, dating back at least to Thomas Jefferson—author of the Declaration of Independence, secretary of state under President George Washington, third president of the United States, and staunch proponent of individual liberty. Although Jefferson is one of the most revered founders of the republic, according to conventional wisdom he was not much of an economist.[2] Jefferson believed in an agrarian society with decentralized institutions and limited political and economic power. He was deeply suspicious of banks and criticized them in vitriolic terms, writing, "I sincerely believe, with you, that banking institutions are more dangerous than standing armies."[3] In a letter to James Madison, Jefferson even suggested, quite seriously, that anyone who cooperated with a federally chartered bank was guilty of treason and should be executed.[4]

The United States, however, did not turn out to be a decentralized agrarian society, in part because finance, commerce, and industry have also had their supporters throughout American history. Jefferson was opposed by Alexander Hamilton, Washington's secretary of the treasury, who favored a stronger federal government that actively supported economic development. In particular, Hamilton believed that the government should ensure that sufficient credit was available to fund economic development and transform America into a prosperous, entrepreneurial country. This would require the introduction of modern forms of finance opposed by Jefferson. This tension between Jefferson and Hamilton has endured to the present day.

Hamilton favored a publicly chartered (though largely privately owned) bank modeled on the Bank of England, which would manage the federal government's money and provide an important source of credit to the government and the economy. Legislation to create the (First) Bank of the United States passed Congress easily in 1791. Jefferson lobbied hard for President Washington to veto it, however, arguing that the power to charter a bank was not expressly granted to Congress by the Constitution and therefore remained with the states under the Tenth Amendment ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people").* Washington went so far as to request that James Madison (principal author of the Constitution and the Bill of Rights) draft a veto, but he also allowed Hamilton the opportunity to respond.[5] Hamilton's fifteen-thousand-word memo, largely written at the last minute, convinced Washington that a federal bank was a "necessary and proper" application of Congress's power and responsibility to promote fiscal stability and regulate trade by supporting the broader commercial system.[6] The president signed the legislation without allowing Jefferson a rebuttal.[7]

After all the furor and rhetoric, the immediate historical aftermath was rather dull. The Bank of the United States functioned broadly as advertised by Hamilton, managing the government's incoming revenues and outgoing payments and facilitating payments across an otherwise small-scale and fragmented financial system.[8] It won over many supporters, although not Jefferson and Madison (at least at first), who formed the Democratic-Republican Party to oppose Hamilton's Federalist Party, in part because of the Bank of the United States.

When it came to the basic economic issues, Hamilton was right. Economic development in the early United States depended heavily on the creation of a well-functioning financial system, as shown by modern scholars such as Richard Sylla and Peter Rousseau.[9] The United States in the 1780s "lacked nearly all the elements of a modern financial system, [but] by the 1820s had a financial system that was innovative, large and perhaps the equal of any in the world."[10] This was due not only to the Bank of the United States, but also to other financial reforms implemented by Hamilton, such as his careful management of cash flows into and out of the Treasury while keeping money on deposit with "approved banks," as well as his highly influential reports to Congress on credit and manufacturing.[11] Hamilton successfully argued that the federal government should assume the debts incurred by the individual states during the American Revolution, thereby setting the valuable precedent that the United States would always pay its debts.[12] In Ron Chernow's words, "Hamilton did not create America's market economy so much as foster the culture and legal setting in which it flourished."[13] The result was a stable and relatively favorable environment for banking. The United States had only three banks in 1789, but twenty-eight banks were chartered in the 1790s and another seventy-three in the first decade of the 1800s.[14] Bank shareholders had limited liability, a real innovation at the time (in England before the 1850s, only the Bank of England had limited liability) that helped attract entrepreneurs and money.[15] By 1825, when the United States and the United Kingdom had roughly the same population (11.1 million and 12.9 million,

respectively), the United States had nearly 2.5 times the amount of bank capital as the United Kingdom.[16]

The United States also rapidly developed a healthy equity market that was able to attract capital from around the world. Already by 1803, more than half of all U.S. securities were held by European investors.[17] By 1825, there were 232 listed securities in the United States (in New York, Philadelphia, Boston, Baltimore, and Charleston combined), approaching the 320 securities listed in England, and the level of equity market capitalization was similar in both countries. Many of the companies listed in American stock markets represented the leading sectors of the modern economy, including insurance, transportation, utilities, and manufacturing.[18] The abundance of both bank capital and equity financing meant that there was plenty of money available to invest in new and expanding businesses—initially concentrated in New England, but soon spreading to the rest of the country.[19]

A modern financial system became even more important with the spread of the Industrial Revolution early in the nineteenth century, which neither Jefferson nor even Hamilton foresaw. At the time of their debates, the Industrial Revolution was decidedly small-scale and largely confined to England. But the progressive application of technology to the production of goods would vastly raise the potential output of the American economy and permanently change its place in the world. Because industrialization required investments in new technology, it also required credit. Jefferson's small-scale farms may have represented a democratic political ideal (at least for those fortunate enough to own those farms and not be slaves working on them), but long-run prosperity required large-scale commerce and industry, both of which required banks. In retrospect, Jefferson's economic positions seem either cranky and uninformed or motivated by his distaste for the Northern commercial interests that he correctly predicted would benefit from a strong central government and eventually undermine Southern plantation (and slave) owners such as himself.[20]

But while Hamilton may have been right about the economics, that was not Jefferson's primary concern. His fear of large financial institutions had nothing to do with the efficient allocation of capital and everything to do with power. Jefferson correctly discerned that banks' crucial economic functions—mediating financial transactions and creating and managing the supply of credit—could give them both economic and political power. In the 1790s, Jefferson was particularly worried that the Bank of the United States could gain leverage over the federal government as its major creditor and payment agent, and could pick economic winners and losers through its decisions to grant or withhold credit. Over the past two hundred years, financial institutions and markets have only become more intertwined with the day-to-day functioning of the economy, to the point where large companies depend on the short-term credit they use to manage their cash flow as much as they depend on electricity. In Jefferson's eyes, the increasing importance of finance to society would only give banks even more power—power that could be used to benefit the bankers themselves, or in extreme cases could even threaten to undermine American democracy.

In matters of economic policy, we tend as a nation to lean toward Hamilton. As President Calvin Coolidge said in 1925, "[The American people] are profoundly concerned with producing, buying, selling, investing and prospering in the world."[21] And for most of American history, that has served us relatively well. The United States would not have the largest economy in the world without a financial sector that has, most of the time, funneled capital toward the investments in new technology and processes that are critical to long-term productivity growth.

However, our Hamiltonian inclinations—to seek out efficiency, to celebrate bigness, and to look favorably on anything that makes money—have been kept at least partially in check by the legacy of Jefferson. Although Jefferson lost the battle over the Bank of the United States (and his worst fears did not materialize), the cause of restraining concentrated economic or financial power was taken up by three of his most important successors. In the 1830s, Andrew Jackson's showdown with the Second Bank of the United States set back the development of a concentrated financial sector. At the beginning of the twentieth century, the crusade against the industrial trusts begun by Theodore Roosevelt ultimately left intact the powerful private banks symbolized by J.P. Morgan; but during the Great Depression of the 1930s, Franklin Delano Roosevelt was finally able to break up the largest banks and constrain their risky activities. While they did not achieve all of their aims, the Jeffersonian tradition represented by these presidents has served as a counterweight to Hamilton's influence, helping prevent a powerful and unfettered financial system from undermining broader prosperity. The American financial system has oscillated between concentration and fragmentation; but over the long term, it helped give us unrivaled prosperity without undermining our democratic system—at least not yet. Today, as we face the largest and most concentrated financial sector in our nation's history, Jefferson's legacy again demands our attention.

JEFFERSON'S REVENGE

Jefferson's fear of big banks was something close to an obsession for the seventh president of the United States, Andrew Jackson. "Old Hickory," like Jefferson, favored the ideal of an agrarian republic and distrusted big-city bankers.[22] Just as important, he believed in presidential power, and he saw a major national bank as a rival that needed to be dealt with.

After its charter expired in 1811, legislation to recharter the Bank of the United States narrowly failed. However, the economic dislocation caused by the War of 1812 and the resulting chaos in the financial system convinced politicians of the need for a national bank. Congress passed legislation creating the Second Bank of the United States, which was signed by President James Madison, and the bank went into operation with a twenty-year charter in 1816.[23]

By the time Jackson was elected president in 1828, the Second Bank functioned as an "important administrative agency of the government"[24]—regulating the money supply, handling the day-to-day financial operations of the U.S. government, issuing bank notes, and providing credit for both federal authorities and private sector clients (including prominent politicians). Under the management of Nicholas Biddle, it supported the development of the American capital markets and helped coordinate a banking system that primarily operated at the state or local level.[25]

Jackson, however, opposed the Second Bank on both economic and political grounds. He hated paper money and believed only in the hardest of hard money—gold and silver. Paper money, he thought, allowed banks and bankers to distort the economy at the expense of common people. In addition, the Second Bank's monopoly over government finances gave Biddle and his friends power (and profits) that, he felt, rightfully belonged to the executive branch. The president was particularly enraged that Biddle used his economic power to curry favor with Congress, influencing elected representatives to support his aims; almost every prominent person supporting Biddle was also substantially in his debt (including some of the leading politicians of the day, such as Daniel Webster and Henry Clay).[26] As Jackson's secretary Nicholas Trist put it, echoing Jefferson, "Independently of its misdeeds, the mere *power,*—the bare existence of such a power—is a thing irreconcilable with the nature and spirit of our institutions."[27]

The "Bank War" began when Biddle and his ally, Henry Clay, attempted to renew the Second Bank's charter in 1832, four years before it expired, in part to create a political issue that Clay could use in his campaign to become president.[28] In order to gain support, Biddle directed the Bank to expand its lending in a bid for popularity.[29] Congress voted to renew the Bank's charter, but Jackson vetoed the renewal. His veto message mixed together a rebuke to the Supreme Court (which had finally resolved the Jefferson-Hamilton debate over the constitutionality of the Bank of the United States in favor of Hamilton), an attack on paper money ("Congress have established a mint to coin money.… The money so coined, with its value so regulated, and such foreign coins as Congress may adopt are the only currency known to the Constitution"), a defense of states' rights, and a swipe at the economic elites ("It is to be regretted that the rich and powerful too often bend the acts of government to their selfish purposes.")[30] In private, Jackson was more personal: "The Bank," he said to Martin Van Buren (his running mate in 1832), "is trying to kill me, *but I will kill it*."[31] The veto held up when Jackson defeated Clay in the 1832 presidential election. Biddle did not go quietly, however. When Jackson began transferring the federal government's deposits out of the Second Bank to his favored "pet banks," the Second Bank demanded payment on bills issued by state banks and reduced its loans by over $5 million, contracting the money supply and causing interest rates to double to 12 percent. Biddle hoped, by damaging the economy, to stir up opposition to Jackson; in the process, he showed that Jackson had not been wrong to fear the power of a major bank to distort the economy for its own purposes.[32]

Eliminating the most efficient commercial bank in the United States was probably not a textbook example of sound macroeconomic management, especially according to today's textbook. Jackson's veto most likely slowed the development of an integrated payments and credit system such as those seen in more advanced parts of Europe.[33] Without a major national bank or a central bank with the ability to stabilize the financial system, the U.S. economy also suffered through severe business cycles through the rest of the nineteenth century.

However, the primary importance of the Bank War was not economic, but political.[34] Although Jackson's economic grounds for opposing a new charter may have been weak, the Second Bank's behavior showed the political danger presented by a powerful private bank. Biddle was able to bribe, cajole, or otherwise pressure congressmen into taking his side against the president. Not all of the Bank's supporters were in it for the money. But as the war raged, Daniel Webster wrote to Biddle, "I believe my retainer has not been renewed or *refreshed* as usual. If it be wished that my relation to the Bank should be continued, it may be well to send me the usual retainers."[35] More ominously, at least as interpreted by Jackson's supporters, Biddle had attempted to hold the economy hostage to his political ends, first expanding credit in order to gain political support and then withholding it (and triggering a recession) in order to punish Jackson.[36] This was exactly what Jefferson had feared.

Both Jefferson and Jackson saw a powerful bank as a corrupting influence that could undermine the proper functioning of a democratic government. While this was not a foregone conclusion—the First Bank had lost its bid for a renewed charter in part because of its political weakness[37]—the Bank War gave a hint of the way financial power could be misused for political ends. Jefferson and Jackson did not think the government could control finance; the idea of a modern, technocratic central bank lay beyond their imagination, far in the future. Instead, they feared that powerful, privately owned financial institutions would gain disproportionate influence over the government. Given the choice between the Second Bank and no national bank at all, Jackson chose the latter. As a result, central banking developed slowly and informally in the United States, especially when compared to Europe.[38] But even with this handicap, the U.S. economy continued to innovate and grow through the nineteenth century.

Most important, Jackson's victory ensured that a powerful private bank was not able to install itself in the corridors of political power and use its privileged position to extract profits for itself, inhibit competition, and hamper broader economic development. Perhaps the United States could in any case have avoided the fate suffered during the same period by Mexico or Brazil—where a small elite controlled a concentrated banking sector, with unfortunate economic results—and by many recent emerging markets.[39] Had Jackson lost the Bank War, it is possible that the Second Bank might have gradually evolved into a modern central bank without distorting the political system to its own advantage.[40] But this was not a risk that Jackson wanted to take, and his populist prejudices against financial elites (and his desire for increased presidential power) ensured that the American financial system would err on the side of fragmentation and decentralization. Although the resulting financial system was vulnerable to macroeconomic shocks, it was generally able to supply the capital needed by a growing business sector, and it did not soon generate a small elite with a dangerous amount of economic and political power.

THE MONEY TRUST

By the late nineteenth century, however, industrialization had created a powerful economic elite that held political power at all levels, with its supporters in substantial control of the Senate, the Republican Party, and the presidency. Seventy years after Jackson, it was time for another confrontation between an independent-minded president and concentrated economic power.

Despite its decentralized financial system, nineteenth-century America had turned out to be a great place to develop new ideas and make money. Americans were among the first to invent or commercialize many new technologies that arose after 1800, building companies based on innovations in agricultural implements, canals, telecommunications, steam power, railroads, chemicals, and other industries. By the end of the nineteenth century, American companies were at the forefront of almost all of the technology-intensive industries that were making it possible to produce more and better goods with fewer and cheaper inputs.[41] Finance played a constructive supporting role during this period, providing the crucial connection or "intermediation" between savers on the one hand and people with productive investment opportunities on the other hand.[42] Capital continued to flow into productive uses even after the demise of the Second Bank.[43]

The innovations that changed the economic landscape changed the political landscape as well. Social mobility and the lack of an entrenched aristocracy meant that newly successful companies and industries could gain political representation quickly, at least when compared to European societies. New money could make its way into politics, whether legally or illegally. By the late nineteenth century, the Senate had become known as the "Millionaires' Club"; buying political support with cash was considered by many to be just an extension of normal business practices.[44]

Railroad wealth was the most prominent late-nineteenth-century example of the entrance of new money into politics. In the three decades immediately following the Civil War, America was swept by a craze for building new railroads. Fortunes were made and lost and businesses built and destroyed, while long-distance travel became much faster and hauling freight became much cheaper than ever before. The railroad barons and their industrial allies acquired great political power, coming to dominate the Senate by the turn of the century. Two of their strongest allies, Senators Mark Hanna and Nelson Aldrich, were important power brokers in the Republican Party, which controlled the White House for all but eight years from 1869 to 1913 and had a Senate majority for all but two years from 1883 to 1913. Hanna managed William McKinley's successful 1896 presidential campaign and dominated the Republican Party machine into the Theodore Roosevelt years; Aldrich was one of the most powerful men in the Senate and largely dictated its positions on government regulation of industry and banking.[45]

Political representation for rising industrial interests is preferable to ossified social structures that restrict innovation and keep new people away from the levers of power.[46] Most of the European societies that had such restrictions struggled to keep up with the Industrial Revolution and fell behind their competitors. The United States also turned out much better than Latin American countries, such as Mexico, which started at roughly similar income levels but where elites controlled concentrated banking systems; in some cases a lack of effective corporate governance led to nepotism and insider transactions that took advantage of outside shareholders.[47]

At the same time, however, the openness of the American political system has always made it possible for the current business elite to use its political power to shift the economic playing field in its favor. Any growing and profitable sector can take this route, from railroads, steel, and automobiles to defense and energy. Each of these industries has used the argument that "what's good for (fill in the blank) is good for America" in order to obtain preferential tariffs, tax breaks, or subsidies.[48]

This was the case for the new industrial trusts that emerged late in the nineteenth century.* These massive agglomerations of economic power were brought on in part by the spread of railways, which created national markets for many goods, making possible economies of scale of previously unheard-of dimensions.[49] Consolidation was also a reaction to prolonged economic downturn and perceived overcapacity in some industries. But it stemmed as well from the old-fashioned instincts of successful industrialists, who realized that combining with their competitors (at least the ones they hadn't been able to wipe out) could give them an effective monopoly, and with it the power to increase prices and profits. The rise of the trusts was a momentous development in American economic history in its own right. But it was also important because it brought concentrated financial power back onto the economic stage.

Standard Oil was an early pioneer of the trusts, followed closely by imitators in other industries. According to historian Thomas McCraw, "in the period 1897–1904 … 4,227 American firms merged into 257 combinations. By 1904, some 318 trusts … were alleged to control two-fifths of the nation's manufacturing assets."[50] The rise of the trusts depended heavily on investment bankers, who provided the money needed to buy shares and rearrange shareholdings and also offered the social glue necessary to bring disparate industrial interests together. A handful of bankers led by J. P. Morgan played a central role in this rapid transformation of the business landscape, giving Morgan an economic importance unmatched by any financier since Biddle, if not the beginning of the republic.[51] Morgan's empire handled an extraordinary share of the money flowing into American industry—as high as 40 percent of total capital raised at the beginning of the twentieth century.[52] In a lightly

regulated banking system, industrial concentration led naturally to financial concentration, and J. P. Morgan stepped forward to take the reins of the financial system.

The 1896 election of McKinley as president was welcomed by large corporate interests that feared the alternative—populist crusader William Jennings Bryan. However, they would be less happy with his second-term vice president and successor (after McKinley's assassination in September 1901), Theodore Roosevelt, who adopted "trust-busting" as a signature policy and made improved supervision of large corporations a major theme of his 1901 State of the Union address.[53] (McKinley had begun investigating the trusts, but Roosevelt was the first president to take them on directly.) Roosevelt pushed through major legislation to tighten regulation of the railroads. More important, his Department of Justice pioneered the use of the Sherman Antitrust Act of 1890 to break up large trusts, first taking aim at the Northern Securities Company, a railroad combination engineered by J. P. Morgan among others.[54] In 1904, the Supreme Court agreed with the Roosevelt administration and dissolved Northern Securities as "an illegal combination in restraint of interstate commerce."[55]

The industrial-finance barons didn't understand why Roosevelt was so worked up; J. P. Morgan's response was "If we have done anything wrong, send your man to see my man, and they can fix it up."[56] But Roosevelt, following in the tradition of Jefferson and Jackson, opposed concentrated industrial power for political reasons; he believed that dominant private interests were bad for democracy and for economic prosperity.[57] In taking on the trusts, he sought not only to obtain greater economic benefits for consumers (the prevailing modern interpretation of antitrust law), but to safeguard democracy from monied elites and maintain an economic system that was open to new ideas and new businesses. In the process, he helped change the way Americans thought about big business. As Nobel Prize–winning economist George Stigler wrote, "A careful student of the history of economics would have searched long and hard on July 2 of 1890, the day the Sherman Act was signed by President [Benjamin] Harrison, for any economist who had ever recommended the policy of actively combatting collusion or monopolization in the economy at large."[58] After Roosevelt, however, the consensus view became that antitrust law should be used to break up monopolies and prevent abuses of market power.

The Roosevelt administration's successful prosecution of antitrust cases in the courts led to more cases brought under Presidents William Howard Taft and Woodrow Wilson, including the court-ordered breakup of Standard Oil in 1911. However, these policies did little to disturb the concentration of money and power that had taken place in the financial sector in parallel with the rise of the industrial trusts. The wave of industrial concentration at the end of the nineteenth century was supposed to stabilize individual markets and cushion particular industries against overexpansion and price wars.[59] Instead, the interaction between large industrial trusts and their bankers created the backdrop for the worst financial crisis in American history to date, which brought concentrated banking power to the political forefront.

In October 1907, a routine (for the time) attempt to manipulate the price of stock in the United Copper Company by company insiders and their Wall Street banker went awry, triggering a run on banks perceived to be connected to the scheme.[60] The panic soon spread to the Knickerbocker Trust Company, one of the largest financial institutions in New York, and then to many other banks in the city. In order to raise cash quickly, banks were forced to sell whatever they could, pushing down asset prices across the board; stock prices also fell as banks cut back on loans to stockbrokers. This is a standard feature of any financial crisis.[61] Any bank has deposits that customers can withdraw immediately, while many of its loans (such as mortgages) cannot be called in on demand. As banks stop lending, borrowers are forced to liquidate assets in order to pay off their debts, reducing asset prices even further and creating more pressure on banks. In any banking system, a crisis can be rapidly magnified by this vicious cycle, sometimes called the "financial accelerator."[62]

This is the type of crisis that central banks are supposed to prevent; but thanks to Andrew Jackson's victory in the Bank War, the United States had not developed a central bank. Instead, J. P. Morgan—the man—stepped in to fill the gap. He and his team, led by Benjamin Strong, decided which banks should fail because they were irredeemably insolvent and which should be saved because they only needed some cash to get them through the panic; then they pressured other major financial institutions to join with Morgan in providing loans and deposits to threatened banks in order to ensure their survival. They were brutal in these choices, and their decisions were final. But despite J. P. Morgan's financial muscle, the private sector could not come up with sufficient funds. The only entity with enough ready money to stabilize the situation was the U.S. government, which deposited $25 million into New York banks to provide the liquidity needed to keep the financial system afloat.[63]

The Panic of 1907, which nearly brought the financial system crashing down, clearly demonstrated the risks the American economy was running with a highly concentrated industrial sector, a lightly regulated financial sector, and no central bank to backstop the financial system in a crisis. The major private banks might be able to reshape industries as they wished, but they could not be relied upon to stabilize the financial system in a crisis, especially with J. P. Morgan in his seventies. Something needed to be done. The stage was set for another political battle over the financial system.

On one side, Nelson Aldrich represented the viewpoint of the banking industry.[64] "No one can carefully study the experience of the other great commercial nations," he argued in an influential 1909 speech, "without being convinced that disastrous results of recurring financial crises have been successfully prevented by a proper organization of capital and by the adoption of wise methods of banking and of currency"—which, to him, meant a central bank that could act as a lender of last resort in a

crisis.[65] Aldrich was chair of the National Monetary Commission, founded in the aftermath of the Panic of 1907, which recommended the creation of a central banking system largely controlled by the private sector bankers themselves. The details of the planned system were hammered out at a secret meeting of top politicians and financiers at Jekyll Island off the coast of Georgia in November 1910. What these bankers wanted was a bailout mechanism that would protect the financial system in the event of a speculative crash like the Panic of 1907. They knew that a new central bank would need the political backing and financial support of the federal government, but at the same time they wanted to minimize government interference, oversight, or control.[66]

However, the Aldrich plan was politically controversial; it looked like a trick to get taxpayers to finance banks and protect them from the consequences of their risky activities. Opponents argued that the problem was a cabal of big banks that were secretly running the country. This fear was likely exaggerated, but there is no doubt that Wall Street banks played a critical role in creating the industrial trusts. In 1912, the House of Representatives, then controlled by the Democratic Party, commissioned an investigation of the "money trust" and its economic influence. (The investigation was proposed by Representative Charles Lindbergh Sr., who called the Aldrich plan a "wonderfully devised plan specifically fitted for Wall Street securing control of the world."[67]) The Pujo Committee concluded that control of credit was concentrated in the hands of a small group of Wall Street bankers, who had used their central place in the financial system to amass considerable economic power.[68] The committee report provided ammunition to Louis Brandeis, a prominent lawyer and future Supreme Court justice. Beginning with a 1913 article entitled "Our Financial Oligarchy,"[69] Brandeis spoke out strongly in favor of constraining banks. He accused the powerful investment banks of using customer deposits and other money that passed through their hands in order to take control of large companies and promote the interests of those companies. The "dominant element in our financial oligarchy is the investment banker," he concluded.[70]

Brandeis served as an adviser to the new Democratic president, Woodrow Wilson, who eventually brokered the compromise that led to the Federal Reserve Act of 1913. The final bill reduced the autonomy of the central bank and gave the government a stronger hand in its operations, notably through a Federal Reserve Board appointed by the president. However, the Federal Reserve banks were (and remain) technically private entities, and private sector banks were given the power to appoint two-thirds of their directors.[71]

While the private bankers didn't get everything they wanted in the new Federal Reserve, they did get the most important thing: an institution that could bail them out with public funds when financial crises occurred. Support by the Federal Reserve can take two broad forms: liquidity loans, where the Fed gives a bank a short-term loan that can be rolled over repeatedly; and lower interest rates, which help banks by promoting economic growth and increasing the chances that bank loans will be paid back.* These steps can mitigate individual disasters. However, the existence of government insurance against a worst-case scenario creates "moral hazard"—the incentive for banks to take on more risk in order to maximize shareholder returns—thereby laying the groundwork for the next system-wide crisis. Each emergency rescue only increases banks' confidence that they will be rescued in the future, creating a cycle of repeated booms, busts, and bailouts.[72]

In principle, in exchange for providing this insurance, the Federal Reserve would supervise the banks it was protecting, preventing them from taking too much risk. But as Brandeis spotted, echoing Jefferson, this overlooked the political dimension: "We believe that no methods of regulation ever have been or can be devised to remove the menace inherent in private monopoly and overweening commercial power."[73] Although Brandeis supported the Federal Reserve Act as a means of giving the government more control over the financial system, he would have preferred to break up large concentrations of industrial or financial power. As it turned out, the original Federal Reserve lacked the modern regulatory powers necessary to constrain the banks. In addition, the first president of the powerful Federal Reserve Bank of New York was none other than Benjamin Strong, J. P. Morgan's lieutenant and the ultimate Wall Street insider. As a result, the initial "solution" to the problem revealed by the Panic of 1907 would prove to be anything but. Instead, light regulation and cheap money would encourage banks to take on enough speculative risk to threaten the entire economy.

Theodore Roosevelt was able to curtail the growth of industrial trusts and shift the mainstream consensus so that large concentrations of economic power came to be seen by most people as dangerous to society.[74] But despite this success against the trusts, the movement to constrain the power of big banks failed, even with one of its leading advocates, Louis Brandeis, as an adviser to President Wilson. The compromise of 1913 prevented private banks from directly controlling the new central banking system. However, the Federal Reserve Act did little to constrain the banks themselves, leaving them free to engage in risky lending and generate huge economic booms that would be politically difficult to rein in. The problem that was glimpsed but not fully understood in 1907 was that when a crash finally arrived, the government would face the hard choice between letting the system collapse and bailing out the banks that had been responsible for the bubble. The original Federal Reserve, with its combination of strong private sector influence and weak regulatory authority, had the power to engineer a bailout, but not to curb the risky activities that could make one necessary.

It took only sixteen years for this flaw in the system to become catastrophically apparent. Rampant speculation in the 1920s led to the Crash of 1929, which was initially followed by a generous bailout for elite New York financial firms, and then by the repeated bungling of attempts to save the rest of the financial system. Not only did the Federal Reserve's safety net encourage excessive risk-taking by bankers; the safety net, it turned out, had gaping holes that could not be fixed in the intense pressure of a crisis. The result was the Great Depression.

Speculation on its own is not necessarily a problem. Entrepreneurs' willingness to speculate on new technologies or new ways of organizing production is a key source of growth and prosperity. However, speculation combined with large amounts of borrowed money can produce dangerous financial crises. Cheap debt makes more money available to bid on assets, driving up prices, creating vast amounts of paper wealth, and attracting new investors who borrow even more heavily so they can double their bets on a rising market. When the market turns, highly leveraged investors can be wiped out quickly, forcing them to liquidate anything that can be sold and causing asset prices to plummet. This sudden collapse in the value of almost everything can trigger widespread bank failures, corporate bankruptcies, and mass unemployment.

The 1920s were a period of significant deregulation, as Republican administrations dismantled the system of state control developed in order to fight the First World War. [75] By the time the war ended and President Warren G. Harding came to power in 1921, there was a determined effort to restore laissez-faire capitalism.[76] Harding's philosophy was "The business of America is the business of everybody in America"; his successor, Calvin Coolidge, famously said, "The chief business of the American people is business."[77] But the two people who best embodied the hands-off philosophy of the decade were Andrew Mellon, treasury secretary from 1921 to 1932, and Herbert Hoover, secretary of commerce under both Harding and Coolidge and president from 1929 to 1933. Mellon's message was clear: government should just get out of the way.[78] Regulation of private business, as espoused by Brandeis and Wilson, slipped out of fashion.[79]

The antiregulatory policies of the 1920s helped make possible a period of rampant financial speculation, driven by investment banks and closely related firms that sold and traded securities in an unregulated free-for-all. Investor protection was minimal; small investors could be lured into complex financial vehicles they didn't understand, and were offered large margin loans to leverage their positions.[80] While the market rose, everyone benefited. But the result was a stock market bubble fueled by borrowing and psychological momentum.[81] Low interest rates set by the Federal Reserve also fueled an economic boom for much of the decade and encouraged increased borrowing by companies and individuals.[82] By 1929, financial assets were at all-time highs, sustained by high levels of leverage throughout the economy. The stock market crash of October 1929 not only destroyed billions of dollars of paper wealth and wiped out many small investors; it also triggered an unprecedented wave of de-leveraging as financial institutions, companies, and investors sold anything they could in an attempt to pay off their debts, sending prices spiraling downward.[83]

The Federal Reserve could have slowed down the boom and avoided the sharp crash of 1929 if it had been willing early enough to "take away the punch bowl" (in the words of later Fed chair William McChesney Martin)[84] by raising interest rates to discourage borrowing and slow down economic growth. But this is never popular with politicians concerned about the next election, banks making large profits from the boom, or ordinary people benefiting from a strong economy. Instead, the Fed was reluctant to slow down the economy; it kept interest rates low for most of the 1920s and even lowered them in 1927, citing few signs of inflation and concerns about financial fragility outside the United States. The markets responded with a strong rally in the second half of 1927, and the Fed raised rates from 3.5 percent to 5 percent in 1928.[85] But there they stopped. Higher rates, it was feared, would choke off farmers who needed capital; they would also end the bonanza of stock price gains that benefited the financial sector and investors.[86] For similar reasons, the Fed also declined to use what regulatory powers it had to rein in debt-based investment strategies and deflate the bubble by using either moral suasion or informal arm-twisting to pressure banks to cut back on loans to finance stock purchases; this too might have ended the boom and slowed down the real economy.[87] Under considerable pressure from the banking lobby, the Fed decided to stand aside.[88]

When the crash came, however, the Fed initially rushed to the rescue. Despite internal debate, the man on the spot—George Harrison, president of the New York Fed—provided liquidity to troubled institutions; "I am ready to provide all the reserve funds that may be needed," he told bankers, urging them to lend to troubled brokers.[89] By the fall of 1930, Harrison could be proud that despite a 40 percent fall in the stock market, not a single major bank had failed. The Aldrich bailout mechanism seemed to work. Instead of J. P. Morgan stepping in to stop the Panic of 1907, this time the Federal Reserve answered the call.[90] And yet the United States, and the world, still experienced the Great Depression.

For the last seventy years there has been heated debate over whether the Fed could have prevented the financial crisis of 1929 from evolving into the Great Depression, or at least limited its impact through more assertive action. A leading view, advanced by Milton Friedman and Anna Schwartz and subscribed to (in amended form) by current Fed chair Ben Bernanke, is

that a spreading bank panic in the early 1930s caused a severe contraction of the money supply and credit, producing the Great Depression. If the Fed had acted assertively to expand the supply of credit, it could have stabilized the banking system and limited the damage to the real economy;[91] the Fed's mental model at the time, however, focused on "free reserves," rather than broader measures of money or credit that would have shown the need for more aggressive action. In addition, rescuing the financial system would have required printing money, which, it was feared, would have adverse consequences; generous bailouts of failing insolvent banks would have created incentive problems for the future. But instead, forced liquidation meant bankruptcy not just for companies and farmers, but also for banks.[92] Widespread bank failures encouraged people to withdraw their money from sound banks; this further dried up the credit available to businesses, causing major collateral damage to the economy, and once the financial system began contracting the process became impossible to stop.* As a result, unemployment rose above 20 percent and much of the American population suffered through a terrible decade of lost jobs, poor living standards, and severe dislocation.

Clearly, something had gone badly wrong. The problem was not that a single bank threatened to usurp political power, like the Second Bank of Jackson's day; it was that there was no effective check on the private banks as a group, whose appetite for risk had created a massive boom and a monumental bust.[94] The Federal Reserve alone lacked either the power or the will to rein in the excesses of the financial sector. The cheap money it supplied had only encouraged excessive risk-taking. When the crisis finally arrived, the government was left with the choice between bailing out banks around the country and encouraging a further speculative cycle or letting the system collapse and inviting widespread economic misery.

The only force available to constrain the banking industry was the federal government, setting up another showdown between political reformers and the financial establishment. This time, however, the magnitude and severity of the Great Depression created the opportunity for a sweeping overhaul of the relationship between government and banks. And the Pecora Commission, an investigation initiated by the Senate Banking Committee, uncovered extensive evidence of abusive practices by the banks—from pumping up questionable bonds they were selling to giving insiders stocks at below-market prices[95]—providing the political ammunition necessary to overcome the objections of the financial sector. The result was the most comprehensive attempt in American history to break up concentrated financial power and constrain banks' activities.[96]

Franklin Delano Roosevelt's favorite president was Andrew Jackson.[97] This affinity was not without its ironies. Roosevelt was a man of the Eastern establishment; while Jackson is sometimes referred to as "frontier aristocracy" and had New York allies, he had no affection for the East Coast elite. Still, both men shared an appreciation for the workings of democracy and a fear that unconstrained private interests could undermine both the economy and the political system. In a sense, they were both descendants of Jefferson, and both sought to shift the balance of power between the financial system and society at large. In January 1936, Roosevelt said, "Our enemies of today are the forces of privilege and greed within our own borders.… Jackson sought social justice; Jackson fought for human rights in his many battles to protect the people against autocratic or oligarchic aggression." Roosevelt also stressed that he was opposed to a "small minority of business men and financiers."[98]

Although Roosevelt faced a far more complex economic situation than did Jackson, his goals were similar: to protect society at large from the economic and political power of big banks. And he was not afraid to confront the bankers head-on; as historian Arthur Schlesinger wrote of the Roosevelt administration's first months in power, "No business group was more proud and powerful than the bankers; none was more persuaded of its own rectitude; none more accustomed to respectful consultation by government officials. To be attacked as antisocial was bewildering; to be excluded from the formation of public policy was beyond endurance."[99] The new legislation of the 1930s—primarily the Banking Act of 1933, better known as the Glass-Steagall Act—reduced the riskiness of the financial system, with a particular emphasis on protecting ordinary citizens. The regulatory framework, however, was relatively simple. Commercial banks, which handled deposits made by ordinary households and businesses, needed to be protected from failure; investment banks and brokerages, which traded securities and raised money for companies, did not. The Glass-Steagall Act separated commercial banking from investment banking to prevent commercial banks from being "infected" by the risky activities of investment banks. (One theory at the time—since largely discredited—was that this infection had weakened commercial banks and helped cause the Depression.)[100] As a result, J.P. Morgan was forced to spin off its investment banking operations, which became Morgan Stanley. Commercial banks were protected from panic-induced bank runs by the Federal Deposit Insurance Corporation (FDIC), but had to accept tight federal regulation in return. The governance of the Federal Reserve was also reformed in the 1930s, strengthening the hand of presidential appointees and weakening the relative power of banks.

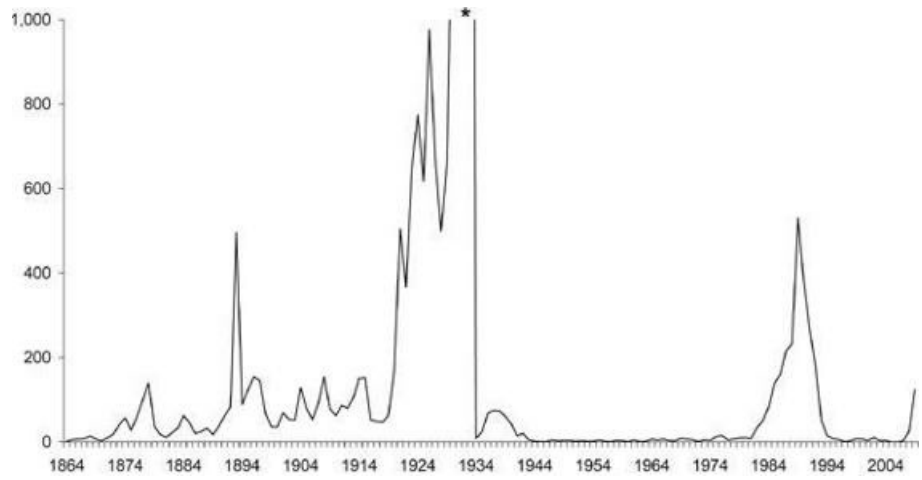
The system that took form after 1933, in which banks gained government protection in exchange for accepting strict regulation, was the basis for half a century of financial stability—the longest in American history. Investment banks were also subject to new regulation and oversight by the Securities and Exchange Commission (SEC), but this regulatory regime focused primarily on disclosure and fraud prevention—making sure that banks did not abuse their customers, rather than ensuring their health and stability.

Postwar commercial banking became similar to a regulated utility, enjoying moderate profits with little risk and low competition. For example, Regulation Q, a provision of the Banking Act of 1933, allowed the Federal Reserve to set ceilings on savings account interest rates. Since savings accounts were a major source of funds for banks, the effect was to limit competition for customers' deposits while guaranteeing banks a cheap source of funds. Limits on opening branches and on expanding across state lines inhibited competition, as did the prohibition against investment banks taking deposits. As a result, banks offered a narrow range of financial products and made their money from the spread between the low (and capped) interest rate they paid depositors and the higher rate they charged borrowers. This business model was emblematized by the "3–6–3 rule": pay 3 percent, lend at 6 percent, and make it to the golf course by 3 P.M. According to one leading banking textbook, "some banks frowned on employees working in their offices after hours lest outsiders perceive lighted windows as a sign of trouble."[101]

The result was the safest banking system that America has known in its history, despite a substantial increase in leverage. The average equity-asset ratio—the share of lending financed by owners' or shareholders' capital rather than borrowed money—had already fallen from 50 percent in the 1840s to around 20 percent early in the twentieth century as informal cooperation mechanisms developed among banks. But due to the double liability principle (which made bank shareholders potentially liable for up to *twice* the money they had invested), this meant that over 20 percent of bank assets were backed by shareholders' capital—a stunningly high cushion against loss for creditors by modern standards. After the creation of the FDIC backstop in 1933, the equity-asset ratio fell below 10 percent for the first time in history.[102] In other words, banks took on significantly more debt and, in the process, generated higher returns for their shareholders.

Ordinarily, low equity levels (high debt levels) should increase a bank's riskiness by increasing the likelihood that it will not be able to pay off its debts in a crisis. Yet despite the increase in leverage, tighter regulation prevented any serious banking crises. As Figure 1-1 demonstrates, the half-century following the Glass-Steagall Act saw by far the fewest bank failures in American history.[103] But once financial deregulation began in the 1970s, these low equity levels became increasingly dangerous.[104]

Figure 1-1: Bank Suspensions and Failures Per Year, 1864—Present



* Actual values for 1930-33 are 1,352, 2,294, 1,456, and 4,004.
Source: David Moss, "An Ounce of Prevention: Financial Regulation, Moral Hazard, and the End of 'Too Big to Fail,'" *Harvard Magazine*, September–October 2009. Used with the permission of Mr. Moss. Updated with data from FDIC, "Failures and Assistance Transactions."

Some of the regulations in place during this period may have been excessive. For example, it's not clear that limiting banks to a single state—a long-standing rule in the United States that was reaffirmed in the 1930s—makes them safer (other than by restricting competition, which increases their profits). Even the need for the Glass-Steagall division between investment banks and commercial banks has been questioned,[105] and recent history has shown that pure investment banks could become systemically important (and therefore qualify for government bailouts) on their own. Still, the regulations of the 1930s were consistent with several decades of sustained growth without major financial crises. No one can conclusively prove that these reforms were essential to postwar economic development. But constraints on banking activities helped prevent the development of massive debt-fueled booms ending in spectacular crashes. The extreme boom-bust cycles of the nineteenth and early twentieth centuries faded into memory, while the financial system funneled capital effectively into productive

investments.[106]

Of course, the story does not end there. The society and economy of the United States remain highly dynamic. New businesses and companies appear and old memories fade away. Political settlements hammered out in previous eras start to seem useless or quaint. Eventually the American tendency toward innovation, risk-taking, and profit-making takes over, and new economic elites arise to challenge the political order.

The laws of the 1930s were intended to protect the economy from a concentrated, powerful, lightly regulated financial sector. In the 1970s, they were beginning to look out of step with the modern world. Bright young minds were inventing new types of financial transactions; banks, particularly investment banks, were making more and more money; and the federal government, charmed by the promised miracles of the financial sector, began relaxing the rules. By the 1990s, Jefferson and Jackson, always awkward topics at any discussion of finance and economics, seemed more irrelevant than ever, and Franklin Delano Roosevelt's New Deal was under widespread attack. The financial sector was bigger, more profitable, and more complicated than it had been in decades. Productivity was rising steadily, economic growth was strong, and inflation was stable and low. Just as some political commentators thought the end of the Cold War signaled the end of history, some economic pundits believed that this "Great Moderation" heralded a turning point in economic history. Sophisticated macroeconomic theories and wise policymakers, they suggested, had learned to tame the cycle of booms and busts that had plagued capitalism for centuries.

In fact, the 1990s were a decade of financial and economic crises, but they were taking place far away, on the periphery of the developed world, in what were fashionably known as emerging markets. From Latin America to Southeast Asia to Russia, fast-growing economies were periodically imploding in financial crises that imposed widespread misery on their populations. For the economic gurus in Washington, this was an opportunity to teach the rest of the world why they should become more like the United States. We did not realize they were already more like us than we cared to admit.

* The Tenth Amendment, part of the Bill of Rights, was technically not yet in force, but by the end of 1790 it had been ratified by nine states out of the ten necessary.

* A trust was a form of legal organization used to combine multiple companies into a single business entity.

* Lowering short-term interest rates can also help banks by "steepening the yield curve." Since banks typically borrow for short periods of time and lend for long periods of time, if short-term rates fall while long-term rates remain unchanged, their profit margin—the spread between long- and short-term rates—increases.

* An alternative explanation, advanced by Barry Eichengreen and Peter Temin, is that the Federal Reserve was constrained by its adherence to the international gold standard; expanding the money supply would have caused a severe devaluation of the dollar.[93]

2
OTHER PEOPLE'S OLIGARCHS

> Financial institutions have priced risks poorly and have been willing to finance an excessively large portion of investment plans of the corporate sector, resulting in high leveraging.
>
> —Korea Letter of Intent to the IMF, December 3, 1997[1]

In the mid-1990s, financial crises in less developed parts of the world were only too common. Mexico had a major meltdown in 1994–1995 and former communist countries such as Russia, the Czech Republic, and Ukraine struggled with severe financial shocks. Then in 1997–1998, what seemed like the mother of all international financial crises swept from Thailand through Southeast Asia to Korea, Brazil, and Russia. The contagion even spread to the United States via Long-Term Capital Management (LTCM), an enormous and terribly named hedge fund, which came to the brink of collapse.

In the United States, economists and policymakers took two main lessons from these crises. The first was that crises could be managed—by pushing other countries to become more like the United States. Through the experiences of 1997–1998, the U.S. Treasury Department and the International Monetary Fund (IMF) developed a game plan for handling financial crises: structural weaknesses such as a failing financial sector had to be dealt with immediately, without waiting for the economy to stabilize. Both directly and through their influence over the IMF, the key architects of U.S. economic policy—Treasury Secretary Robert Rubin, Deputy Treasury Secretary Larry Summers, and Federal Reserve chair Alan Greenspan—pressed crisis-stricken countries to liberalize their financial systems, increase transparency in their political systems, and model the governance of their corporations on the Anglo-American system (with a greater role for mutual funds and other institutional investors). For their pains, the Rubin-Summers-Greenspan trio was featured on the cover of *Time* magazine as the "Committee to Save the World."[2]

The second lesson was that while the U.S. economy was not completely immune to financial panics, any real damage could be contained through a few backroom deals. At the urging of the Federal Reserve, LTCM was essentially bought out and refinanced by a group of private sector banks, preventing a major crisis; a series of interest rate cuts by the Fed even kept the stock market bubble growing for another two years. The mature U.S. financial system, it seemed, could withstand any infection that might spread from the developing world, thanks to its sound financial system and macroeconomic management.

Crises were for countries with immature economies, insufficiently developed financial systems, and weak political systems, which had not yet achieved long-term prosperity and stability—countries like Thailand, Indonesia, and South Korea. These countries had three main characteristics that created the potential for serious instability in the 1990s: high levels of debt, cozy relationships between the government and powerful individuals in the private sector, and dependence on volatile inflows of capital from the rest of the world. Together, these ingredients led to economic disaster. Debt-fueled booms, collapsing bubbles, and panic-stricken financial systems were all reminiscent of the Crash of 1929, but the conventional wisdom was that the United States had put these growing pains behind it, thanks to strong corporate governance, deposit insurance, and robust financial regulation. Emerging market crises were an opportunity for the United States to teach the world how to deal with financial crises. Few people suspected that, despite the many obvious differences between emerging Asian economies and the world's largest economy, some of those lessons would become relevant to the United States only a decade later.

ANATOMY OF EMERGING MARKET CRISES

In the 1950s, South Korea was one of the most economically backward countries in the world, ravaged by war and a half-century of Japanese oppression. No outside observer would have regarded it as a candidate for rapid economic development. By 1997, however, South Korea had arrived—literally, having joined the club of rich countries, the Organization for Economic Cooperation and Development (OECD), in 1996.[3] Korea's leading companies were fast building global reputations in a wide range of technology-intensive sectors, including shipbuilding, computer chips, automobiles, and consumer electronics. Top family-owned business groups ("chaebol") such as Samsung, Daewoo, Hyundai, and LG were increasingly prominent global brands. Korea also benefited from a stable political system, with relatively open elections dating back to 1987.

However, Korea exhibited some of the classic weaknesses that produce emerging market crises. Economic activity was dominated by the giant chaebol, whose weak governance structures did little to constrain the whims of their founders. Hostile takeovers were essentially impossible due to a web of local rules. Institutional shareholders did not effectively monitor or control management.[4] The chaebol were also deeply in debt: Samsung's debt was 3.5 times its equity, Daewoo's was 4.1 times, Hyundai's was 5.6 times, and so on.[5] Leverage (the ratio of debt to equity) in the corporate sector was more than twice that of the United States.[6]

In earlier decades, the chaebol had been kept in check by state-owned banks that had carefully allocated credit, limiting the risk that the system would get out of control.[7] By the 1990s, however, the tables had turned. The chaebol had grown big enough to become a political force of their own.[8] Helped by their newfound political influence, they were in position to borrow on advantageous terms, making it possible to run up debt cheaply. Because Korea was regarded as having a sufficiently mature financial market, symbolized by membership in the OECD, its banks could easily borrow short-term money overseas and make longer-term loans to the corporate sector. Alternatively, the chaebol could borrow directly from foreign banks that were now eager to lend to Korea's booming economy.

The availability of cheap short-term debt led the chaebol to splurge on long-term capital investments. The head of Samsung decided that he needed to add an automotive wing to his already far-flung group—an expensive bet that turned out badly. The founder of Daewoo expanded aggressively into the former Soviet bloc, building manufacturing plants from Eastern Europe to Central Asia, and also placed a big bet on cars. Korean manufacturers, led by Samsung and LG, invested heavily in DRAM chip production capacity, driving down margins. These questionable investments, made possible by cheap borrowing, caused returns on capital to fall—making it harder for the chaebol to repay their ever-increasing debts.

Trouble first appeared in 1996 and early 1997 among smaller chaebol who had made risky bets with borrowed money, attempting to move up to the top tier. Hanbo Group (based on a major steel operation), the number 14 chaebol in 1995,[9] defaulted on its debts in January 1997; Kia, the carmaker that was investing heavily to break into the U.S. market, was also in serious financial trouble.[10] The government stepped in with various rescue packages, even for relatively small chaebol, typically providing subsidies or other forms of assistance so that a relatively healthy company could take over a failing company and limit job losses.[11] The largest firms enjoyed stronger implicit government guarantees—the conventional assumption that the government would not let them go under—which helped protect them from failure.[12] Still, by summer 1997, six of the thirty largest business groups had gone bankrupt.[13]

The Korean model and its high short-term-debt levels seemed sustainable as long as economic prospects looked strong and investors thought that companies could pay them back. But financing long-term investments with short-term foreign debt creates a major vulnerability: if lenders start to worry about getting repaid, they will try to pull out their money (refusing to roll over loans); but because companies put that money in long-term investments, they will not be able to pay it back on demand. In this situation, borrowing in U.S. dollars only increased the vulnerability—fears that a country is in trouble can become self-fulfilling as foreign bankers and bondholders scramble to pull their money out first, triggering the defaults that they were afraid of.

For the first nine months of 1997, the Korean economy grew at an impressive rate of around 6 percent.[14] In July, however, the "Asian financial crisis" broke out in Thailand as a crisis of confidence caused a collapse in the local currency, the baht. Overleveraged companies saw their debts double practically overnight (because their debts were in foreign currencies, the amount they owed doubled when the value of the Thai baht fell by half) and were forced to default, causing mass bankruptcies and layoffs. One month later, the crisis spread to Indonesia, where the currency collapsed and domestic companies failed.

At first investors assumed that Korea was sufficiently developed to withstand the storm, but anxiety was spreading outward from Southeast Asia. On October 23, the Hong Kong stock market declined sharply, rattling investors. Then Standard & Poor's downgraded Korean sovereign and corporate debt, stoking fears that Korea would be the next country to be hit by the crisis.* Financial markets started to think again of Korea as an emerging market subject to high economic volatility, which made its short-term debt levels seem excessive. Foreign banks became reluctant to roll over their loans and new international financing

became hard to obtain. The currency depreciated sharply, falling from 886 won per dollar in July to 1,701 won per dollar in December. Everyone with dollar debts was hit hard, since now it took twice as many won to cover the same dollar debt payments.[15]

The Korean government attempted to stabilize the situation, using its foreign exchange reserves to help state-owned banks pay off their foreign debts and to slow down the depreciation. But it could not stop the downward spiral—as the currency fell, it became harder for companies to repay foreign debts, and as some fell behind on repayments, creditors became more reluctant to roll over the debts of others.[16] The stock market declined sharply and credit collapsed as banks, unable to pay their own foreign debts, reacted by cutting off loans to domestic companies—which made it harder for companies to produce the exports they needed to pay off their debts.[17] The economy declined sharply, leading to layoffs and street protests.

The International Monetary Fund, an intergovernmental organization charged with helping countries in economic distress, did provide financial support subject to some conditions. The IMF emergency lending program put limits on bailouts to the corporate sector, insisted that support to the banking system become transparent and that insolvent banks themselves be taken over, and outlined changes in the governance of chaebol to limit overinvestment. Many of these ideas were strongly supported by Korean reformers working under new president Kim Dae-jung, who wanted to take advantage of chaebol weakness to push through reforms that would make future growth more sustainable—in part by reducing what he saw as the economic and hence political clout of the chaebol.[18]

But the IMF program also contained three striking and controversial dimensions. First, consistent with the view of the U.S. Treasury, it insisted on tightening monetary policy and, despite the strength of the government's balance sheet, did not condone an increase in government spending to offset the contraction in the private sector.[19] As a result, Korea was unable to cushion its economic downturn with the type of stimulus package and low interest rates deployed by the United States and most developed countries in 2008–2009.[20]

Second, in the debt renegotiations with foreign lenders, which involved the U.S. Treasury closely,[21] there was no write-down of the amount owed by Korean banks; although the United States did help force creditors to roll over their loans, the amount they were owed did not change. So while Korean companies were left to struggle, foreign banks and bondholders were effectively bailed out of their poor lending decisions—giving them no incentive to avoid the same mistakes in the future.[22]

Third, the IMF insisted that Korea needed to become *more* open to foreign capital, quickly. Paragraph 31 of the Letter of Intent between Korea and the IMF reads as follows:

> To increase competition and efficiency in the financial system, the schedule for allowing foreign entry into the domestic financial sector will be accelerated. Foreign financial institutions will be allowed to participate in mergers and acquisitions of domestic financial institutions in a friendly manner and on equal principles. By mid-1998, foreign financial institutions will be allowed to establish bank subsidiaries and brokerage houses. Effective immediately foreign banks will be allowed to purchase equity in domestic banks without restriction, provided that the acquisitions contribute to the efficiency and soundness of the banking sector.[23]

The premise was that the crisis had not occurred because Korea was too exposed to volatile flows of short-term foreign capital, but because it was not open enough to foreign direct investment, including in the financial sector. To many observers, it looked like the IMF and the United States were taking advantage of the crisis to push forward their program of global financial liberalization.[24]

While every crisis is unique, Korea was in many ways typical of the experiences of emerging markets in the 1990s. Large, well-connected companies expanded rapidly by taking on large amounts of cheap debt, unconstrained by the forces that should prevent irresponsible corporate behavior in a capitalist economy; outside shareholders had little influence over powerful founders, and creditors lent money freely, assuming that the leading chaebol were too important for the government to let them go bankrupt.[25] Even though state-owned banks nominally controlled the flow of capital, tight relationships between the private sector and the government meant that the chaebol felt they had little to fear. Political factors played an important role in the economic crisis.

This central role of politics is common to many emerging market crises. Political connections were even more crucial in Indonesia, where the late President Suharto could never be mistaken for Thomas Jefferson. Under no possible interpretation was Suharto interested in protecting citizens against the power of the government. Instead, his goals were some combination of maintaining order, improving the economic welfare of ordinary people, and enriching his own inner circle.

Suharto adopted neither a communist-style planned economy nor an "anything goes" free market system. Instead, he cultivated a small group of private businesspeople whose family businesses became the backbone of the economy. Aided by the president and his family, who opened doors for their friends (and shut them for their competitors), these entrepreneurs built

factories, developed cities, and learned how to export raw materials, agricultural products, and simple manufactured items to the rest of the world. As in many other low-income countries in the past half-century, economic development was dominated by a small economic elite defined by their personal ties to the ruling family, which traded favors for both political support and cold, hard cash—a pattern known as "crony capitalism."[26] For example, Indofood became one of the largest conglomerates in the country, largely because of a longtime personal friendship between its founder, Liem Sioe Liong, and Suharto.[27] Suharto's wife, Siti Hartinah Suharto, known as Madame Tien, was involved in so many business deals that she was referred to by critics as "Madame Tien Percent" for her alleged fees.[28] Suharto's children also cut themselves into many major deals; his daughter was involved in the largest taxi company, one son tried to build cars, and another son was a financial entrepreneur.[29]

For a long time, the system worked reasonably well. Annual income per capita grew from $1,235 in 1970, just after Suharto came to power, to just over $4,545 by 1997.[30] Indonesia was still a poor country with pervasive poverty, but thirty years of economic growth had created higher standards of living for millions of people. The country was regarded as a development success story by the World Bank and by foreign investors, who supplied much of the capital needed to build factories, roads, and apartment buildings. Everyone knew that the flow of capital was controlled by Suharto's family and friends, but this was actually attractive to investors, who quite reasonably thought it safer to lend money to people with strong political connections. The increasing availability of foreign capital fueled economic growth.

But easy money also fueled overinvestment and increasing risktaking, especially by well-connected businesspeople who assumed they would be bailed out by their powerful friends if things turned out badly. And over time, success in business became less a question of innovation and sound management than of using political connections to obtain government favors and subsidies. The result was an economic boom that could be sustained only by ever-increasing amounts of foreign debt, which came crashing down in 1997.

Russia provided a different example of the dangers created by a well-connected economic elite with easy access to foreign capital. With the collapse of communism after 1991, many former Soviet republics attempted to build capitalist economies with independent private sectors. In Russia, with its vast reserves of oil and gas, privatization of state enterprises provided a direct route to creating the major companies that would be the foundation of the economy. The reformers in the government of President Boris Yeltsin initially planned to create companies with a large number of relatively small shareholders. But in 1995, with Yeltsin facing a difficult reelection campaign the next year, they allowed a small group of powerful businessmen to buy large stakes in major state enterprises cheaply; in return, the businessmen provided crucial financial and media support to Yeltsin during the campaign. This was the creation of the Russian oligarchs, who dominated the economy in the 1990s.[31]

The new power of the oligarchs, however, did not translate into strong economic growth or fiscal stability for the government, whose tax revenues depended heavily on the volatile price of oil. Needing to keep social spending at a reasonable level to avoid widespread protests, the IMF (and the United States) encouraged the Russian government to open up the country to capital so that foreigners could lend enough money to bridge the government into more prosperous times—the idea being that Russia could pay back those loans with future economic growth.[32] Private capital could also help restructure the oil and gas industry, develop new fields, and fund other productive investment projects that had been neglected under communism—even if the entire enterprise had a pungent whiff of corruption.

However, Russia's fragile economy was vulnerable to the financial crisis that began in Asia in 1997. The resulting slowdown in global economic growth caused drops in the prices of the commodities that Russia exported, notably oil, hurting both company profits and government tax revenues. By mid-1998, both the government and the private sector were in serious trouble because they had large short-term debts to global banks and foreign investors—and those debts were magnified by the falling value of the ruble. Even an emergency IMF loan in July 1998 could not bail the government out of its problems, and in August Russia was forced to default on its foreign debts, causing massive capital flight out of the country.[33]

NOT ENOUGH LIFEBOATS

Financial crises, at least in emerging markets, have political roots. Although severe crises are generally preceded by a large buildup of debt, that appetite for debt is the product of political factors, most often including close relationships between the economic and political elites.

The downward spiral that occurred in Korea, Indonesia, Russia, and other countries hit by the 1997–1998 crisis was remarkably steep. When foreign credit disappears, economic paralysis ensues; the government is forced to use its own foreign currency reserves to pay for imports, service debt, and cover losses in the private sector. If the country cannot right itself before defaulting on its own government debts, it risks becoming an economic pariah.

As the currency collapses, companies default on their debts, and unemployment rises sharply, the reality on the ground becomes nasty. Leading businesspeople—often selected for their personal relationships or political skills rather than their management ability—focus on saving their most prized possessions. Facing shorter time horizons, executives care less about the long-term value of their firms and more about their friends and themselves. As George Akerlof and Paul Romer wrote in their classic paper on "looting," businesspeople will profit from bankrupting their own firms when "poor accounting, lax regulation, or low penalties for abuse give owners an incentive to pay themselves more than their firms are worth and then default on their debt obligations."[34]

In Russia, as in most emerging market crises, there was a sharp increase in "tunneling"—borderline illegal ways for managers and controlling shareholders to transfer wealth from their businesses to their personal accounts.[35] Boris Fyodorov, a former Russian minister of finance who struggled against corruption and the abuse of authority, argued that confusion only helps the powerful;[36] when there are complicated government bailout schemes, multiple exchange rates, or high inflation, it becomes difficult to monitor the real market prices of assets and protect the value of firms.[37] In the extreme confusion caused by a crisis, insiders can take the money (or other valuables) and run, leaving banks, industrial firms, and other entities to collapse. Alternatively, confusion means that government officials have extraordinary discretion to save firms or let them fail. Describing an earlier financial crisis, Carlos Diaz-Alejandro wrote,

> [T]he ad hoc actions undertaken during 1982–83 in Chile to handle the domestic and external financial crisis carry with them an enormous potential for arbitrary wealth redistribution.… Faith in orderly judicial proceedings to clear up debts and claims on assets appeared to be quite low; stories abounded of debtors fleeing the country, and of petty and grand financial chicanery going unpunished.[38]

From a macroeconomic perspective, the government needs to restore the confidence of foreign investors. Large government deficits (Russia) require cuts in government spending and higher taxes; large private sector debts (Korea and Indonesia) need to be rescheduled; and to attract capital, interest rates need to be higher, even though this hurts the local economy.

But responding to crises also has a political dimension. The IMF is ready to lend money, but only if it (along with its backers among the major industrial countries) believes that the government has sufficient political will to sustain the policies necessary to stabilize the situation; in the case of Indonesia, for example, this involved cutting back on the cozy relationships with economic elites that helped produce the crisis.[39] This means less use of national reserves to cover the local private sector's debts, less bailout money for the banking system, and fewer subsidies all around. Essentially, the government needs to choose whom to save; it has to squeeze at least some of the oligarchs. Of course, this is rarely the strategy of choice among emerging market rulers, whose reflex is to protect their old friends when the going gets rough—it can be tough to find new supporters in the middle of a crisis—even coming up with innovative forms of subsidies, such as guaranteeing the debts of private companies. In some instances, rulers prefer, at least in the short term, to inflict pain on the working class through layoffs, reduced government services, and higher taxes, on the assumption that big private businesses produced the original boom and can also drive the recovery.

Eventually, however, at least some within the elite have to lose out, both because there aren't enough foreign currency reserves to cover everyone's debts and because external lenders (first among them the IMF) demand some sign that the excessive risk-taking that produced the crisis is being punished. In both Thailand and Indonesia in 1997, the real fight was over which powerful families would lose their banks. In Thailand, the issue was handled relatively smoothly; more than fifty Thai "finance houses" (lightly regulated financial intermediaries) were shut down and some of the country's largest banks were taken over by the government. In Indonesia, however, the question was whether the parliamentary government would close the banking operations belonging to one of President Suharto's sons. In the struggle that ensued, the son's bank first lost its license to operate, but then appeared to have obtained another license with the suspected aid of the presidential palace; in the end, local officials did not have sufficient political will or power to stand up to the ruling family, undermining IMF (and U.S.) support and deepening the economic crisis.[40] In Korea, the confrontation was between the government and the largest chaebol,

some of which had quite blatantly broken the law. After a series of showdowns—in which Daewoo threatened to default and political forces rallied to its assistance—the government won, and the hugely powerful Daewoo group went through bankruptcy and restructuring.

It is unheard of that all the oligarchs lose out, since the government can easily claim that they are essential to the domestic economy; some typically become even more powerful by absorbing their rivals, as happened in Korea, where Hyundai acquired the failing Kia. As the oligarchs in Yeltsin's Russia found out in 1998, it's a game of musical chairs; the post-crash government has enough foreign exchange reserves to help some big companies pay their debts, but not all of them. Usually the biggest of the big—the top chaebol, Suharto's close business allies (under the protection of Bacharuddin Jusuf Habibie, who succeeded Suharto as president), and the large Russian natural resource companies (such as Gazprom)—survive and prosper thanks to generous bailouts and other forms of government support. It's their smaller competitors who are cut adrift, while ordinary people suffer through government "austerity measures." Of course, the "dispossessed" oligarchs fight back, calling in political favors or even trying subversion—including calling up their contacts in the American foreign policy establishment, as the Ukrainians did with some success in the late 1990s.[41] But the aftermath of an emerging market crisis typically leads to a shakeout of the oligarchy, with political power concentrated in a smaller number of hands.

However, another common feature of emerging market crises is that they don't last forever. Even while outside observers are still despairing over corporate governance, macroeconomic management, and crony capitalism, growth picks up again. In 1999, the Korean economy grew by 11.1 percent; the Russian recovery took slightly longer, with growth of 4.5 percent in 1999 and 11 percent in 2000; and while growth took longest to resume in Indonesia, by 2000 its economy was expanding at close to 4 percent per year.[42] A lower exchange rate boosts exports, widespread unemployment reduces the cost of labor, and companies with rescheduled debts or new companies with clean books can take advantage of both higher sales and lower costs. Surviving businesses can use their increased market shares and reaffirmed political connections to grow bigger and stronger. The oligarchs who run them can become even wealthier; Carlos Slim bought up companies on the cheap after the 1982 crisis in Mexico and used the boom-bust cycle of the early 1990s (and his strong political connections) to consolidate his dominant position in telecommunications—becoming one of the world's richest men in the process.[43]

Growth can come back without any real fundamental reforms. Foreign lenders learn exactly the wrong lessons from a crisis: they learn that when push comes to shove, the IMF will protect them against the consequences of their bad investments; and they learn that it's always best to invest in the firms with the most political power (and hence the most assurance of being bailed out in a crisis), perpetuating the pattern of crony capitalism. As a result, foreign capital flows back, and emerging markets can repeat the boom-bust-bailout cycle for a long time, perhaps indefinitely.

But long-term economic growth is unlikely to result. Although oligarchies may be consistent with episodes of growth, they are not good at supporting the development of new entrepreneurs and the commercialization of new technologies.[44] In fact, entrenched economic elites may have an interest in limiting competition from new ideas and new people. Political elites, dependent on those economic elites for support, are unlikely to adopt policies to increase competition. Without a business environment that promotes innovation and competition from new entrants—like the one enjoyed by the United States early in the nineteenth century—periodic episodes of debt-fueled expansion do not add up to sustained economic growth.

Fundamental reform requires more than rearranging the seats on the government lifeboat; it requires weakening the economic and political power of the oligarchs and creating a healthier, more competitive economic system. This is only possible for a government with an independent base of support and legitimacy strong enough for it to challenge the economic elites. These are tough conditions to achieve, but not impossible ones, as the Korean case shows.

Korea had the advantage of a serious reformer, Kim Dae-jung, winning the presidency a month after the crisis hit.[45] Kim had fought for years against the previous regime and its backers and was deeply skeptical of the chaebol and the claim that they needed special treatment. He had numerous allies, including the prominent People's Solidarity for Participatory Democracy, which lobbied hard for corporate governance reform as a way to constrain the chaebol, strengthen the economy, and protect democracy.[46] Big companies such as SK Telecom and Samsung Electronics were forced to become more transparent to protect minority shareholders against looting. The government also pushed through reforms limiting the power of the chaebol: they were no longer allowed to cross-guarantee debts within groups, investments across companies within a chaebol were curtailed, the number of affiliated companies within a chaebol was reduced, large companies were required to have outside directors, financial disclosure requirements were strengthened, chaebol control over the nonbank financial sector was restricted, and there was a push to reduce debt levels.[47]

Although the reforms did not solve all of the problems presented by economic concentration, they did lead to a solid economic recovery. The rapid expansion of 1999 and 2000 was followed by annual growth of 4–5 percent in the early 2000s—a respectable rate for a country as developed as Korea, though slower than during the pre-1997 period. There is an active debate in Korea over whether the post-crisis corporate and political reforms went far enough; the largest chaebol, including Samsung, LG, SK, and Hyundai, still dominate the economic landscape. But the reforms were a step in the right direction,

because they addressed the core problem that led to the crisis—concentration of economic power in an elite with the ability to influence the political system.

Ultimately, ending the cycle of debt-fueled bubbles and wrenching crises takes more than an IMF bailout package and a new minister of finance with a Ph.D. from an American university.[48] Since emerging market crises are the result of political conditions, sustained growth requires an end to the close relationships between economic and political elites that distort the competitive environment and encourage the misallocation of capital. Making this transition successfully is one of the central challenges for all emerging market economies.

NO WORRIES

Few people, if any, thought that these crises had anything to teach the United States, the world's richest economy and flagship democracy. The differences between Indonesia or Korea and the United States are obvious: income level, financial system, political track record, and so on. Our most ingrained beliefs run directly counter to the idea that a rich, privileged oligarchy could use government relationships to enrich itself in the good times and protect itself in the bad times. Our economic system is founded on the notion of fair competition in a market free from government influence. Our society cherishes few things more than the idea that all Americans have an equal opportunity to make money or participate in government. There is no construct more important in American political discourse than the "middle class."

The United States was not untouched by the emerging markets crisis of 1997–1998. In 1998, the most prestigious hedge fund in the world was arguably Long-Term Capital Management, founded only four years before in Greenwich, Connecticut, by a legendary trader, two Nobel Prize–winning economists, and a former vice chair of the Federal Reserve, among others.[49] When the crisis broke out, LTCM had about $4 billion in capital (money contributed by investors), which it had leveraged up with over $130 billion in borrowed money.[50] It bet that money not on ordinary stocks or bonds, but on complex arbitrage trades (betting that the difference between the prices of two similar assets would vanish) and directional trades (for example, betting that volatility in a given market would decrease).

However, LTCM's models were based on data gathered under ordinary market conditions. When the financial crisis spread and various markets seized up, it began losing money on many of its major trades, and its capital fell to less than $1 billion. But the real problem was that with LTCM on the verge of becoming insolvent, the banks and hedge funds that had lent it money (either directly or through derivatives transactions) were at risk of losing billions of dollars of their own. Fearing the damage an LTCM failure could do to the financial system as a whole, the Federal Reserve Bank of New York brought together representatives from the largest New York banks and pressured them to find a solution. In September 1998, the banks put in $3.6 billion of new money in exchange for a 90 percent ownership stake in the fund, largely wiping out the existing partners; with the new money, LTCM was able to ride out the storm without causing any collateral damage.

LTCM proved that in the new, globalized world, contagion from faraway emerging markets could spread to the United States. However, it also seemed to prove that any damage could be contained through effective intervention and sound macroeconomic management, without requiring taxpayer money or slowing down the real economy. As the long boom of the 1990s continued and the stock market continued to go up, LTCM soon faded into memory.

U.S. policymakers did draw a number of important lessons from the emerging market crises, outlined by Treasury Secretary Larry Summers in a major lecture at the 2000 conference of the American Economics Association.[51] Financial crises were the result of fundamental policy weaknesses: "Bank runs or their international analogues are not driven by sunspots: their likelihood is driven and determined by the extent of fundamental weaknesses." It was more important to look at the soundness of the financial system than to simply count the total amount of debt: "When well-capitalized and supervised banks, effective corporate governance and bankruptcy codes, and credible means of contract enforcement, along with other elements of a strong financial system, are present, significant amounts of debt will be sustainable. In their absence, even very small amounts of debt can be problematic." Companies should not be allowed to expect government support in a time of crisis: "It is certain that a healthy financial system cannot be built on the expectation of bailouts." And in a time of crisis, it was critical to take rapid action to clean up failing banks: "Prompt action needs to be taken to maintain financial stability, by moving quickly to support healthy institutions and by intervening in unhealthy institutions." The best advice Summers offered was a principle famously associated with Mexican president Ernesto Zedillo during a crisis earlier in the decade: "markets overreact, so policy needs to overreact as well."

These were all valid conclusions. In summary, they meant that emerging market countries should become more like the United States, with our strong legal institutions, transparent accounting, elaborate bank regulations, and independent political system—or, more accurately, they should become more like the conventional image that we held of our own country.

The idea that a major financial crisis of the type that ravaged emerging markets in the 1990s could originate in the United States was too preposterous to even be conceived of. Two of the crucial ingredients—tight connections between economic and political elites and dependence on fickle short-term flows of foreign capital—seemed completely out of the picture.[52] Despite rising debt due to growing trade imbalances, Summers's argument implied that our superior financial system made high debt levels sustainable. More fundamentally, political economy—the study of interactions between the political and economic systems—was only appropriate for developing and emerging market countries. In countries that had already "emerged," like the United States, economic questions could be studied without reference to politics. Instead, economic and financial policy presented only technocratic questions, which Summers compared to regulation of air travel:

> The jet airplane made air travel more comfortable, more efficient, and more safe, though the accidents were more spectacular and for a time more numerous after the jet was invented. In the same way, modern global financial markets

carry with them enormous potential for benefit, even if some of the accidents are that much more spectacular. As the right public policy response to the jet was longer runways, better air-traffic control, and better training for pilots, and not the discouragement of rapid travel, so the right public policy response to financial innovation is to assure a safe framework so that the benefits can be realized, not to stifle the change.

———

But in September-October 2008, when Lehman Brothers collapsed and panic seized the U.S. economy, money flooded out of the private financial system in what looked like a classic emerging market crisis.* In retrospect, it was clear that the run-up in housing prices of the 2000s was a bubble fueled by over-optimism and excess debt worthy of any emerging market. The diagnosis of the 1997 Korean Letter of Intent seemed to apply perfectly to 2008 America (substituting "household" for "corporate"): "Financial institutions have priced risks poorly and have been willing to finance an excessively large portion of investment plans of the corporate sector, resulting in high leveraging. At the same time, the dramatic decline in stock prices has cut the value of banks' equity and further reduced their net worth."[53] And when the federal government began rescuing major banks presided over by ultra-wealthy executives—while letting smaller banks fail by the dozens—it began to seem as if our government was bailing out its own, uniquely American oligarchy.

In similar situations in the 1990s, the United States had urged emerging market countries to deal with the basic economic and political factors that had created devastating crises. This advice was often perceived as arrogant (especially when the United States also insisted that crisis-stricken countries open themselves up further to American banks), but the basic logic was sound: when an existing economic elite has led a country into a deep crisis, it is time for change. And the crisis itself presents a unique, but short-lived, opportunity for change.

As in Korea a decade before, a new president came to power in the United States in the midst of the crisis. And just like Kim Dae-jung in Korea, Barack Obama had campaigned as the candidate of change. Yet far from applying the advice it had so liberally dispensed to others, the U.S. government instead organized generous financial support for its existing economic elite, leaving the captains of the financial sector in place.

What had happened?

* Standard & Poor's and other credit rating agencies rate bonds issued by governments and companies. The ratings are supposed to reflect the likelihood that the issuer will pay off its debts. A rating downgrade indicates that the agency is losing confidence in the issuer.

* There was one huge difference, which was that money did not leave the country; instead, it left the private sector for the safety of U.S. Treasury obligations. But the effect on the private sector financial system was the same.

1980–

In this present crisis, government is not the solution to our problem; government is the problem.

—Ronald Reagan, inaugural address, January 20, 1981[1]

On December 9, 1985, the cover of *Business Week* featured John Gutfreund, the CEO of Salomon Brothers and "The King of Wall Street." "Merrill Lynch remains the best-known Wall Street house and Goldman Sachs the best-managed, but Salomon Bros. is the firm most feared by its competitors," wrote Anthony Bianco. "It is the prototype of the thoroughly modern investment bank—the not-so-benevolent King of the Street."[2]

Salomon was the epitome of the new breed of Wall Street investment bank, built around a swashbuckling, risk-taking bond trading operation powered by "quants" recruited from academic research institutions and filled with "financial engineers" designing new products. Its strategy was to take large risks on its own account rather than simply taking fees for providing advice or executing trades. As Bianco put it, "What sets Salomon apart is the sheer scale on which it oper-ates in the markets, reflecting an appetite for risk unrivaled among financial middlemen." Four years later, *Liar's Poker,* Michael Lewis's memoir of his years at Salomon, would cement its status as the paradigmatic bank of the 1980s, the same decade that produced the original Oliver Stone *Wall Street* movie, with Gordon Gekko's famous "Greed is good" speech.

Looking back, however, Salomon seems so … small. When the *Business Week* story was written, it had $68 billion in assets and $2.8 billion in shareholders' equity. It expected to earn $1.1 billion in operating profits for all of 1985. The next year, Gutfreund earned $3.2 million.[3] At the time, those numbers seemed extravagant. Today? Not so much.

If the financial crisis of 2007–2009 produced a king of Wall Street, it would most likely be Jamie Dimon, CEO of JPMorgan Chase and the "Last Man Standing," according to the title of a recent book.[4] (Lloyd Blankfein of Goldman Sachs would be the other contender.) Compared to other megabanks, JPMorgan was less exposed to toxic securities and came through the credit crisis in better shape. In addition, it capitalized on the problems of other banks to snap up Bear Stearns and Washington Mutual, gaining strength in both investment banking and retail banking. And it took advantage of its weakened competitors to grab market share across the board, taking the top spot in investment banking revenues in the first half of 2009.[5] At his company's annual meeting in May 2009, Dimon could justifiably claim, "This might have been our finest year ever."[6] In addition, his status as a longtime Democratic donor with strong political connections, as well as the Obama administration's need to work with someone on Wall Street, gave him increased influence in Washington. Dimon, *The New York Times* wrote in July 2009, "has emerged as President Obama's favorite banker, and in turn, the envy of his Wall Street rivals."[7]

At the time, JPMorgan Chase had over $2 trillion in assets,[8] not counting positions not recorded on its balance sheet, such as derivatives exposures; it had $155 billion in balance sheet equity; and it earned $4.1 billion in operating profits in the second quarter alone. By comparison, the 1985 Salomon Brothers, even after converting to 2009 dollars to account for inflation, only had $122 billion in assets, $5 billion in equity, and $2 billion in operating profits for an entire year.[9] (Goldman Sachs, as a pure investment bank, offered perhaps a more accurate comparison to Salomon; in the second quarter of 2009, it had $890 billion in assets, $63 billion in equity, and $5 billion in operating profits.)[10]

Although Dimon voluntarily took no cash bonus for 2008, his total compensation including stock awards was still $19.7 million, more than three times Gutfreund's inflation-adjusted earnings of $5.8 million.[11] And this was in a bad year for Wall Street CEOs; in 2007, Dimon earned $34 million, Blankfein $54 million, John Thain of Merrill Lynch $84 million, and John Mack of Morgan Stanley $41 million.[12]

Something changed during the last quarter-century. One factor was a wave of mergers that created fewer and fewer, but larger and larger, financial institutions. JPMorgan Chase was the product of the mergers of Chemical Bank, Manufacturers Hanover, Chase Manhattan, J.P. Morgan, Bank One, and First Chicago—all since 1991—even before the bargain-basement acquisitions of Bear Stearns and Washington Mutual in 2008. (Salomon itself was acquired by Travelers, which then merged with Citicorp into Citigroup.)

In addition, the financial sector itself simply got bigger and bigger. When John Gutfreund became CEO of Salomon in 1978, all commercial banks together held $1.2 trillion of assets, equivalent to 53 percent of U.S. GDP. By the end of 2007, the commercial banking sector had grown to $11.8 trillion in assets, or 84 percent of U.S. GDP. But that was only a small part of the story. Securities broker-dealers (investment banks), including Salomon, grew from $33 billion in assets, or 1.4 percent of GDP, to $3.1 trillion in assets, or 22 percent of GDP. Asset-backed securities such as collateralized debt obligations (CDOs), which hardly existed in 1978, accounted for another $4.5 trillion in assets in 2007, or 32 percent of GDP.* All told, the debt held by the financial sector grew from $2.9 trillion, or 125 percent of GDP, in 1978 to over $36 trillion, or 259 percent of GDP, in 2007.[13]

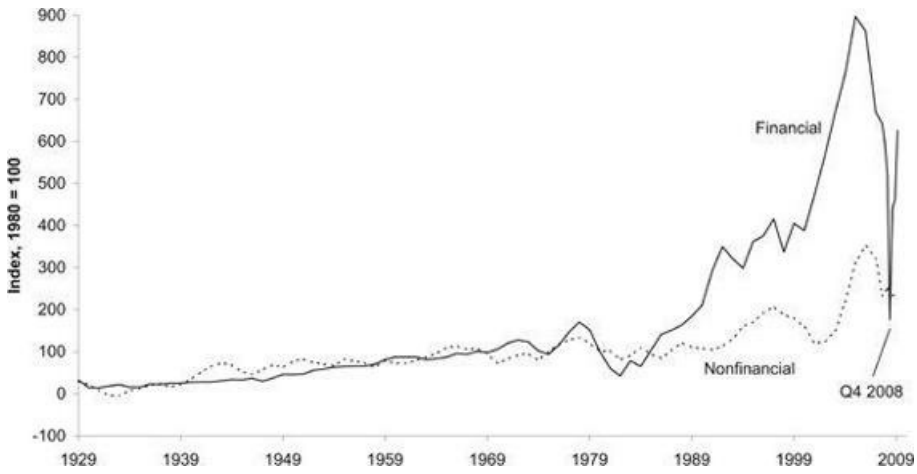
Some of this growth was due to an increase in borrowing by the nonfinancial sector—the "real economy." However, the expansion of the financial sector vastly outpaced growth in households and nonfinancial companies. Instead, most of the growth in the financial sector was due to the increasing "financialization" of the economy—the transformation of one dollar of lending to the real economy into many dollars of financial transactions. In 1978, the financial sector borrowed $13 in the credit markets for every $100 borrowed by the real economy; by 2007, that had grown to $51.[14] In other words, for the same amount of borrowing by households and nonfinancial companies, the amount of borrowing by financial institutions quadrupled.

Even these numbers do not include the derivatives positions that financial institutions were building up at the same time, because derivatives—bets on the value of other assets, such as stocks or currencies—are not conventionally accounted for on bank balance sheets. Worldwide, over-the-counter derivatives, which essentially did not exist in 1978, grew to over $33 trillion in market value—over twice U.S. GDP—by the end of 2008.[15] A large portion of these derivatives was held by U.S. financial institutions, which were among the world leaders in the business. No matter how you measure it, the size and economic influence of America's financial sector grew enormously over the past thirty years; the Salomon Brothers of 1985 would be trivial today.

As the financial sector amassed more and more assets, it became a bigger part of the national economy. Between 1978 and 2007, the financial sector grew from 3.5 percent to 5.9 percent of the economy (measured by contribution to GDP).[16] Its share of corporate profits climbed even faster, as shown in Figure 3-1. From the 1930s until around 1980, financial sector profits grew at roughly the same rate as profits in the nonfinancial sector. But from 1980 until 2005, financial sector profits grew by 800 percent, adjusted for inflation, while nonfinancial sector profits grew by only 250 percent. Financial sector profits plummeted at the peak of the financial crisis, but quickly rebounded; by the third quarter of 2009, financial sector profits were over six times their 1980 level, while nonfinancial sector profits were little more than double those of 1980.[17]

Not surprisingly, bankers' salaries and bonuses also shot upward. In 1978, average per-person compensation in the banking sector was $13,163 (in 1978 dollars)—essentially the same as in the private sector overall, which averaged $13,142. From 1955 through 1982, the average banker's compensation fluctuated between 100 percent and 110 percent of average private sector pay. Richard Fisher, chairman of Morgan Stanley in the 1990s, recalled that when he left Harvard Business School in the early 1960s, "investment banking was about the worst-paying job available to us. I started at Morgan Stanley at $5,800 a year. It was the lowest offer I had … I'm sure my classmates who went to Procter & Gamble started at $9,000 a year."[18] Then banking pay took off, until by 2007, the average banker was making over twice as much as the average private sector employee.[19]

Figure 3-1: Real Corporate Profits, Financial vs. Nonfinancial Sectors



Source: Bureau of Economic Analysis, *National Income and Product Accounts*, Tables 1.1.4, 6.16; calculation by the authors. Financial sector excludes Federal Reserve banks. Annual through 2007, quarterly Q1 2008–Q3 2009.

This trend was driven by stupendous growth at the top end of the income distribution. In *Liar's Poker,* $800,000 counted as a big bonus for an experienced trader.[20] In 1990, Salomon Brothers paid its top traders then shocking cash bonuses of more than $10 million.[21] In 2009, it emerged that a single executive at Citigroup—head of a commodities trading group that was loosely descended from Salomon—was due a $100 million bonus.[22] And the real money was in hedge funds; in 2007, five fund managers earned at least $1 billion each for themselves, led by John Paulson, who made $3.7 billion successfully betting against the housing market and the mortgage-backed securities built on top of it.[23]

Bigger, more profitable, and richer—the financial sector grew in every way imaginable during the last three decades. Most important, it became more powerful.

BORING BANKING

This is not what a casual observer would have expected in the 1970s, a time when the financial sector composed just over 3 percent of U.S. GDP and paid its workers little more than the private sector overall. For the entire postwar period, finance had generally been what the authors of the Depression-era banking regulations intended it to be—safe and boring. As described in chapter 1, the regulatory framework created in the 1930s prescribed a strict separation between commercial and investment banks. Commercial banks had an explicit government guarantee in the form of federal deposit insurance, but paid for it with tight federal regulation. Boxed in by rules limiting the businesses they could engage in, the states they could enter, and the interest rates they could pay (but also protected from competition by those same rules), commercial banking became the stereotype of a conservative, low-risk profession.

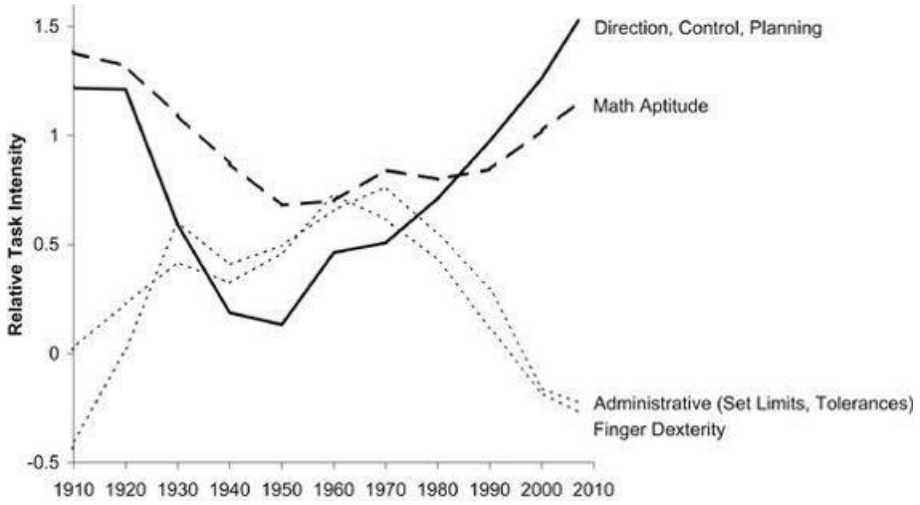
Investment banking, though riskier, was a far cry from the trading floor of *Liar's Poker,* where traders routinely risked hundreds of millions of dollars and ate guacamole out of five-gallon drums.[24] Like commercial banking, investment banking had taken on the features of a cozy cartel. For example, commissions on stock trading had been fixed (since 1792) by the New York Stock Exchange, preventing price competition. Securities firms earned most of their revenues from the traditional businesses of underwriting stocks and bonds (finding buyers for new securities being issued by corporations), providing brokerage services for institutional clients and an increasingly affluent public, and advising companies on mergers and acquisitions. These businesses were built around long-term client relationships, where reputation mattered. Leading banks such as Morgan Stanley cultivated an image as genteel, "white shoe" firms that emphasized client service rather than making a buck. As Nicholas Brady, treasury secretary in the administration of George H. W. Bush and a former investment banker, said in 2009, "When I came to Wall Street in 1954, it was a profession, one that financed the building of this country's industrial capacity and infrastructure."[25]

At the time, nonfinancial corporations had relatively simple financial needs, at least compared to the plethora of products and services available today: they raised short-term money by taking out bank loans, they raised long-term money by issuing bonds, and they raised capital by issuing stock. The loans were extended and held by commercial banks; the bonds and stocks were placed by investment banks with investors for a small slice of the proceeds. Since investment banks were not making loans directly, holding large chunks of corporate debt or equity, or trading large volumes of securities on their own account, there was little need for massive investment banks; from 1946 through 1981, total financial assets of all securities broker-dealers remained under 2 percent of U.S. GDP.[26]

"Boring banking" was reflected in the nature of the work done in the financial industry, which would be largely unrecognizable to people accustomed to today's era of quantitative sophistication and perpetual innovation. Thomas Philippon and Ariell Reshef have analyzed the task complexity of the jobs done by employees in financial services firms over the last century (Figure 3-2) and found that math aptitude and decision-making were less important between 1940 and 1970 than either earlier or later in the century. By contrast, finger dexterity and routine administrative tasks were relatively more important during this period than in the earlier or later periods.[27]

This does not mean that bankers somehow became noncompetitive and lost the urge to make money after the Depression. There were plenty of attempts to skirt existing banking regulations. Large bank holding companies evaded restrictions on interstate banking by buying separate subsidiary banks in multiple states; thrifts—savings banks and savings and loan associations founded to serve households—competed for deposits by offering interest rates above what commercial banks could pay. But during this period, the federal government took active steps to close regulatory loopholes and maintain the basic framework created in the 1930s. The Bank Holding Company Act of 1956 increased regulation of bank holding companies and limited their ability to buy banks in multiple states. In 1966, Congress gave the Federal Reserve authority to regulate deposit rates paid by thrifts. Congress even expanded the regulatory framework to include stronger consumer protection measures, such as the Truth in Lending Act of 1968 and the Fair Credit Reporting Act of 1970. Not only was the government making sure that banks were safe and sound, it was trying to make sure that banks did not abuse their customers.[28]

Figure 3-2: Realtive Job Complexity in the Financial Sector



Source: Thomas Philippon and Ariell Reshef, "Wages and Human Capital in the U.S. Financial Industry: 1909–2006," Figure 3.

During most of this period, the American economy flourished. From 1947 to 1973, real GDP (adjusted for inflation) grew at an average annual growth rate of 4.0 percent,[29] and American corporations grew, prospered, and expanded throughout the world. This was a period of major technological innovation in multiple capital-intensive industries, as the middle class bought cars and household appliances, the government spent heavily on an increasingly sophisticated defense industry, and the revolution in computer technology began with the development of mainframes and minicomputers. It also saw the emergence of the modern venture capital industry, which has played a crucial role in the funding of technological innovation. There were many reasons for the success of the postwar economy, but it is clear that "boring banking" did not constrain financing of innovation and development. Instead, it facilitated a phase of tremendous growth in economic output and prosperity.

CHANGING BANKING

Beginning in the 1970s and accelerating through the 1980s, the financial services industry broke free from the constraints of the Depression-era bargain. While there were banking executives who hoped for wholesale deregulation, there was no concerted plan by the financial sector to overthrow its regulatory constraints. Instead, like many historical phenomena, this development emerged from a confluence of factors: exogenous events, such as the high inflation of the 1970s; the emergence of academic finance; and the broader deregulatory trend begun in the administration of Jimmy Carter but transformed into a crusade by Ronald Reagan. The eventual result was an out-of-balance financial system that still enjoyed the backing of the federal government—what president would allow the financial system to collapse on his watch?—without the regulatory oversight necessary to prevent excessive risk-taking.

Like many major trends, this one was not entirely visible to its participants at the outset. Throughout American history, regulatory change has been more about settling disputes between segments of the business community than about sweeping social transformations, and the beginnings of financial deregulation were no different.

Fixed commissions for stock trading were one of the first dominoes to fall. As David Komansky, later CEO of Merrill Lynch, recalled, "There was no discounting, no negotiating. Fixed prices meant fixed prices for the entire Street; we couldn't give you a discount even if we wanted to. It was the greatest thing in the world."[30] Most Wall Street brokerage firms were happy to profit from this cartel. But not everyone saw things this way. Large institutional investors such as mutual funds and pension funds, which had grown in importance as increasingly affluent Americans amassed savings and large corporations set up pension plans for their employees, wanted lower prices for their large orders. Donald Regan, CEO of Merrill Lynch in the early 1970s, also wanted an end to fixed commissions. Merrill, as the largest broker on Wall Street, stood to gain the most from competition, and Regan already had a vision of his company as a large, diversified financial services firm.[31] William Salomon, then head of Salomon Brothers, also supported an end to fixed commissions.[32]

Called upon to adjudicate this dispute in the early 1970s, the Securities and Exchange Commission obliged, ordering the elimination of fixed commissions in the New York Stock Exchange (NYSE).[33] The NYSE complied on May 1, 1975, which had ripple effects through-out the securities industry. Competition over brokerage commissions meant that institutional investors could make large trades much more cheaply, leading to an increase in trading volume. After enjoying comfortable, cartel-like profits for decades, securities brokers were now given a much larger market, but also a much more competitive one. One source of competition was brokers such as Charles Schwab who focused on providing discounted services to individuals. As a result, the small partnerships that had populated Wall Street for decades began to fade away, replaced by larger, more heavily capitalized firms that expanded into higher-margin businesses, searching for new sources of profits.[34]

The world of traditional commercial and savings banks was also undergoing changes that would have far-reaching implications. One precipitating factor was the high inflation of the 1970s. High inflation meant higher interest rates, since no one will lend money at 3 percent if inflation is 6 percent. Because the interest paid on traditional savings accounts was capped by Regulation Q, money flowed out of those accounts toward higher-yielding Treasury bills and other forms of short-term debt issued by corporations and governments.[*] Money market funds,[†] invented in 1971, grew from only $3 billion in assets in 1976 to $230 billion by 1982.[35] At the same time as banks were losing their easy source of cheap funds, rising interest rates meant that they were losing money on the mortgages they had made, mostly at fixed rates. Many mortgages made in the early 1970s[36] were still paying only 7 percent even as inflation spiked into double digits at the end of the decade, meaning banks were not even receiving enough interest to make up for inflation. (Homeowners, on the other hand, profited as their debts were inflated away—helping to convince a generation of Americans that houses were the best investment they could possibly make.)

These economic shifts primarily affected savings and loan associations (S&Ls), which were more exposed to mortgages than commercial banks. But at the time, the S&Ls—not the Wall Street investment banks—and their lobbying organization, the United States League of Savings Institutions, were a powerful political force with influence on both sides of the political aisle. Although individually small, they had a favorable public image (in a country that professes to live by small-town values), they were located in virtually every congressional district, and they benefited from the disproportionate representation of rural states in the Senate. "When it came to thrift matters in Congress, the U.S. League and many of its affiliates were the de facto government," said former Federal Home Loan Bank head Edwin J. Gray in 1989.[37]

In response to S&L pressure, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980, which phased out Regulation Q, enabling banks to compete for deposits by paying higher interest rates—in the process eliminating one pillar of the "boring banking" business model. No longer able to rely on an artificially low cost of money, banks would have to seek new sources of revenue in new businesses. The bill eased this shift by allowing S&Ls to expand from home mortgages into a range of riskier loans and investments, making it easier for them to make the mistakes that produced the S&L crisis later in the decade. The bill also overrode any state laws restricting the interest that could be charged on first mortgages—meaning that banks could charge whatever interest rates the market would bear.[38]

By 1980, the traditional business models of both investment and commercial banking were eroding in the face of macroeconomic changes and the first waves of deregulation. As historian Charles Geisst wrote of Wall Street, "A turning point had been reached on the Street.… The more placid days of the past were gone forever."[39] There was still no coherent program or ideology that laid out what the financial services industry should look like and what its relationship to the government should be. But that was changing.

At the time, a movement was growing in the halls of America's leading universities that would help transform the financial sector. This movement was the discipline of academic finance, pioneered by economists such as Paul Samuelson, Franco Modigliani, Merton Miller, Harry Markowitz, William Sharpe, Eugene Fama, Fischer Black, Robert Merton, and Myron Scholes, most of whom went on to win the Nobel Prize. These scholars brought sophisticated mathematics to bear on such problems as determining the optimal capital structure of a firm (the ratio between debt and equity), pricing financial assets, and separating and hedging risks.[40]

Academic finance had a tremendous impact on the way business is done around the globe. For example, research on capital structure contributed to a significant increase in indebtedness by corporations.[41] (Debt provides leverage, and therefore increases expected returns along with risk.) It also expanded the market for advising corporations on their funding strategies—a lucrative opportunity investment bankers quickly seized. Similarly, the quantitative study of financial markets helped bankers identify a new universe of ways to make money. New methods for calculating the relative value of financial assets made possible arbitrage trading, where traders sought out small pricing discrepancies that, in theory, should not exist; by betting that the market would make these discrepancies disappear, they could make almost certain money. The Black-Scholes Model (developed by Black, Scholes, and Merton) provided a handy formula for calculating the price of a financial derivative, and in the process gave rise to the derivatives revolution.

Thus academic finance produced important tools that would create new markets and vast new sources of revenues for Wall Street. But it was perhaps even more important for the ideology it created. A central assertion of the academic finance movement in the 1960s and 1970s became known as the Efficient Market Hypothesis: precisely because traders are looking for and exploiting inefficiencies in asset prices, those inefficiencies cannot last for more than a brief period of time; as a result, prices are always "right." As outlined by Eugene Fama in 1970, the Efficient Market Hypothesis comes in a weak form, a semi-strong form, and a strong form. The weak form holds that future prices cannot be predicted from past prices; the semi-strong form holds that prices adjust quickly to all publicly available information (meaning that by the time you read the news in the newspaper, it is too late to make money on the news); and the strong form holds that *no one* has any information that can be used to predict future prices, so market prices are always right. At the time, Fama argued, with empirical evidence, that the weak and semi-strong forms were correct. He acknowledged that there are exceptions to the strong form—exchange floor traders and corporate insiders do have information they can profit from—but found no evidence that anyone else (mutual fund managers, for example) is able to "beat the market" through better information or analysis.[42]

Despite Fama's caveats, the strong form became the intellectual justification for financial deregulation. If a free market will always produce fundamentally correct asset prices, then the financial sector can be left to its own devices. This principle applies directly to securities and derivatives; for example, if a municipality buys an interest rate swap from an investment bank, it must be getting a good deal, since the price it pays is set by the "market" (even if the transaction is negotiated privately between the parties). It applies more broadly to the fees charged for financial services; if the penalty interest rate on a credit card is 30 percent, that must be the true price of the risk that the card issuer is taking on that customer. And conceptually, it even applies to compensation in the financial sector; if a trader takes home a $5 million bonus at the end of the year, that must be the true value of his labor. (Or, as Goldman Sachs CEO Lloyd Blankfein recently asserted in defense of his bankers' high pay, "If you examine our practices on compensation, you will see a complete correlation throughout our history of having remuneration match performance over the long term.")[43]

These were not mathematical consequences of the Efficient Market Hypothesis, but they flowed naturally from it. The basic belief was that if a financial transaction was taking place, it was a good thing. This belief reflects a general economic principle; given perfectly rational actors with perfect information and no externalities, all transactions should be beneficial for both parties. But few economists ever believed that these assumptions actually held in the real world. And over the next few decades, dozens of leading economists such as Joseph Stiglitz, Robert Shiller, and Larry Summers set about knocking holes in the Efficient Market Hypothesis.[44] Brad DeLong, Andrei Shleifer, Summers, and Robert Waldmann created a model showing that "noise trading can lead to a large divergence between market prices and fundamental values."[45] Even Fischer Black (of Black-Scholes fame) agreed. At the 1985 meeting of the American Finance Association, he argued that it was impossible to differentiate between noise and information, and hence impossible to determine who was a noise trader and who was an information trader. Consequently, prices could wander far away from fundamental values for indefinite periods of time.[46]

The Efficient Market Hypothesis did not develop in a vacuum; it was in the vanguard of a broad movement in economics

arguing for decreased regulation and increased liberalization of markets. By the 1990s, there was also an emerging consensus that developing countries should abandon restrictions on the flow of capital and open their economies up to foreign money. The argument, as advanced by Stanley Fischer, then second-in-command at the International Monetary Fund, was that "free capital movements facilitate a more efficient global allocation of savings, and help channel resources into their most productive uses, thus increasing economic growth and welfare," providing benefits that would outweigh any risks.[47] Again, there were important skeptics. Jagdish Bhagwati argued in 1998 that trade in dollars was not the same as trade in goods, because free capital flows would generate financial crises whose potential costs needed to be taken into account.[48] But the belief in free movements of capital, like the belief in efficient markets, became strong enough in some circles to shrug off the need for empirical justification.[49]

The Efficient Market Hypothesis, like the doctrine of free capital flows, provided ready ammunition for anyone who wanted to argue that banks should be allowed to do as they pleased, that financial innovations were necessarily good, and that free financial markets would always produce optimal social outcomes. Even so, it might have remained only a cry in the academic wilderness or an esoteric Wall Street doctrine. But it had the fortune of being in the right place at the right time—of coinciding with a once-in-a-generation shift in the American political climate.

The election of Ronald Reagan marked a crucial turning point in American political history. Although Richard Nixon had already shown how to build a new Republican majority by capitalizing on resentment against Lyndon Johnson's Great Society and the culture of the 1960s, it was Reagan who gave that movement a usable political ideology. Although Jimmy Carter had overseen the beginnings of deregulation with airlines, railroads, and trucking, it was more a topic for policy wonks than for the broader electorate; drawing in part on the ideas of economist Milton Friedman, Reagan made deregulation an ideological crusade.[50] Like many successful leaders, Reagan managed to bring together many conflicting movements and beliefs in his coalition. But his central message, as he said in his first inaugural address, was that "government is not the solution to our problem; government is the problem."[51] According to Reagan, making government smaller and weaker would not only increase personal freedom, it would unleash the creativity and productivity of the private sector.

Reagan fought this battle on many fronts. He cut taxes in an unsuccessful attempt to "starve the beast"—force government to shrink by cutting its funding. He reduced funding to regulatory agencies, hoping to achieve through understaffing what he could not pass through Congress. He installed people who had no interest in regulation at the head of major regulatory agencies. Faced with a Democratic majority in the House of Representatives through his entire presidency, he was unable to fully achieve his goal of dismantling government regulation, but he set the tone for both Republican and Democratic administrations that would follow. (Reagan's ascent to power also closely followed the formation of Margaret Thatcher's first government in the United Kingdom in 1979; Thatcher's deregulatory policies helped unleash the forces of financial innovation in London, with similar results.)

For the financial sector, Reaganism meant breaking down the rules that constrained the activities of financial institutions. As his first treasury secretary (and later chief of staff), Reagan named Donald Regan, the Merrill Lynch CEO who had championed deregulation of brokerage commissions and sought to make Merrill into a diversified financial services company. It was not unusual for a treasury secretary to come from the banking industry. But it was unusual for a treasury secretary to embrace a deregulatory agenda as broad as the one Regan espoused. In an October 1981 interview, he said that his top priority was "the deregulation of financial institutions … trying to deregulate as quickly as possible in the field of interest rates, mandatory ceilings, things of that nature."[52]

The savings and loan industry, still struggling with high interest rates and overreliance on mortgage lending, presented an opportunity for the new administration to test out its theories. In 1982, Congress passed the Garn–St. Germain Depository Institutions Act—hailed by President Reagan as "the first step in our administration's comprehensive program of financial deregulation"[53]—which lifted many regulations on the savings and loan industry, allowing them to expand further into new businesses, such as commercial lending and investing in corporate bonds (including junk bonds), to compensate for the collapse of the "boring banking" business model.[54] In addition, the bill authorized state-chartered banks to offer mortgages with adjustable rates[55] (national banks had been able to offer adjustable rate mortgages since the previous year)[56]—a central feature of the last twenty-five years of innovation in residential lending—and relaxed other constraints on mortgage lending for national banks. The following year, acting under the authorization granted by the bill, the Office of the Comptroller of the Currency lifted all restrictions on loan-to-value ratios (the percentage of a house's appraised value that could be borrowed), maturities (fifteen years, thirty years, etc.), and amortization schedules (meaning that banks could offer mortgages where the principal balance went up over time).[57] The Garn–St. Germain Act also made it easier for banks to operate across state borders by allowing interstate mergers between banks and S&Ls.[58]

The Reagan administration's willingness to help the banking industry also extended to the new innovations that were beginning to take hold on Wall Street. Lewis Ranieri, one of the legendary traders at Salomon Brothers, worked directly with

administration officials to create a new market for mortgage-backed securities.[59] In 1968, the federal agency Ginnie Mae had begun securitizing mortgages—buying mortgages from lenders, combining them in pools, and issuing securities backed by those pools to the lenders (who could then sell them to investors).* The principal on these mortgages (but not the risk that borrowers might prepay) was guaranteed by Ginnie Mae, and therefore by the U.S. government. This guarantee insulated banks from the risk of default by their borrowers and also provided a way to attract money from a wide range of investors to the housing market. In the 1970s, Salomon attempted to create its own mortgage-backed securities out of Bank of America mortgages, but ran into problems with tax laws and with state regulations.

The solution to Salomon's problem was a new bill, the Secondary Mortgage Market Enhancement Act of 1984, which Ranieri helped create and defended before Congress.[60] This bill cleared away the tax issues and state regulations that had hampered Salomon's earlier efforts, giving investment banks the ability to buy up virtually any mortgages, pool them together, and resell them in slices with varying levels of risk. Securitization was made even easier when the Tax Reform Act of 1986 created the Real Estate Mortgage Investment Conduit, or REMIC, which created tax advantages making mortgage-backed securities more attractive. These new laws were unequivocally good for the investment banks, which gained a new market from which they could earn millions of dollars in fees. In return, they were supposed to increase the flow of money into the housing sector, making it easier for people to buy houses. The new market for private mortgage-backed securities also helped commercial banks and S&Ls, which could now pass on the risk of their fixed rate mortgages (which lose value if interest rates increase) to investors in the new securities.[61]

These legislative victories showed the growing influence of Wall Street, but they also depended on Wall Street's ability to wrap itself in the ideology of homeownership—the idea that making it easier for people to buy houses is always a good thing. In contrast to the thrifts, the major commercial and investment banks did not make major gains in the 1980s, despite the friendly attitude of the Reagan administration. Major legislation to break down the Glass-Steagall barrier fell victim to Democrats in Congress. (It also faced opposition from some investment banks, which did not want commercial banks invading their turf.) The Financial Institutions Deregulation Act of 1983, which would have allowed bank holding companies to expand into securities and insurance, died in Congress.[62]

Comprehensive deregulation was also derailed by the savings and loan crisis, which worsened steadily through the 1980s. As it turned out, the Garn–St. Germain Act, by allowing S&Ls to expand into new businesses, prompted many of them to gamble on high-risk investments. S&Ls lacked experience in these businesses, as did their regulators, and over 2,000 banks failed between 1985 and 1992, with a peak of 534 in 1989. (By comparison, only seventy-nine banks failed during all of the 1970s.)[63] Ultimately, over one thousand people were indicted and thrifts suspected of fraud cost the government over $54 billion.*[64]

When Ronald Reagan left office, his program to deregulate the financial sector remained incomplete. The industry still faced significant constraints, such as limits on interstate banking and the Glass-Steagall separation of commercial and investment banks. But although his ambitions remained unfulfilled, Reagan had transformed academic theories and policy prescriptions into a potent ideology that would play a major role in political discourse for at least the next two decades. The collapse of much of the communist bloc beginning in 1989 lent further support to the idea that free market capitalism was the right answer to any question.

EXCITING BANKING

The basic principle behind any oligarchy is that economic power yields political power. The legislative failures of the Reagan administration showed that, in the 1980s, Wall Street did not yet hold sway in Washington. While academic finance provided the intellectual justification for financial nonregulation and the Reagan Revolution provided the political ideology of weak government, these would have mattered less had finance remained simply one industry among many. Instead, the banking industry went through a revolution of its own—one aided in part by academic theories and incipient deregulation, but largely driven by the creativity and competitiveness of a generation of talented bankers. Their serial innovations created the new money machines that fueled the rapid, massive growth in the size, profitability, and wealth of the financial sector over the last three decades—all of which helped Wall Street become a dominant political force in Washington.

This process began in the 1970s, when Michael Milken, a trader at Drexel Burnham Lambert, had the insight that "junk bonds"—bonds that were rated below "investment grade" by the credit rating agencies*—were generally underpriced, either because investors had an irrational aversion to them or because they lacked a liquid market in which to trade them. He capitalized on that market inefficiency, building an operation that dominated the trading and sales of junk bonds. By creating a large, liquid market for junk bonds—which grew from $6 billion in 1970 to $210 billion in 1989[65]—he made it easier for companies to raise money and opened up vast new opportunities for investment banks to generate profits by underwriting, selling, and trading these formerly neglected bonds. By making it easy to raise large amounts of money quickly, junk bonds also made possible the leveraged buyout craze of the 1980s, in which acquirers would pay for acquisitions by issuing large amounts of new debt. Those acquisitions, in turn, generated huge fees for the investment banks that advised the companies engaged in those transactions and also underwrote and sold the necessary debt. They also left companies struggling with huge debt burdens, often requiring painful restructuring and sometimes leading to bankruptcy.

In the 1980s, the Securities and Exchange Commission and the U.S. Attorney's Office for the Southern District of New York (led by Rudy Giuliani) launched investigations of Milken and Drexel Burnham Lambert for insider trading, securities manipulation, and fraud. The investigations eventually led to convictions for both Milken and his employer for securities and reporting violations.[66] But junk bonds—rebranded as "high-yield" bonds—remained a popular form of financing, with over $600 billion in new bonds issued by U.S. corporations from 2003 through 2007.[67] Equally important, investor demand for higher-yield, higher-risk bonds remained strong—driving the recent boom in mortgage-backed securities, especially as returns on Treasury bonds fell to historic lows in the past decade.

The private mortgage-backed securities invented by Lewis Ranieri at Salomon Brothers, with an assist from the federal government, had even larger implications for the future than Milken's creation of the junk bond market. Without securitization, banks generally either held on to the mortgage loans that they made or sold them on the secondary market to Fannie Mae or Freddie Mac—government-sponsored enterprises that provided liquidity to the housing market. By buying mortgages, guaranteeing their principal payments, and turning them into mortgage-backed securities, Fannie and Freddie provided funding for banks to make more mortgages and absorbed some of the risk of the market. Because whole mortgages were difficult to trade (since every mortgage is unique), the number of transactions generated by each mortgage was small.

Securitization created many new ways for banks to profit. For the banks making the initial mortgages, securitization created a new market for their loans, making it easier for them to recover their cash and lend it out again to another borrower, boosting volume. Investment banks had three new ways to make money. They could take fees out of each securitization that they created; they could earn fees selling the new mortgage-backed securities to investors; and they could earn fees (or trading profits) by trading these securities. In each case, the revenues available depended on the volume of mortgage-backed securities. The total volume of private mortgage-backed securities (excluding those issued by Ginnie Mae, Fannie Mae, and Freddie Mac) grew from $11 billion in 1984 to over $200 billion in 1994 to close to $3 trillion in 2007.[68] In addition, once mortgage securitization had caught on, investment banks looked for any other financial assets they could turn into securities—credit card debt, student loans, anything that paid a more or less steady stream of cash flows—further expanding the market.

While mortgage securitization was good for the banks that originated the mortgages and turned them into securities, it was a mixed blessing for everyone else. On the one hand, by attracting additional investors to the mortgage market, it expanded the pool of money available to people who wanted to buy houses. On the other hand, it made possible the "originate to distribute" business model, in which lenders could make profits lending money to people who could not pay it back, making mortgage defaults and foreclosures more likely. Under this model, the risk of default is passed downstream to the investors buying the mortgage-backed securities, who therefore become responsible for policing the quality of the underlying loans; instead of having to make sure that borrowers were likely to pay them back over the next thirty years, lenders could be paid back immediately when they sold off the mortgages for securitization. When it turned out that investors had no idea what risks they were taking on, the result was the collapse of a housing bubble larger than any in recorded American history.

In addition to mortgage-backed securities, Salomon Brothers also pioneered arbitrage trading, which took a variety of forms. For example, traders could make certain money by finding two securities that should but did not have the same value—say, U.S. Treasury bonds maturing in August 2040 and September 2040—buying one, selling the other,* and waiting for their prices to converge. Or they could achieve the same goal by buying the interest payments and the final principal payment on a 30-year bond separately while selling the whole 30-year bond (including interest and principal) for a higher price. In general, such trades make money in one of two ways. Either there is a complex product, often involving embedded options, that other people in the market do not know how to value correctly, or there is a regulation that creates a market inefficiency that can be exploited. In any case, under ordinary market conditions, arbitrage opportunities are close to free money—at least until the number of competitors mimicking a particular strategy drives its profitability down to zero—a far cry from the traditional business of lending money and taking the risk that it might not be paid back.

Although Salomon pioneered quantitative arbitrage trading, the practice soon spread to other investment banks, causing a huge flow of talent into Wall Street (significantly driving up the mathematical aptitude shown on the Philippon-Reshef skill curve) and leading to vast growth in banks' proprietary trading activities (trading on their own account, rather than executing trades for clients).* Its popularity also fueled the rapid growth of hedge funds (lightly regulated investment funds open only to institutions and rich individuals), which grew collectively from less than $30 billion in assets under management in 1990 to over $1.2 trillion in 2005,[69] with estimates over $2 trillion by 2008.[70] Arbitrage became a staple trading strategy of many hedge funds. And because hedge funds rely on investment banks to execute their trades, the growth of hedge funds provided another source of revenue for the banks.

But while it made the hedge funds and the investment banks plenty of money, arbitrage trading had two other effects. Because hedge funds are largely unregulated, large risk exposures were building up outside the view of the financial regulators. And because arbitrage spreads are typically very thin—pricing inefficiencies tend to vanish as traders take advantage of them—making significant profits required large amounts of borrowed money. This leverage was the reason why some proprietary trading operations lost large amounts of money during the 1997–1998 emerging markets crises when prices failed to converge as expected—leading even Salomon Brothers to largely disband its arbitrage team.[71]

The fourth money machine of modern finance—after high-yield debt, securitization, and arbitrage trading—was the modern derivatives market. While commodity futures contracts (in which, for example, a farmer commits to sell wheat in the future for a pre-specified price) had been around for centuries,* the market for financial derivatives remained small until the early 1980s, largely because traders—or, more accurately, the managers responsible for keeping those traders in line—had no good way of calculating what they were worth. But in the 1970s, the Black-Scholes Model gave banks a new way to calculate the value of complicated derivatives and the hedges they used to protect themselves.†

Wall Street embraced these quantitative models because they made it easier to price and trade derivatives in bulk. Nassim Taleb and Pablo Triana have argued that quantitative models are *worse* at pricing derivatives than the heuristics used by traders from the pre-quantitative era.[72] Nonetheless, the formulas gave banks the confidence to sell growing volumes of increasingly complicated trades to clients, since the models enabled them to keep track of how much money they were making on each one. Mathematical models also made it possible to break down complicated trades into simpler ones, a critical factor in the development of sophisticated financial products.

The modern derivatives revolution began with the invention of the interest rate swap (by Salomon Brothers) in 1981. In this transaction, Company A pays interest at a fixed rate to Company B and Company B pays interest at a floating rate (which can go up or down as economic conditions change) to Company A. Interest rate swaps allow companies to exchange fixed rate payments for floating rate payments, or vice versa—"swapping" interest rate risks between the two parties.‡ Similarly, currency swaps allow companies to swap currency risks by exchanging different currencies (or combinations of currencies). Interest rate swaps can also be combined with currency swaps. These two basic derivatives became popular ways for companies to manage financial or operational risks.

For example, a company might have issued $100 million in bonds on which it has to pay a floating interest rate (like an adjustable rate mortgage). Because it does not want to bear the risk that interest rates will go up, it can buy an interest rate swap from a derivatives dealer. The company will pay a fixed rate—say, 7 percent, or $7 million per year—to the dealer; in exchange, the dealer will pay the company the same floating rate that the company has to pay on its bonds. The net result is that the company now pays $7 million per year whether interest rates go up or down, and the dealer bears the interest rate risk. Currency swaps are similar; for example, a U.S. manufacturer with a multiyear contract in Thai baht might enter into a currency swap in order to lock in a constant future exchange rate and protect itself from the risk that the baht will fall. In either case, these derivatives allow companies to offload risks that they do not want to take onto the financial markets, where presumably some party will take on those risks in exchange for a high expected return. (Because the evolution of derivatives has run ahead of regulatory and accounting rules, derivatives can also serve other purposes, such as helping companies smooth their earnings over multiple periods or reduce their tax bills by deferring earnings into the future.)

By the middle of 2008, the market for over-the-counter (customized) interest rate swaps had grown to over $350 trillion in face value (the amount on which interest is calculated) and over $8 trillion in gross market value.*[73] The derivatives dealers—both investment banks and large commercial banks—were taking a piece of every interest rate swap in fees. Even better, the dealers would typically hedge their exposures; ideally, for every swap with one client, they would conduct an opposite swap with another client, so the two trades canceled out—leaving nothing but fees from both clients.

But ordinary swaps were easy for any derivatives dealer to duplicate, and competition between banks soon drove profit margins down near zero. The solution was to invent newer, more complex versions of interest rate and currency derivatives that were hard for competitors to duplicate—and hard for clients to understand. There were "inverse floaters," whose interest rates went in the opposite direction from market interest rates, souped up with leverage and embedded options. There were interest rate swaps that changed their terms based on currency exchange rates. Each of these trades was a customized combination of bonds, swaps, and options that was virtually impossible for a typical client to accurately value; the dealer would charge a large fee, break the transaction into its component parts, and hedge them individually at a much lower cost.

Derivatives expert Satyajit Das has outlined the abusive economics of these transactions. Describing the mechanics of a typical inverse floater, he wrote, "Chairman Greenspan might wax lyrical about the unbundling of risks but we spent most of our waking hours frantically rebundling the risks and stuffing them down the throats of any investor we could find."[74] Because these derivatives were zero-sum trades—one party's loss was the other's profit—one side could be badly burned. Orange County lost almost $2 billion on inverse floaters and similar trades that treasurer Robert Citron clearly did not understand; real-economy companies such as Procter & Gamble and Gibson Greetings similarly lost tens or hundreds of millions of dollars.[75] But these transactions generated large fees for the dealers; Merrill Lynch alone made $100 million on deals with Orange County.[76]

One crucial innovation in the recent history of derivatives, which played an important role in creating the latest financial crisis, was the credit default swap. A credit default swap is a form of insurance on debt; the "buyer" of the swap pays a fixed premium to the "seller," who agrees to pay off the debt if the debtor fails to do so. Typically the debt is a bond or a similar fixed income security, and the debtor is the issuer of the bond. Historically, monoline insurance companies provided insurance for municipal bonds, and Fannie Mae and Freddie Mac insured the principal payments on their mortgage-backed securities. With credit default swaps, however, now anyone could sell insurance on any fixed income security.

Credit default swaps were invented in the early 1990s by Bankers Trust, but were popularized by J.P. Morgan later in the decade as a way for banks to unload the default risk of their asset portfolios; this enabled them to lower their capital requirements, freeing up money that could be lent out again.[77] Credit default swaps also provide a way for a bond investor to hedge against the risk of default by the bond issuer. But because there is no requirement that the buyer of a credit default swap own the debt in question, these derivatives are also a handy way to gamble on the chances of *any* company defaulting on its debts (similar to buying insurance on your neighbor's house); this quality made them a new type of security that could be minted in infinite quantities and traded, providing another source of profit for derivatives dealers. And as discussed later, they would play a crucial role in greasing the wheels of the securitization machine that grew enormously in size in the last decade.

This explosion of new products created vast new profit-making possibilities for financial institutions. These opportunities were mainly available to a handful of investment banks and large commercial banks that could invest in powerful new computer technology and attract highly trained mathematicians and scientists from leading research universities. These large banks also had the scale required to build full-service derivatives operations that could assemble complex transactions and hedge their component parts. These new businesses helped blur the traditional line between commercial and investment banks, replacing it with a divide between small banks, which continued taking deposits and making loans, and big banks, which could branch out into securitization, proprietary trading, and derivatives.

At the same time, large banks were also growing by invading each other's territories and acquiring smaller rivals. Banks had been trying to get around the restrictions on interstate banking and the constraints of the Glass-Steagall Act for decades. Congress responded repeatedly with legislation limiting bank activities, including the Bank Holding Company Act of 1956, the Savings and Loan Holding Company Act of 1967, and the Bank Holding Company Act Amendments of 1970. Beginning in the 1970s, however, the banks became more aggressive, while Congress's resolve waned.

On the one hand, commercial banks sought to raise money for corporate clients, a traditional function of investment banks. In 1978, Bankers Trust began placing commercial paper (short-term debt) issued by corporations with investors. The Federal Reserve Board of Governors ruled that this practice did not violate the Glass-Steagall Act, opening a loophole that was ultimately (after an initial setback in the Supreme Court) upheld by the D.C. Circuit Court of Appeals in 1986.[78] In 1986, the Federal Reserve opened up another loophole, allowing commercial banks to set up affiliated companies (through a common bank holding company) to deal in specific securities that were off-limits to commercial banks, subject to limits on the revenues earned from those securities. Over the next decade, under the direction of chair Alan Greenspan, the Fed expanded the loophole, which began with municipal bonds, mortgage-backed securities, and commercial paper, to include corporate bonds and equities;[79] the Fed also raised the limit on revenues from the securities business and relaxed rules that enforced a separation between banking and securities operations within a single bank.[80] Commercial banks happily took advantage of the opportunity to plunge into new and esoteric businesses. In 1993, for example, NationsBank created a securities subsidiary, NationsSecurities, which began selling its clients mutual funds that invested heavily in inverse floaters and other complex derivatives; the next year, those funds plummeted in value when rising interest rates caused losses on many derivatives.[81]

On the other hand, investment banks sought to encroach on the territory of commercial banks. In the mid-1970s, for example, Merrill Lynch introduced the cash management account (CMA)—a brokerage product that included a money market account with check-writing privileges. This was a key element in Donald Regan's strategy to provide a full spectrum of financial services; as he said, "I wanted to get into banking, and CMA was the way to do it."[82] Cash management accounts competed directly with traditional savings and checking accounts for deposits, and enabled securities firms to sweep up a larger share of their clients' assets.

Investment banks also benefited from the general shift in financial intermediation (the movement of money from people who have it to people who need it) from banks into the capital markets. Traditionally, households and businesses would put their excess cash in deposit accounts at commercial banks or S&Ls, which would lend the cash out as mortgages and commercial loans. However, the high interest rates of the 1970s convinced investors to move their savings from bank accounts to money market funds, which invested in short-term bonds and commercial paper. Increasing affluence also fed the growth of mutual funds and pension funds, which sought out higher-yield investments. This demand for yield created the opportunity for investment banks to raise money for corporate clients by issuing commercial pa-per and bonds and selling them directly to large institutional inves-tors. Money still flowed from households to corporations, but instead of passing through commercial banks, now it could pass through a money market fund or mutual fund—with a helping hand from Wall Street.

Mortgage-backed securities had a similar effect. Institutional investors bought mortgage-backed securities created by investment banks; the cash flowed to mortgage lenders, who no longer needed to be affiliated with traditional banks, because they did not rely on deposits for funding. This flow of money—from investors to special-purpose entities created by investment banks to nonbank mortgage lenders to homebuyers—bypassed the traditional banking system, escaping traditional banking regulation. Large commercial banks also got in on the action, using securitization to tap the capital markets for funds to complement the money deposited by their banking customers.

As banks created new markets and expanded into new businesses, they inevitably got bigger. But they also got bigger the old-fashioned way: by buying each other. Especially after the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 relaxed constraints on interstate banking, a handful of large regional banks rushed to construct coast-to-coast networks. NationsBank bought Boatmen's Bancshares in 1996 and Barnett Bank in 1997 to become the biggest bank holding company in the country, passing Bank of America (which had bought Security Pacific in 1992); then NationsBank bought Bank of America in 1998, and in 2004 the new Bank of America bought FleetBoston (itself the merger of the three largest banks in New England). JPMorgan Chase was the product of the mergers of Chemical Bank and Manufacturers Hanover (1991), First Chicago and National Bank of Detroit (1995), Chemical and Chase Manhattan (1996), Bank One and First Chicago (1998), J.P. Morgan and Chase Manhattan (2000), and JPMorgan Chase and Bank One (2004). Wells Fargo bought First Interstate in 1996 and merged with Norwest in 1998. Wachovia was built out of the mergers of First Union, CoreStates, and Wachovia between 1998 and 2001. The largest financial services conglomerate of all (at the time) was put together by Sandy Weill, who began with Commercial Credit, bought Primerica (which owned Smith Barney) in 1988, added Travelers Insurance in 1993, bought Salomon Brothers in 1997, and finally merged his empire with Citicorp in 1998.

The major commercial banks used acquisitions not only to become bigger, but also to push their way into investment banking. Bank of America bought Robertson Stephens in 1997; NationsBank bought Montgomery Securities in 1997; and Chase Manhattan bought Hambrecht & Quist in 1999. European banks joined in, with Credit Suisse buying First Boston in 1988 and Donaldson, Lufkin & Jenrette in 2000, Swiss Bank Corporation (now part of UBS) buying Dillon, Read in 1997, and Deutsche Bank buying Bankers Trust in 1998. America remained populated with thousands of small community banks. But at the top of the pyramid, a handful of financial juggernauts were scrambling over each other to become as big and as broad as possible, as fast as possible. The goal was to create ubiquitous financial "supermarkets" that could provide the full range of financial services to both retail and corporate customers, anywhere.

In short, the financial sector was getting bigger. Between 1980 and 2000, the assets held by commercial banks, securities firms, and the securitizations they created grew from 55 percent of GDP to 95 percent.[83] Financial sector profits grew even faster, from an average of 13 percent of all domestic corporate profits from 1978 to 1987 to an average of 30 percent from 1998 to 2007.[84] The growth was faster still for the largest banks. Between 1990 and 1999, the ten largest bank holding companies' share of all bank assets grew from 26 percent to 45 percent, and their share of all deposits doubled from 17 percent to 34 percent.[85] And they continued to grow. In 1998, the merged Travelers and Citibank had $700 billion in assets;[86] at the end of 2007, Citigroup had $2.2 trillion in assets, not counting $1.1 trillion in off-balance-sheet assets,[87] even after the spinoff of the Travelers insurance businesses. Bank of America was not far behind, growing from $570 billion after the NationsBank–Bank of America merger to $1.7 trillion at the end of 2007.[88]

The transformation of the financial sector through expansion into new businesses and wave after wave of mergers changed the nature of the industry. At its peak was a handful of megabanks with hundreds of billions or trillions of dollars in assets. All of these banks, whatever their origins, were heavily involved in underwriting securities, manufacturing securities (securitization), trading securities, and trading derivatives. Some of them—the ones with roots in commercial banking, such as Citigroup, JPMorgan Chase, and Bank of America—also had wide-ranging branch operations taking hundreds of billions of dollars of deposits. Others—the traditional investment banks and brokerages such as Goldman Sachs, Morgan Stanley, and Merrill Lynch—chose to avoid the hassle and fixed cost of the deposit-taking business altogether, funding their operations through the capital markets. But these alternatives were simply different strategies to obtain the funds necessary to play in the riskier, more profitable world of modern finance. Although greater size should make banks safer, the largest banks compensated by engaging in riskier activities. In 2004, Gary Stern and Ron Feldman—president and senior vice president of the Federal Reserve Bank of Minneapolis—found that "after becoming larger, banks 'spend' their diversification benefit by taking on additional risk. For example, larger banks hold assets in riskier categories, such as commercial and industrial loans, relative to smaller banks."[89] The goal was to be big *and* to take on risk.

The main divide in the industry was no longer between commercial and investment banks; it was between the megabanks, with their portfolios of businesses that had hardly existed three decades before, and the thousands of traditional banks that still made their money taking deposits and extending loans (although now they were more likely to sell those loans off to be securitized). Federal Reserve governor Daniel Tarullo recapped the story in a 2009 speech:

> The regulatory system accommodated the growth of capital market alternatives to traditional financing by relaxing many restrictions on the type and geographic scope of bank activities, and virtually all restrictions on affiliations between banks and non-bank financial firms. The result was a financial services industry dominated by one set of very large financial holding companies centered on a large commercial bank and another set of very large financial institutions not subject to prudential regulation.[90]

These megabanks, whether based downtown, in midtown, or in North Carolina, were the new Wall Street.

* To create asset-backed securities, a new legal entity buys and holds some assets (such as mortgages) and then issues new bonds that are backed by those assets. So the assets behind asset-backed securities are *in addition to* the assets on the balance sheets of commercial and investment banks.

* Depositing money in a savings account is the same as lending money to your bank; buying short-term commercial paper is lending money to a company; buying a Treasury bill is lending money to the U.S. government. Since interest rates on savings accounts were capped but interest rates on other lending were not, people moved money out of savings accounts into other forms of lending.

†A money market fund is a mutual fund that invests in short-term, liquid debt such as Treasury bills or commercial paper. Although money markets are generally not guaranteed against losing value, they attempt to maintain a share price of $1, which makes them look and function like savings or checking accounts.

* To create a mortgage-backed security (MBS), a large number of mortgages are pooled together; the mortgage-backed securities each have a claim on the payments made on those mortgages. The net effect is that each investor in the

MBS owns a tiny piece of each mortgage, distributing each mortgage's risk of default among a large number of investors.

* The mismanagement and outright fraud that led to these failures were one of the inspirations for George Akerlof and Paul Romer's paper on "looting."

* Bonds are IOUs issued by companies or governments. They are given ratings by credit rating agencies; those ratings are supposed to reflect the probability that the issuer will default on the IOU. "Investment-grade" bonds are those that are highly rated, meaning that there is a small probability of default. "Junk" bonds are any bonds that do not earn investment-grade ratings.

* In financial markets, it is possible to sell assets that you don't actually have, known as selling "short." In a short sale, the seller borrows an asset (say, a share of stock) from Party A and then sells it to Party B; at some point in the future, the seller must buy the asset from someone in order to return it to Party A. The seller is betting that the price will have fallen in the meantime, earning it a profit.

* Arbitrage trading received a tremendous boost from the rapid drop in the cost of computing power. Using computers, banks could search the markets for pricing discrepancies and profit from them, provided that they could finance their positions long enough for prices to converge.

* Simple options—in which the farmer pays a small amount now for the right, but not the obligation, to sell wheat in the future for a pre-specified price—were also common before the 1970s.

† In general, a derivatives dealer (a bank) attempts to hedge its positions; that is, if it sells one client an option to buy yak pelts in the future, it will try to buy an equivalent option from another counterparty so its positions cancel out. To hedge a complex trade that is customized for an individual client, the dealer may have to execute multiple trades with other counterparties, which may result in an imperfect hedge.

‡ The risk of a floating rate liability, such as an adjustable rate mortgage, is that interest rates will go up and your periodic payments will go up. The risk of a fixed rate liability, such as a fixed rate mortgage, is that interest rates in general will go down and you will be stuck paying a high interest rate. Depending on the nature of their business, different parties prefer one type of risk or the other.

* In the interest rate swap example above, the face value, or notional value, is $100 million. However, the amount of money that changes hands is much smaller; if, at the end of a given year, the floating rate is 7.25 percent, then the dealer only pays the company 0.25 percent (the difference between the floating and fixed rates), or $250,000.

4
“GREED IS GOOD”

The Takeover

> Derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing to and are capable of doing so.… The vast increase in the size of the over-the-counter derivatives markets is the result of the market finding them a very useful vehicle.
>
> —Alan Greenspan, chair of the Federal Reserve, July 16, 2003[1]

The 1980s came to a close with the peak of the savings and loan crisis. The failure of over 2,000 banks between 1985 and 1992 was by far the largest financial sector mass die-off since the Great Depression.[2] The government bailout of the S&L industry cost more than $100 billion, and hundreds of people were convicted of fraud.[3] In 1990, Michael Milken, the junk bond king, pleaded guilty to six felonies relating to securities transactions. In 1991, Citibank was facing severe losses on U.S. real estate and loans to Latin America and had to be bailed out by an investment from Saudi prince Al-Waleed bin Talal. In 1994, Orange County lost almost $2 billion on complicated interest rate derivatives sold by Merrill Lynch and other dealers; county treasurer Robert Citron pleaded guilty to securities fraud, although no one on the "sell side" of those transactions was convicted of anything. In 1998, Long-Term Capital Management collapsed in the wake of the Russian financial crisis and had to be rescued by a consortium of banks organized by the Federal Reserve.

Scandals are a constant refrain throughout the history of the financial services industry. Particularly severe episodes of wrongdoing often lead to the implementation of new rules that at least close the particular barn door that had been left open in the past; the most important example was the new regulatory scheme created during the Great Depression. The failures and scandals of the late 1980s and 1990s were closely linked to recent deregulatory policies or financial innovations: expansion of savings and loans into new businesses; junk bonds and leveraged buyouts; quantitative arbitrage trading; and over-the-counter derivatives. Someone familiar with the history of the financial system might have expected this record of disaster to lead to greater skepticism of financial innovation and closer oversight of the industry.

Instead, the 1990s witnessed the final dismantling of the regulatory system constructed in the 1930s. The Riegle-Neal Act of 1994 practically eliminated restrictions on interstate banking, allowing bank holding companies to acquire banks in any state and allowing banks to open branches in new states. The Gramm-Leach-Bliley Act of 1999 effectively demolished the remaining barriers separating commercial and investment banking—barriers that had already been significantly weakened during the preceding decade—by allowing holding companies to own subsidiaries engaged in both businesses (as well as insurance).

These laws only confirmed trends that had begun in the 1970s, and signified that the federal government would no longer attempt to resist the desires of the large commercial banks to become national, full-service financial supermarkets. More important, the government turned its back on the new financial products that had recently emerged, refusing to regulate over-the-counter derivatives or to police the new Wild West of mortgage lending that appeared late in the decade. Instead, leading policymakers from Alan Greenspan on down chose to rely on "self-regulation" of financial markets—the idea that market forces would be sufficient to prevent fraud and excessive risk-taking.

Despite the scandals and crises that marked the 1990s, this was the decade when Wall Street translated its growing economic power into political power and when the ideology of financial innovation and deregulation became conventional wisdom in Washington on both sides of the political aisle. The unprecedented amounts of money flowing through the financial sector, increasingly concentrated in a handful of megabanks, were the foundation of the new financial oligarchy. In the United States, however, political power on a national scale is generally not bought through simple corruption—by exchanging money under the table for political favors. Instead, Wall Street used an arsenal of other, completely legal weapons in its rise to power. The first was traditional capital: money, which wielded its influence directly via campaign contributions and lobbying expenses. The second was human capital: the Wall Street veterans who came to Washington to shape government policy and shape a new generation of civil servants. The third, and perhaps most important, was cultural capital: the spread and ultimate victory of the idea that a large, sophisticated financial sector is good for America.[4] Together, these powerful forces gave Wall Street a degree of political influence that no amount of payoffs to corrupt politicians could have bought.

CAMPAIGN MONEY

Money has long played an important role in American electoral politics. The interpretation of the First Amendment to protect the financing of political speech, along with the relative weakness of political parties (compared to other advanced democracies) in enforcing discipline among their members, has made it a requirement for individual legislators to devote considerable time and effort to raising money. The escalating cost of campaigning has increased the importance of money. Between 1974 and 1990, the cost of a seat in the House of Representatives—the average expenses of an election winner—grew from $56,500 to $410,000; from 1990 to 2006, it tripled to $1,250,000 (more than doubling even after accounting for inflation).[5]

The financial sector was a central player in this evolution. The sector was the leading contributor to political campaigns throughout the past two decades. But campaign contributions from the financial sector (including finance, insurance, and real estate) grew much faster than contributions overall, more than quadrupling, from $61 million in 1990 to $260 million in 2006. (After excluding insurance and real estate, the sector still contributed over $150 million in 2006; the second-ranking industry group, health care, contributed only $100 million in 2006.) Over the same time period, contributions from the securities and investment industry *sextupled* from $12 million to $72 million, and that $72 million omits the millions of dollars in contributions from the law firms that served the securities industry. (According to one analysis, from 1998 to 2008, the financial sector spent $1.7 billion on campaign contributions and $3.4 billion on lobbying expenses; the securities industry alone spent $500 million on campaign contributions and $600 million on lobbying.)[6] The largest commercial and investment banks, which stood to gain the most from deregulation and consolidation, were also the largest sources of campaign cash. In 1990, the companies in the banking sector that contributed the most money were Goldman Sachs, Salomon Brothers, Barnett Banks (the largest bank in Florida, bought by NationsBank in 1997), Citibank, J.P. Morgan, and Morgan Stanley; in 2006, they were Goldman, Citigroup, Bank of America, UBS, JPMorgan Chase, and Morgan Stanley.[7]

Money from the financial sector flowed precisely where it could do the most good. After becoming chair of the Senate Banking Committee in 1999, Phil Gramm raised more than twice as much money from the securities industry than from any other industry. In 1998, the securities industry's primary beneficiary in the Senate was Alfonse D'Amato, Gramm's predecessor as chair of the Senate Banking Committee; in 1996, D'Amato trailed only Gramm. More recently, the chair of the Senate Banking Committee, Christopher Dodd, received $2.9 million from the securities industry in 2007–2008—more than three times as much as any other senator who was not a major presidential candidate.[8] The securities industry was also the top donor to Barney Frank, chair of the House Financial Services Committee. And the securities industry's favorite member of Congress over the decades has been New Yorker Charles Schumer, first a member of the House Financial Services Committee and later a member of the Senate Banking Committee (and chair of the Democratic Senatorial Campaign Committee in 2006 and 2008), who has aggressively championed Wall Street over the years.[9]

There is a perpetual debate over whether politicians help their major donors because they want to make sure the money keeps flowing, or whether the donors give the money because they appreciate the politicians' positions. In any case, the 1990s, a period of increasing financial sector contributions, were also the decade when the deregulatory campaign crashed through any remaining congressional opposition. Powerful members of Congress sponsored legislation on the financial sector's wish list. Gramm put his name on the 1999 Gramm-Leach-Bliley Act, which largely repealed the Glass-Steagall separation of commercial and investment banking. Gramm was also the major force behind the Commodity Futures Modernization Act of 2000, which prohibited federal regulation of over-the-counter derivatives. Schumer was a major proponent of Gramm-Leach-Bliley, and in 2001 he and Gramm passed legislation to cut in half fees paid by financial institutions to the SEC.[10] (Gramm left the Senate in 2002 to become a vice chair at UBS Warburg.)

Over the past twenty years, the financial services industry became an extremely powerful lobby in Washington, able to win votes in both Republican and Democratic Congresses. In April 2009, Senator Richard Durbin said, "the banks—hard to believe in a time when we're facing a banking crisis that many of the banks created—are still the most powerful lobby on Capitol Hill. And they frankly own the place."[11] No one thought he was saying anything extraordinary.

When it came to money, however, Wall Street had no particular advantage over other industries, except that it had more of it. And while campaign contributions gave Wall Street influence on Capitol Hill, important decisions elsewhere in Washington are made by appointed officials who do not depend on campaign money. Congress can pass legislation that constrains the activities of financial institutions (or not), but that legislation must be translated into regulations and those regulations must be enforced by the executive branch—either administration officials, primarily in the Treasury Department, or regulators serving in the Federal Reserve or one of an alphabet soup of agencies (SEC, CFTC, OCC, OTS, FDIC, NCUA, and so on).[12]

A second source of Wall Street's political power was its ability to place its people in key positions in Washington. As the big banks became richer, more of their executives became top-tier fund-raisers who could be tapped for administration jobs. More important, as the world of finance became more complicated and more central to the economy, the federal government became more dependent on people with modern financial expertise—which meant people from the big banks and from their most cutting-edge businesses. This constant flow of people from Wall Street to Washington and back ensured that important decisions were made by officials who had absorbed the financial sector's view of the world and its perspective on government policy, and who often saw their future careers on Wall Street, not in Washington.

The core problem in regulation is whether regulators will enforce rules that harm the interests of the industry they oversee, or whether they will be "captured" by that industry, as described in George Stigler's 1971 paper "The Theory of Economic Regulation": "as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit."[13] Capture does not imply that regulators are corrupt, or that their actions are motivated by their personal interests. By contrast, regulatory capture is most effective when regulators share the worldview and the preferences of the industry they supervise. And as banking insiders gained power and influence in Washington, the positions they held—that complex financial products, free financial markets, and large, sophisticated financial institutions were good for America—became orthodoxy inside the Beltway.

Throughout the past two decades, many senior officials moved back and forth between Wall Street and Washington. This was not a new phenomenon; after all, financial services have been an important part of the American economy for a long time. In the last two decades, however, two things changed. First, as the industry changed, the type of leaders it sent to Washington changed. Instead of people who had grown up managing large commercial banks or traditional investment banking firms, now it was people from the newer, riskier, more profitable businesses who were entering public service. Robert Rubin, President Clinton's first director of the National Economic Council (NEC) and second treasury secretary, began his Goldman Sachs career in risk arbitrage (betting on the likelihood of corporate events, such as acquisitions), branched out into relative value arbitrage (capitalizing on pricing discrepancies between similar securities), and co-headed Goldman's fixed income trading department before becoming co-chair of the firm.[14] Henry Paulson, President George W. Bush's last treasury secretary, headed Goldman Sachs from 1999 to 2006, at a time when its trading operations were the most profitable part of the firm.

Second, the increasingly complex nature of finance changed the balance of power between Wall Street insiders and other economic policymakers. Executives from major financial institutions had always been prized in Washington for their relationships with major corporations in all industries. But as finance became more esoteric and policy questions became more technical, Wall Street experience became even more important. On many issues crucial to the financial sector—such as derivatives, securitization, or capital requirements—all the people with relevant expertise were Wall Street veterans. Financial policy took on the trappings of a branch of engineering, in which only those with hands-on experience on the cutting edge of innovation were qualified to comment. In order to stay informed about what was going on in the world of finance, the government had to borrow people from the major banks, who consequently had disproportionate influence over policy. For example, Frank Newman was CFO at Bank of America before joining Treasury in 1993 as undersecretary for domestic finance and later as deputy secretary. During the controversy triggered by the 1994 derivatives losses of Orange County, he wrote a letter urging Congress to "indefinitely postpone" legislation regulating derivatives. In 1995 he became senior vice chair of Bankers Trust, the derivatives dealer most tainted by the 1994 scandals; he was promoted to CEO in 1996.[15]

Many Wall Street bankers took on major positions in the government during the Clinton and George W. Bush administrations. Besides Rubin and Paulson, Goldman Sachs supplied treasury undersecretaries to both administrations—Gary Gensler under Clinton and Robert Steel (who went on to become CEO of Wachovia) under Bush. Other Goldman alumni included Senator Jon Corzine, a member of the Senate Banking Committee; Stephen Friedman, director of the NEC under Bush and chair of the New York Fed; William Dudley, an executive under Tim Geithner at the New York Fed and later its president; Joshua Bolten, director of the Office of Management and Budget (OMB) and chief of staff to President Bush; and a slew of Paulson advisers at Treasury, including Neel Kashkari, head of the Troubled Asset Relief Program (TARP). Other Wall Street executives in the Clinton administration included Roger Altman of Lehman Brothers and the Blackstone Group (a private equity firm) as deputy treasury secretary and Lee Sachs of Bear Stearns as a deputy assistant secretary and later as assistant secretary

for financial markets.[16]

Rapid change in the financial sector put key regulators in the position to make important decisions affecting the industry, and many of those decisions were friendly to the industry. In 1993, Wendy Gramm, chair of the Commodity Futures Trading Commission (CFTC), issued an order exempting most over-the-counter derivatives from federal regulation; in the same year she was named to the board of directors of Enron, a leading trader of energy derivatives and major supporter of that order.[17] As chair of the CFTC from 1999 to 2001, William Rainer co-authored a report recommending that an existing ban on single-stock futures be lifted;[18] that recommendation was implemented by the Commodity Futures Modernization Act of 2000. In 2001, Rainer became CEO of OneChicago, a new exchange to trade single-stock futures.[19] James Gilleran, former CEO of the Bank of San Francisco, became head of the Office of Thrift Supervision in 2001. During his tenure, the agency became known for its lax regulation of thrifts; Gilleran said, "Our goal is to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion."[20] In 2005, he left to become CEO of Federal Home Loan Bank of Seattle. As a Treasury official during the George H. W. Bush administration, John Dugan led a study that advocated the repeal of interstate banking restrictions and of the Glass-Steagall Act; as a lawyer advising the American Bankers Association, he helped steer the Gramm-Leach-Bliley Act through Congress. In 2005, George W. Bush named Dugan Comptroller of the Currency, in which capacity he helped shield federally chartered banks from state regulators.[21]

The close connections between the private and public sectors were also enhanced by longtime government officials who chose to move to the private financial sector. Michael Froman, a member of Rubin's NEC and then his chief of staff at Treasury, followed Rubin to become an executive at Citigroup. Gerald Corrigan worked at the Federal Reserve for over twenty years, serving as the president of the New York Fed from 1985 to 1993; in 1994 he joined Goldman Sachs, where he became a partner and senior executive in 1996. David Mullins, a former assistant secretary at Treasury and vice chair of the Federal Reserve Board of Governors, resigned from the Fed in 1994 to become a partner in Long-Term Capital Management.

The revolving door not only placed Wall Street veterans in important positions in Washington. It also ensured the development of strong personal relationships between leading bankers and government officials, giving the large banks privileged access to key policymakers, and promoted the spread of the Wall Street worldview in the corridors of political power. The prospect of landing prestigious or high-paying jobs in the financial sector may also have influenced the decisions of regulators and administration officials, who may have had an incentive not to make enemies among their potential future employers.

But banks also had a more direct means of putting pressure on their regulators—the market for regulatory fees. The Federal Reserve makes the money for its day-to-day operations from its banking activities, and the FDIC makes its money from insurance premiums levied on banks. But the other major regulators, including the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), are funded by fees levied solely on the banks that they regulate. And while each regulator nominally had its own sphere of jurisdiction—bank holding companies for the Fed, national banks for the OCC, and so on—financial institutions that fell under multiple regulatory agencies were allowed to select their primary regulator. As a result, regulatory agencies had to compete for funding by convincing financial institutions to accept their regulation, which created the incentives for a "race to the bottom," in which agencies attract "customers" by offering relatively lax regulatory enforcement.

The OTS stood out in this competition. According to William Black, a law professor and former official at the Federal Home Loan Bank Board, "The reputation of the Office of Thrift Supervision was that it was the weakest, and the laxest, and it was indeed outright friendly to the worst of the non-prime lending."[22] American International Group (AIG), a massive insurance company with one of the largest derivatives trading operations in the world, opened a savings and loan—and then chose the OTS as its primary regulator, even though the agency, with its focus on mortgage lending, had no chance of monitoring the risks taken on by AIG's infamous Financial Products division. In 2005, the giant mortgage lender Countrywide, then regulated by the OCC, met with the OTS to discuss switching regulators. According to *The Washington Post,* "Senior executives at Countrywide who participated in the meetings said OTS pitched itself as a more natural, less antagonistic regulator than OCC and that [Countrywide CEO Angelo] Mozilo preferred that. Government officials outside OTS who were familiar with the negotiations provided a similar description."[23] In March 2007, the OTS approved Countrywide's application to convert itself from a bank holding company into a savings and loan holding company in order to fall under the OTS's regulation.[24]

Between the revolving door and the competition for regulatory "business," there was a confluence of perspectives and opinions between Wall Street and Washington that was far more powerful than emerging-market-style corruption. Wall Street's positions became the conventional wisdom in Washington; those who disagreed with them, such as Brooksley Born, were marginalized as people who simply did not understand the bright new world of modern finance. This groupthink was a major reason why the federal government deferred to the interests of Wall Street repeatedly in the 1990s and 2000s.

One of history's curiosities is that this shift happened within a Democratic administration, headed by a president elected largely because of middle-class economic insecurity. Of all the people to migrate from Wall Street to Washington, the most important was Robert Rubin. When Rubin joined the Clinton administration in 1993—having first gained entrance to the party's inner circles through his fund-raising prowess[25]—the transformation of the financial sector into a risktaking, moneymaking colossus was well underway. But the right of big banks to make money free from government intervention was not yet secured. There was still a major force in American politics that was skeptical about Wall Street and the unbridled pursuit of profit: the Democratic Party, which had helped block deregulatory legislation in Congress in the 1980s.

Bill Clinton was elected president in 1992 without any apparent strong opinion of the financial sector. Although his campaign theme was "the economy, stupid,"[26] as a challenger he was able to propose a broad economic platform (including health care reform, a middle-class tax cut, and education spending) without having to take a position on Wall Street. When Clinton took office, his appointments reflected a broad range of views within the Democratic Party. Lloyd Bentsen, a moderate who had spent the past twenty-two years in the Senate, was secretary of the treasury; Roger Altman, from both Wall Street and the Carter administration, was his deputy; Robert Reich, a traditional liberal (in the American sense) was secretary of labor; Laura Tyson, an advocate of industrial policy, was chair of the Council of Economic Advisers; and Rubin was director of the NEC, a new body created by Clinton to coordinate economic policymaking.

The crucial question was whether to increase spending on social programs and follow through on the campaign pledge of a middle-class tax cut, or to balance the budget in order to keep interest rates low. Rubin was a political liberal in many ways, supporting government social programs and opposing the welfare reform bill of 1996.[27] But he believed even more in fiscal responsibility and the importance of building a friendly relationship with the "bond market" in order to provide a foundation for long-term growth. The theory was that the bond market was distrustful of Democratic presidents; if it suspected Clinton of fiscal irresponsibility, it would demand higher yields on U.S. government debt, pushing up interest rates across the economy and stifling economic growth.

At a January 1993 meeting, the Clinton economic team agreed that deficit reduction should be their top priority, in order to establish credibility with Wall Street.[28] (This policy prompted Clinton adviser James Carville to say, "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody.")[29] They were betting that by increasing taxes and bringing budget deficits under control, they could reduce interest rates and stimulate growth. These policy choices approximately coincided with the beginning of one of the longest economic booms in recent history—from 1993 to 2000, annual real GDP growth averaged 3.9 percent, while inflation averaged only 1.8 percent[30]—although other factors probably contributed to the boom, including the increasing use of computer technology and the impact of globalization.

In early 1995, Rubin succeeded Bentsen as treasury secretary, becoming the administration's primary economic policymaker, at a crucial moment for the White House. After its resounding defeat in the 1994 congressional elections, many insiders felt that the Democratic Party needed to turn to the left and advocate more populist economic policies. Rubin, however, favored the administration's centrist course, maintaining a pro-business stance and focusing on deficit reduction. Clinton sided with Rubin, confirming the Democrats' transformation into a market-oriented, business-friendly party that could be trusted by Wall Street.[31]

The ascendancy of the former co-chair of a premier investment bank also sent a signal that the administration would be sympathetic to Wall Street. While big business and big banks could historically count on the support of the Republicans, now they could rely on the Democrats as well. With Rubin in place, the government was unlikely to go after any of the new cash cows the financial sector had created in the last two decades, such as securitization, derivatives, or quantitative proprietary trading.

In addition to shaping the economic policies of the Clinton administration, Rubin mentored a generation of Democratic policymakers who are largely sympathetic with his views. He brought in some key Treasury officials directly from Wall Street, including Gensler from Goldman Sachs (now chair of the CFTC) and Lee Sachs from Bear Stearns (now a counselor to the treasury secretary). In contrast, Rubin's two top protégés did not come from Wall Street, but they largely adopted his perspective on economic and financial issues. Larry Summers, deputy secretary under Rubin and his successor as treasury secretary, was an academic economist and former chief economist at the World Bank. Tim Geithner, assistant secretary and then undersecretary for international affairs, was a career civil servant. But they shared Rubin's opinion that financial innovation and free markets were generally good for America. Summers opposed derivatives regulation even more strongly than Rubin; in his 2003 memoir, Rubin wrote, "Larry characterized my concerns about derivatives as a preference for playing tennis with wooden racquets—as opposed to the more powerful graphite and titanium ones used today."[32] (Summers and Geithner are now director of the NEC and treasury secretary, respectively.) Rubin was also a founder of the Hamilton Project, a centrist study group based at the Brookings Institution, which served as a way station for rising economy policy specialists such as Peter Orszag (now director of the OMB) and Jason Furman (now deputy director of the NEC). The end result was a Democratic policy establishment that no longer took its cues from unions and consumer advocates, but was now open or even

friendly to the positions of Wall Street.

This political realignment was, in many ways, a huge boon to the Democratic Party. "Rubinomics" established the party's credibility in the eyes of the business and financial communities, repairing the damage done by the perceived economic mismanagement of the Carter administration and helping to balance the fund-raising scales against the Republicans. The long boom of the 1990s, whether or not it should be credited to Clinton-era policies, looked especially good when compared to the record of the George W. Bush administration, which saw slower growth (average real GDP growth of 2.2 percent, down from 3.9 percent under Clinton) and declining median income (falling from $52,500 in 2000 to $50,300 in 2008, both in 2008 dollars).[33] The shift of the Republican Party toward "cultural" issues also helped throw more investment banking and hedge fund moguls into Democratic arms.

The story of the Clinton administration demonstrates the key role that influential Wall Street insiders could play in reshaping the landscape of national politics. By 2008, the economic consensus of the Democratic establishment was based on the policies of Clinton, Rubin, and Summers.

In the 1990s, only one figure in the Washington economic elite surpassed Rubin in stature: Alan Greenspan, chair of the Federal Reserve from 1987 until 2006 and one of the most important legacies of the Reagan administration. Although Greenspan was not a Wall Street banker—he headed a New York economic consulting firm for nearly thirty years before becoming Fed chairman—there came to be no truer believer in the ideology of free markets, financial innovation, and deregulation.

Greenspan was a "lifelong libertarian Republican" and a longtime associate of Ayn Rand, the philosopher and novelist who argued for pure laissez-faire capitalism.[34] He believed in both the doctrine of efficient markets and the Reagan Revolution against governmental interference in the economy. He looked forward eagerly to a world without government regulation:

> Regulation is inherently conservative. It endeavors to maintain the status quo and the special interests who benefit therefrom.… With technological change clearly accelerating, existing regulatory structures are being bypassed, freeing market forces to enhance wealth creation and economic growth.
>
> In finance, regulatory restraints against interstate banking and combinations of investment and commercial banking are being swept away under the pressures of technological change.…
>
> As we move into a new century, the market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures. This is a likely outcome since governments, by their nature, cannot adjust sufficiently quickly to a changing environment, which too often veers in unforeseen directions.
>
> The current adult generations are having difficulty adjusting to the acceleration of the uncertainties of today's silicon driven environment. Fortunately, our children appear to thrive on it. The future accordingly looks bright.[35]

Greenspan was naturally predisposed to be friendly toward the financial sector and its desire to be left alone by government. As a central banker, he first made his mark injecting liquidity into the financial system to pull the stock market out of its 23 percent fall on Black Monday, October 19, 1987. This was the first example of what came to be known as the "Greenspan put"—the idea that if trouble occurred in the markets, the Fed would come to their rescue.* Greenspan cut interest rates sharply in 1998 following the Russian crisis and in 2001 following the collapse of the Internet bubble, each time helping to cushion the impact of the downturn and arguably pumping up the next bubble. The underlying theory, set out in Greenspan's famous 1996 "irrational exuberance" speech, was that the Fed should not attempt to head off bubbles, but instead should focus on helping the economy recover when those bubbles popped: "[H]ow do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? … We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability."[36] This position was an endorsement of the Efficient Markets Hypothesis and the idea that the Fed should not attempt to determine if prices are accurate, but should leave that function to the markets.

Wall Street appreciated Greenspan's monetary policy, because it meant that he would not raise interest rates preemptively to choke off a boom (unless that boom was also creating higher inflation). But it appreciated his hands-off regulatory policy even more. The Federal Reserve is one of the most important financial regulatory agencies, not only regulating bank holding companies but also enforcing consumer protection laws. But for almost two decades it was led by a man whose faith in financial innovation outweighed any interest he had in regulating the financial sector, and who had entered public life in order to "engage in efforts to advance free-market capitalism as an insider."[37]

For example, Greenspan strongly believed that financial derivatives served a valuable role in dispersing risk throughout the financial system, and that market participants were sophisticated enough to manage the risks created by derivatives. In July 2003, he told the Senate Banking Committee,

> What we have found over the years in the marketplace is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing to and are capable of doing so.… The vast increase in the size of the over-the-counter derivatives markets is the result of the market finding them a very useful vehicle. And the question is, should these be regulated? Well, indeed, for the United States, they are obviously regulated to the extent that banks, being the crucial creators of these derivatives, are regulated by the banking agencies, but not beyond that. And the reason why we think it would be a mistake to go beyond that degree of regulation is that these derivative transactions are transactions amongst professionals.[38]

For Greenspan, the rapid growth of the derivatives market was *proof* that they were socially beneficial. He believed, like many free market purists, that markets are self-regulating, and that as long as market participants have sufficient information, they will be aware of any potential dangers and protect themselves from them, and therefore outcomes in an unregulated market are necessarily good. This attitude even extended to fraud; as Brooksley Born recounted, "He explained there wasn't a need for a law against fraud because if a floor broker was committing fraud, the customer would figure it out and stop doing business with him."[39]

Greenspan dominated the Fed during his tenure, and his views became close to dogma on the Board of Governors. At an August 2005 symposium held by the Kansas City Federal Reserve Bank to honor Greenspan, Raghuram Rajan presented a paper asking in prophetic detail whether deregulation and innovation had increased rather than decreased risk in the financial system.[40] Rajan, then chief economist of the International Monetary Fund, was met with a torrent of attacks by Greenspan's defenders.[41] Fed vice chair Donald Kohn responded by restating what he called the "Greenspan doctrine." Kohn argued that self-regulation is preferable to government regulation ("the actions of private parties to protect themselves … are generally quite effective. Government regulation risks undermining private regulation and financial stability"); financial innovation reduces risk ("As a consequence of greater diversification of risks and of sources of funds, problems in the financial sector are less likely to intensify shocks hitting the economy and financial market"); and Greenspan's monetary policy resulted in a safer world ("To the extent that these policy strategies reduce the amplitude of fluctuations in output and prices and contain financial crises, risks are genuinely lower"). Kohn's conclusion reflected the prevailing view of Greenspan at the time: "such policies [recommended by Rajan] would result in less accurate asset pricing, reduce public welfare on balance, and definitely be at odds with the tradition of policy excellence of the person whose era we are examining at this conference."[42] Larry Summers more directly said he found "the basic, slightly lead-eyed premise of [Rajan's] paper to be misguided."[43]

Besides his considerable powers as steward of U.S. monetary policy and one of the chief regulators of the financial sector, Greenspan also mattered because of his tremendous public stature. As the U.S. economy settled into a long boom with falling unemployment and low inflation, he became probably the world's most famous and respected economist. If Greenspan said that derivatives improved the management of risk and financial innovation was always good, that provided cover for anyone in Washington who didn't know what to think about the issue.

With Greenspan at the Federal Reserve, Rubin and Summers at Treasury, a reliably friendly and compliant set of regulators, and millions of dollars flowing into Congress with each election cycle, Wall Street had friends throughout Washington in the 1990s. Little changed in the following decade under the Bush administration, which believed even more strongly in deregulation. Rarely has one industry enjoyed such unchecked power in Washington.

THE IDEOLOGY OF FINANCE

It is one thing to have important congressmen dependent on your campaign contributions, and to have your own people in key positions of power, and even to have some regulators enthralled by the prospect of lucrative jobs. Those factors alone gave Wall Street tremendous political power. But in addition to these traditional forms of political capital, the major banks amassed another form of power: cultural capital.

Politics is like sales. If you are trying to close a large deal with a major corporation, it helps to have friends on the inside, it helps to have buyers who see their fortunes aligned with yours, and it can even help to dangle the prospect of a high-paying job before the key decision-maker. But it is even better if the buyers really, independently want what you are selling. It is best of all if they believe that buying what you are selling is a symbol of their own judgment and sophistication—that buying your product marks them as part of the informed elite.

Any industry—say, Big Tobacco—can buy friends in Washington, who will work hard behind the scenes to help that industry. But over the last two decades, Wall Street's friends could work in the light of day, as the causes they championed gained an enthusiastic following among elites in Washington and New York (and major European capitals). The idea that a sophisticated, unrestrained financial sector was good for America became part of the conventional wisdom of the political and intellectual class. As a result, deregulation was no longer something to be buried in thousand-page bills—although that did happen—but was instead the focus of celebratory photo opportunities. In June 2003, representatives of three industry organizations joined the vice chair of the FDIC and the director of the OTS to kick off a project to "identify and eliminate any regulatory requirements that are outdated, unnecessary or unduly burdensome." Each of them threatened a symbolic stack of paper documents with a pair of garden shears—except for James Gilleran, director of the OTS, who brought a chainsaw.[44]

Over the past twenty years, finance changed in the public eye from a boring and slightly untrustworthy pursuit to the glistening centerpiece of the modern American economy. In much of the country, suspicion of bankers remained high or even increased with the prosecutions of people from Ivan Boesky and Michael Milken (insider trading) to Henry Blodget (talking up bad stocks). But where it mattered most—on elite academic campuses, in the business and financial media, in think tanks, and in the halls of power in Washington—banking became the latest chapter of the American Dream, the way to make vast riches by working hard and creating innovative new products that would supposedly improve life for everyone.

The positive image of Wall Street had at least three main components. The first was the idea that financial innovation, like technological innovation, was necessarily good. The second was the idea that complex financial transactions served the noble purpose of helping ordinary Americans buy houses. The third was that Wall Street was the most exciting place to be at the turn of the new millennium.

Innovation, in American English, is an unambiguously positive word. Dating back to Benjamin Franklin and Eli Whitney, we like to see ourselves as a nation of creative, resourceful inventors who solve problems through ingenuity and hard work. More recently, when we think of innovation, we think of technology: of Hewlett and Packard in their garage, or Jobs and Wozniak in theirs. And given all the material benefits that technological innovation has given us, it seems logical that financial innovation must be equally beneficial.

The language of innovation has been widely used to describe recent changes in the financial sector. In a 1995 paper, Robert Merton wrote, "Looking at financial innovations … one sees them as the force driving the global financial system towards its goal of greater economic efficiency. In particular, innovations involving derivatives can improve efficiency by expanding opportunities for risk sharing, by lowering transaction costs and by reducing asymmetric information and agency costs."[45] Two years later, Alan Greenspan said,

> The unbundling of financial products is now extensive throughout our financial system. Perhaps the most obvious example is the ever-expanding array of financial derivatives available to help firms manage interest rate risk, other market risks, and, increasingly, credit risks.… Another far-reaching innovation is the technology of securitization—a form of derivative—which has encouraged unbundling of the production processes for many credit services.… These and other developments facilitating the unbundling of financial products have surely improved the efficiency of our financial markets.[46]

As the financial sector became a bigger part of the U.S. economy, the celebration of financial innovation only increased. In 2006, even as he warned about potential risk management challenges generated by derivatives, Tim Geithner (then New York Fed president) said of the current wave of financial innovation,

> These developments provide substantial benefits to the financial system. Financial institutions are able to measure and

> manage risk much more effectively. Risks are spread more widely, across a more diverse group of financial intermediaries, within and across countries.
>
> These changes have contributed to a substantial improvement in the financial strength of the core financial intermediaries and in the overall flexibility and resilience of the financial system in the United States. And these improvements in the stability of the system and efficiency of the process of financial intermediation have probably contributed to the acceleration in productivity growth in the United States and in the increased stability in growth outcomes experienced over the past two decades.[47]

Even in April 2009, after the financial crisis, Greenspan's successor, Ben Bernanke, said, "Financial innovation has improved access to credit, reduced costs, and increased choice. We should not attempt to impose restrictions on credit providers so onerous that they prevent the development of new products and services in the future."[48] The fact that Bernanke, a brilliant and widely respected academic, would sing the praises of financial innovation even after the financial crisis shows the powerful hold this ideology exerted on both economists and policymakers.

Merton and Greenspan's argument about "risk sharing" and "unbundling" added intellectual heft to the ideology of innovation. According to this story, derivatives and securitization have the beneficial effect of spreading risk out among more market participants and allocating specific risks to the people who most want to hold them. Credit default swaps, for example, allow banks to divide up interest rate risk and default risk between different investors. Since all parties are negotiating freely in an open market, these transactions should be good for everyone—and they can be, if those parties know what they are doing. The rebranding of complexity as innovation, however, provided a blanket justification to any new financial products, paving the way not only for the inverse floaters sold to Orange County but for similar products sold to individual investors. Reverse convertibles, for example, are structured notes where the investor gets either a fixed interest rate *or* a share of stock, depending not only on the final stock price but on the path it takes getting there; because of their complexity, few investors are able to value them accurately, making them prey to unscrupulous brokers and banks.[49] ("I was told there was no risk with these," said one retiree who lost over $90,000 on reverse convertibles.)[50]

The ideology of innovation had its skeptics. Warren Buffett famously labeled derivatives "financial weapons of mass destruction" in the Berkshire Hathaway 2002 annual report.[51] In his 2001 book *Fooled by Randomness,* Nassim Taleb argued that modern financial technology underestimated the likelihood of extreme events, with potentially catastrophic implications.[52] Janet Tavakoli's 2003 book, *Collateralized Debt Obligations and Structured Finance,* discussed the potential problems involved in securitization, including the risk of fraud.[53] And decades before, Hyman Minsky had pointed out the role of innovation in enabling financiers to increase their profits at the risk of destabilizing the economy.[54] They could all be ignored as long as market conditions remained benign. But the Merton-Greenspan "risk unbundling" story was proven horribly wrong by the financial crisis that began in 2007—caused in part by innovative products that made it possible for financial institutions and investors to take on massive amounts of risk hidden inside AAA-rated securities that later plummeted in value. Eventually even Greenspan was forced to admit his mistake in a congressional hearing.[55]

The recent orgy of financial innovation turned out so badly because financial innovation is *not* like technological innovation. There are financial innovations that do benefit society, such as the debit card. And derivatives, as discussed earlier, can be useful tools to help companies hedge their operational risks. But there is no law of physics or economics that dictates that *all* financial innovations are beneficial, simply because someone can be convinced to buy them. The core function of finance is financial intermediation—moving money from a place where it is not currently needed to a place where it is needed. The key questions for any financial innovation are whether it increases financial intermediation and whether that is a good thing.

Much recent "innovation" in credit cards, for example, has simply made the *pricing* of credit more complex. Card issuers have lowered the "headline" price that they advertise to consumers while increasing the hidden prices that consumers are less aware of, such as late fees and penalty rates. These tactics have increased the profits of credit card issuers, but have not increased financial intermediation—except insofar as they helped consumers underestimate the cost of credit and therefore borrow excessive amounts of money.[56]

Innovation that increases the availability of credit can also be harmful. The stated-income mortgage, where loan originators explicitly did not verify borrowers' incomes, made it easier for some people to borrow more money to buy houses, but also served as an invitation to fraud (by both borrowers and mortgage brokers) and left many borrowers unable to repay their mortgages. Investments can be economically value-creating or value-destroying; when financial intermediation increases to the point where value-destroying investments are being funded, financial innovation is doing more harm than good.

But in the 1990s and 2000s, the theory of risk unbundling and diversification reigned largely unchallenged in Washington; people who didn't subscribe to it could be written off as ignoramuses who failed to understand the elegance of modern finance. Merton and his colleague Myron Scholes, after all, won the Nobel Prize in economics in 1997 (a year before the collapse of their hedge fund). It also helped that financial services were one arena where U.S. firms were in the international vanguard, inventing most of the new products and markets of the past few decades. With the trade deficit in manufactured goods widening

continuously, structured securities were one of our most attractive exports, especially to European banks and investors looking for higher-yield investments. After the Internet bust, Wall Street became our most prestigious economic center, and keeping it that way became an end in itself. As Senator Schumer said in 2007 of existing financial regulations, "We are not going to rest until we change the rules, change the laws and make sure New York remains No. 1 for decades on into the future."[57]

The New American Dream was to make tens of millions on Wall Street or as a hedge fund manager in Greenwich, Connecticut. But it was also connected to the Old American Dream—to own a house of one's own. In the last thirty years, the Wall Street ideology borrowed heavily from the older, more deep-rooted American ideology of homeownership, which became widely accepted after World War II as government programs and economic prosperity made possible a homeowning middle class. Wall Street co-opted this ideology to justify the central place of modern finance in the economic and political system, especially as the homeownership rate climbed from 64 percent, where it sat from 1983 to 1994, to a high of 69 percent in the 2000s.[58]

The ideology of homeownership has its roots in two sources. The first is the idea that homeownership is intrinsically good—it encourages individual responsibility, provides financial security, promotes community attachment, encourages people to take care of property, and so on. This ethos may have something to do with the important place of independence and self-reliance in the constellation of American values. Or it may be the product of various government policies designed to encourage homeownership. There may also be an element of truth to this idea; homeownership is generally thought to create positive externalities, since homeowners are on average more likely to devote effort to improving their communities. After reviewing other empirical studies and doing their own analyses, Edward Glaeser and Jesse Shapiro conclude:

> [T]here is a limited body of evidence suggesting that homeownership creates positive spillovers for near neighbors. Homeowners do appear to be more active citizens. They vote more. They take better care of their homes. Houses that are surrounded by homeowners are worth a little more than houses that are surrounded by renters.[59]

However, much of the positive effect of homeownership is due not to ownership itself, but to other factors that differentiate owners and renters. In another paper, Glaeser and Denise DiPasquale found that "almost one-half of the effect of homeownership disappeared when we controlled for the time that the person had lived in the home."[60] William Rohe and Michael Stegman compared a sample of low-income homebuyers with similar low-income renters over time and found that the homebuyers were less likely to engage in informal neighboring, more likely to participate in block associations, and no more likely to participate in other types of community associations.[61] Alyssa Katz concludes, in *Our Lot,* "scholars found that once they set aside the various traits that tend to determine whether someone chooses to own or rent one's home, homeowners and tenants really aren't that different."[62]

The second source of the ideology of homeownership is the idea that owning a home is the best possible investment for a household. Although widely believed, this idea is questionable at best: absent government incentives, betting several times your entire net worth not only on a single type of asset, but on a single building and plot of land, is almost the worst investment you could make after accounting for risk. Many families have made money from housing price appreciation (particularly if they took out mortgages before the inflation of the 1970s), but their high returns are primarily due to the high leverage built into a typical mortgage—leverage that produces massive defaults and foreclosures in a housing downturn such as the one that began in 2006. The things that make housing attractive as an investment are favorable government policies, such as the mortgage interest tax deduction, in which the government subsidizes mortgages for homeowners.*

In any case, homeownership ranks alongside motherhood and apple pie in the firmament of American values, and helping more people buy houses is almost always seen as a good thing. Lewis Ranieri capitalized on this ideology when he created the market for private mortgage-backed securities beginning in the late 1970s. Mortgage-backed securities would enable lenders to replenish their coffers by tapping the entire world of securities investors, expanding the amount of credit available to homeowners and thereby allowing more people to buy houses at lower interest rates. At a congressional hearing, Katz recounts. "Ranieri promised that putting private bankers and their sales forces in charge of mortgage securities would save borrowers half a percent on every loan."[63] Congress agreed; in a 1983 report, the Senate Banking, Housing, and Urban Affairs Committee warned that without expanding the market for private mortgage-backed securities, "mortgages would cost more and be more costly to obtain."[64] Ranieri hitched the mortgage-backed securities market to the cause of expanding homeownership, ensuring its political success.

In the 1990s and 2000s, another financial innovation appeared on the scene with the potential to extend the dream of homeownership to millions more households: subprime mortgage lending. (Subprime lending had been around for decades, but only recently became a major source of money to buy houses, as opposed to refinancing them.)[65] During the housing boom, lenders scrambled to offer mortgages to people who would never have qualified for them before the boom. These were high-cost loans to people with no verified ability to pay them off, which made sense only assuming that continually rising housing

prices would leave the lenders with valuable collateral in case of default. These practices looked a lot like predatory lending. But the mortgage lenders and the investment banks that bought and securitized their mortgages justified such activity on the grounds that it promoted homeownership. "Our innovative industry has created a great way to expand homeownership by offering loans to those who can make payments, but who don't qualify for 'A' paper because of poor credit or bankruptcy," said Ron McCord, former president of the Mortgage Bankers Association, in 1997.[66]

And the story stuck. Not only did the federal government make no attempt to regulate subprime lending, but it even became a cheerleader for the subprime boom. The Clinton administration had made an expansion of homeownership a central part of its economic strategy; in 1995, Clinton set a goal of a 67.5 percent homeownership rate[67] at a time when the actual rate was 65 percent (it would peak the next decade at 69 percent).[68] In order to help meet this goal, the Department of Housing and Urban Development mandated that Fannie Mae and Freddie Mac—the giant government-sponsored enterprises that provided funding for the mortgage market—had to devote 42 percent of their money to loans to low- and moderate-income households. That target was increased to 50 percent in 2000 and then to 56 percent in 2004.[69]

Growing real household incomes helped a bit in the mid-1990s. But beginning in 1997, the growth of housing prices outstripped income growth; after 1999, real median household income *fell* for five consecutive years as housing prices soared.[70] Under these circumstances, as George W. Bush not only continued his predecessor's support for increased homeownership but even made the "ownership society" a centerpiece of his political message, the only thing that could keep the homeownership boom going was expanded availability of credit.

Alan Greenspan became an eloquent spokesman for the synergy between financial innovation and homeownership. In a 2005 speech discussing the impact of new financial technology, he said,

> Improved access to credit for consumers, and especially these more-recent developments, has had significant benefits. Unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes. Access to credit has enabled families to purchase homes, deal with emergencies, and obtain goods and services. Home ownership is at a record high.[71]

The only caveat that Greenspan gave was that the increase in credit availability made it more important to ensure widespread financial education.

For anyone who had doubts about the value of financial innovation and the importance of Wall Street, the ideology of homeownership provided easy assurance. The idea that complex securities could help low- and middle-income families own homes was especially attractive to Democratic congressmen and officials who might ordinarily be distrustful of mortgage lenders and investment bankers, and helped seal off Wall Street's new money machine from criticism.

The economic and political elites could agree that innovation was good, and that homeownership was good. But the ideology of finance went beyond the idea that Wall Street was good for America. Banking was not only the center of the U.S. economy—it became cool, seductive, and even sexy.

In 1987, Tom Wolfe's novel *The Bonfire of the Vanities* introduced the term "Master of the Universe" to American culture, in the form of multimillionaire investment banker Sherman McCoy, who lived in "the sort of apartment the mere thought of which ignites flames of greed and covetousness under people all over New York and, for that matter, all over the world."[72] Although the term was used sarcastically, and McCoy turns out badly in both the human and financial senses, the image of the swashbuckling, super-rich banker engaged in transactions too complex to be understood by ordinary mortals was born.

Also in 1987, Oliver Stone's movie *Wall Street* was released, with its memorable antihero, corporate raider Gordon Gekko (played by Michael Douglas). Although the movie's story shows the corruption and ultimate downfall of Gekko, it is remembered for his "Greed is good" speech, which justified the pursuit of money above all else. As screenwriter Stanley Weiser wrote recently, many people would later tell him the movie made them *want* to work on Wall Street: "A typical example would be a business executive or a younger studio development person spouting something that goes like this: 'The movie changed my life. Once I saw it I knew that I wanted to get into such and such business. I wanted to be like Gordon Gekko.' "[73]

Liar's Poker, Michael Lewis's 1989 memoir, an ironic antibildungsroman in which the hero is fascinated but ultimately repelled by life at Salomon Brothers, popularized life on Wall Street for a generation of college students. As Lewis wrote much later,

> I hoped that some bright kid at, say, Ohio State University who really wanted to be an oceanographer would read my book, spurn the offer from Morgan Stanley, and set out to sea.
>
> Somehow that message failed to come across. Six months after *Liar's Poker* was published, I was knee-deep in letters from students at Ohio State who wanted to know if I had any other secrets to share about Wall Street. They'd read my

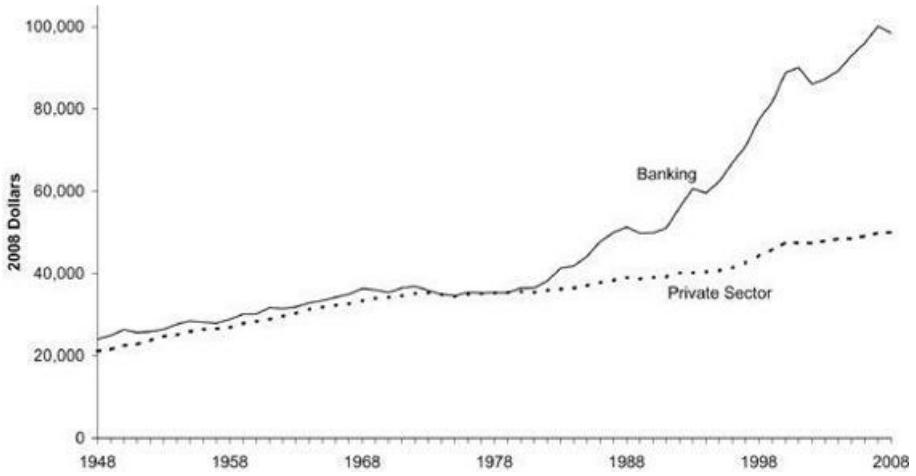
book as a how-to manual.[74]

Clearly, being a bond trader on Wall Street was different from being a loan officer in the era of 3–6–3 banking. The risk, the testosterone, and the sums of money at stake were all deeply seductive to overachievers from top schools. They *wanted* to order guacamole in five-gallon drums, swear constantly, and place million-dollar bets while eating cheeseburgers.

After *Liar's Poker,* the financial sector only became more and more exciting in popular culture. From Salomon, the torch of innovation passed to Drexel Burnham Lambert and Michael Milken, who were starring characters in James Stewart's 1992 bestseller, *Den of Thieves;* the takeover binge they made possible was memorialized by Bryan Burrough and John Helyar in *Barbarians at the Gate,* their 1990 account of the leveraged buyout of RJR Nabisco. After Drexel collapsed, the cutting edge of finance shifted to derivatives desks. In his 1997 memoir, *F.I.A.S.C.O.,* former derivatives trader (and current law school professor) Frank Partnoy chronicled the derivatives culture, where people would describe a trade where they made money at the expense of a client as "ripping his face off." (The comparatively genteel phrase in *Liar's Poker* was "blowing up a customer.") But if Partnoy expected his book to slow the growth of the derivatives industry, he was no doubt disappointed. By this point, the bankers were the heroes of the story, not the villains.

No amount of cautionary tales could change the fact that Wall Street was becoming a deeply seductive place, in a way that traditional banking never was. There were the concrete-steel-and-glass towers crammed full of modern technology. There was the mathematical complexity of modern trading, a game seemingly reserved for the very smart. There was the feeling of being at the center of the financial world, whether raising billions of dollars for multinational corporations or making massive trades that moved the market prices flashing on the Bloomberg screen. There was the lifestyle—eating sushi at Nobu, riding everywhere in a Lincoln Town Car, talking on cell phones (before everyone had one), checking e-mail on BlackBerrys (before everyone had one), and globetrotting in first class (still not available to everyone). To open *Sex and the City,* the 1996 book that launched the eponymous TV show, Candace Bushnell chose an investment banker: "Tim was forty-two, an investment banker who made about $5 million a year."[75]

Figure 4-1: Real Average Annual Compensation, Banking vs. Private Sector Overall

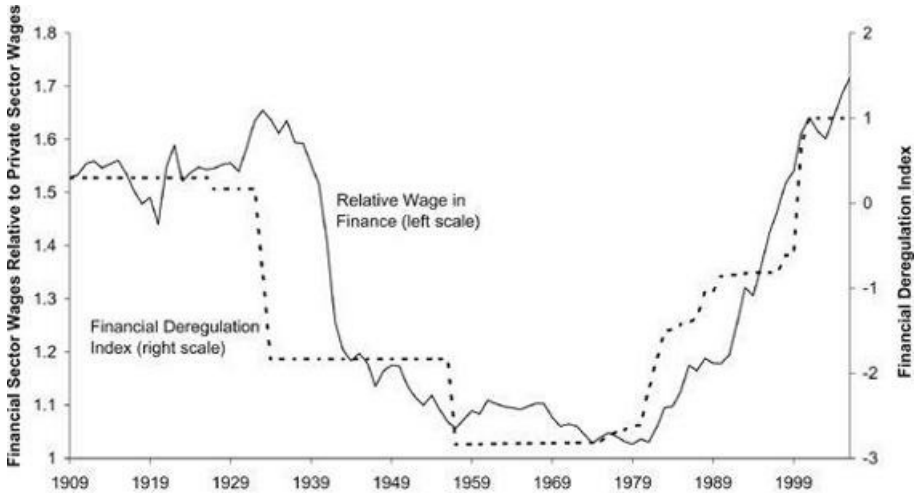


Source: Bureau of Economic Analysis, *National Income and Product Accounts*, Tables 1.1.4, 6.3, 6.5; calculation by the authors. Banking includes financial sector less insurance, real estate, and holding companies. Annual compensation is total wage and salary accruals divided by full-time equivalent employees.

And, of course, there was the money. The vast amounts of money flowing through Wall Street and the extreme free market ethos of the industry resulted in ever-larger amounts of money spinning off into the bank accounts of top traders, salesmen, and bankers. From 1948 until 1979, average compensation in the banking sector was essentially the same as in the private sector overall; then it shot upward, as shown in Figure 4-1, until in 2007 the average bank employee earned twice as much as the average private sector worker.[76] Even after taking high levels of education into account, finance still paid more than other professions. Thomas Philippon and Ariell Reshef have analyzed financial sector compensation and found that the "excess relative wage" in finance—the amount that cannot be explained by differences in education level and job security—grew from zero around 1980 to over 40 percentage points earlier this decade; 30–50 percent of excess wages in finance cannot be explained by differences in individual ability. They also found that deregulation was one factor behind the recent growth of compensation in finance. (Figure 4-2 shows the relationship between the unadjusted relative wage in the financial sector—the ratio between average wages in finance and average wages in the private sector as a whole—and the extent of financial

deregulation, as calculated by Philippon and Reshef.)[77]

Figure 4-2: Relative Financial Wages and Financial Deregulation



Source: Thomas Philippon and Ariell Reshef, "Wages and Human Capital in the U.S. Financial Industry: 1909–2006," Figure 6.

The rewards for success grew much, much faster as traders' potential bonuses climbed into the millions and then the tens of millions. In 2008—which was a horribly bad year for most banks—1,626 JPMorgan Chase employees received bonuses of more than $1 million; at the smaller Goldman Sachs, which had thirty thousand employees, 953 received bonuses of more than $1 million, and 212 received bonuses of more than $3 million.[78] In the 1990s, Internet start-ups were seen as the quickest route to vast wealth, for the lucky few who founded companies that successfully went public. By the 2000s, it was investment banks and hedge funds, where smart college graduates could *expect* to make millions.

Wall Street began to skim off the cream of America's top schools— not only graduates of business schools and Ph.D. programs in math and science, but twenty-two-year-old college students with no background or expertise in anything at all. As investment banks began descending onto Ivy League campuses and tempting students with stories of client "impact," dinners at expensive restaurants, and glimpses of much greater wealth, seniors who had never even wondered what a bond was suddenly wanted to be investment bankers. Sealing the deal was the fact that Wall Street was perceived as the ultimate door-opener, a respectable way to make money and then, like Robert Rubin, go into public service. The point of the "Greed is good" speech was that by pursuing profits (both for your company and for yourself) you were contributing to the greater good. For college seniors, it was easy to think that maximizing their personal earnings coincided with maximizing societal good—making it easy to justify joining the ranks of the bankers on Wall Street.

As a result, banking and finance became more and more popular among the young and the privileged. Claudia Goldin and Lawrence Katz have examined data on Harvard undergraduates and found that while only 5 percent of men in classes around 1970 were in finance fifteen years after graduation, that figure tripled to 15 percent for classes around 1990.[79] The share of each class entering banking and finance careers grew from under 4 percent in the 1960s to 23 percent in recent years.[80] At Princeton's School of Engineering and Applied Science, "Operations Research and Financial Engineering" became the most popular undergraduate major.[81] The banks thus became major beneficiaries of the American educational system. Whether society benefited is another question. Kevin Murphy, Andrei Shleifer, and Robert Vishny have argued that society benefits more when talented people become entrepreneurs who start companies and create real innovations than when they go into rent-seeking activities that redistribute rather than increase wealth.[82] If this is true, then this diversion of talent to Wall Street constituted a real tax on economic growth over the last two decades.

Among the economic and intellectual elites, finance became a highly prestigious and desirable profession. Working on Wall Street became a widely acknowledged marker for educational pedigree, intelligence, ambition, and wealth. Outsiders may not have understood exactly what happened on a trading floor or in a hedge fund, but they knew that it was important, it was fast-moving, it was intellectually complicated, it had something to do with greasing the wheels of the global economy, and it had something to do with making it easier for ordinary people to buy houses. They also knew that it was very well paid. In America, where we like to believe that wealth is a function of hard work and contribution to society, that was all good.

THE WALL STREET–TREASURY COMPLEX

This combination of money, people, and prestige created what Jagdish Bhagwati identified in 1998 as the "Wall Street–Treasury complex."[83] Bhagwati described how the ideology of free markets "lulled many economists and policymakers into complacency about the pitfalls that certain markets inherently pose," while the revolving door placed representatives of Wall Street into influential positions in Washington. "This powerful network," he wrote, "is unable to look much beyond the interest of Wall Street, which it equates with the good of the world." Bhagwati was writing in the context of global financial liberalization, which the United States was then pushing on developing countries (both directly and through its influence at the IMF), and which had contributed to the emerging market crises of the past year.

By the time of Bhagwati's article, the power of Wall Street reached deep into Washington. The major banks, including both traditional investment banks and commercial banks that expanded into securities and derivatives, had spent the last two decades opening and exploiting vast new mines filled with money. They had funneled millions of dollars of that money to key congressmen who could make or break legislation affecting the financial sector. The treasury secretary was a former chairman of Goldman Sachs, the assistant secretary for financial markets was a former Goldman partner, and the Federal Reserve chairman was an ardent fan of Wall Street. The Clinton administration, which had tied its fortunes to keeping Wall Street bond traders happy, was deep into a multiyear campaign to boost homeownership rates and was depending on the financial sector to make it possible.

Behind these Washington power brokers was a new conventional wisdom about the importance and value of Wall Street. The previous Nobel Prize in economics had been given to two economists who had helped launch the derivatives revolution and were now partners at the hottest hedge fund in the world. The dogma of financial innovation had few doubters in Washington. Vibrant, profitable banks were assuming the status of national champions in a country that saw the transition from manufacturing to knowledge-intensive services as its destiny. And Wall Street was the most prestigious destination for graduates of America's top universities. For all intents and purposes, Wall Street had taken over.

* A put option gives its holder the right to sell an asset, such as a share of stock, at a predetermined price. If the stock falls sharply in value, the put option allows the holder to sell it at a higher-than-market price, and is therefore a form of protection against risk. The "Greenspan put" was thought to be the equivalent of a put option for everyone in the market.

* Owning a house has other advantages, such as increased freedom in deciding what to do with the house and land and increased peace of mind. However, these advantages have nothing to do with the value of the house as an investment.

5
THE BEST DEAL EVER

> These amendments are intended to reduce regulatory costs for broker-dealers by allowing very highly capitalized firms that have developed robust internal risk management practices to use those risk management practices, such as mathematical risk measurement models, for regulatory purposes.
>
> —Securities and Exchange Commission, "Final Rule: Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities," Effective August 20, 2004[1]

By the mid-1990s, Wall Street was a dominant force in Washington. It had survived the implosion of the savings and loan industry in the late 1980s, the election of a Democratic president in 1992, a congressional investigation of predatory subprime lending in 1993, and a wave of scandals caused by toxic derivatives deals in 1994 without facing any significant new constraints on its ability to make money.

The U.S. financial elite did not owe its rise to bribes and kickbacks or blood ties to important politicians—the usual sources of power in emerging markets plagued by "crony capitalism." But just as in many emerging markets, it constituted an oligarchy—a group that gained political power because of its economic power. With Washington firmly in its camp, the new financial oligarchy did what oligarchies do—it cashed in its political power for higher and higher profits. Instead of cashing in via preferred access to government funding or contracts, however, the major banks engineered a regulatory climate that allowed them to embark on an orgy of product innovation and risk-taking that would create the largest bubble in modern economic history and generate record-shattering profits for Wall Street.

When the entire system came crashing down in 2007 and 2008, governments around the world were forced to come to its rescue, because their economic fortunes were held hostage by the financial system. The title of Louis Brandeis's 1914 book, *Other People's Money,* referred to ordinary people's bank deposits, which could be used by investment bankers—"Our Financial Oligarchy"—to control industries and generate profits. In 2008, however, the banks found another way to tap other people's money: the taxpayer-funded bailout.

THE GOLDEN GOOSE

The boom in real estate and finance in the 2000s resulted from the explosive combination of a handful of financial "innovations" that were invented or greatly expanded in the 1990s: structured finance, credit default swaps, and subprime lending. Most financial regulators looked on the creation of this new money machine with benevolent indifference. Structured financial products were sold largely to "sophisticated" investors such as hedge funds and university endowments and therefore subject to limited oversight by the Securities and Exchange Commission; credit default swaps were insulated by regulatory inattention and then by the Commodity Futures Modernization Act; subprime lending was winked at by the Federal Reserve. That was how the financial sector wanted it, and Washington was happy to oblige.

Traditionally, investors invested in financial assets that had some direct tie to the real economy: stocks, corporate or government bonds, currencies, gold, and so on. By contrast, banks engineer structured products to have any set of properties (maturity, yield, risk, and so forth) that they want.[2] Structured products include pure derivatives, discussed in chapter 3, which are side bets on other financial assets. For example, an investor can pay $100 to a bank and get back, one year later, an amount that is calculated based on the performance of several currencies and interest rates. They can also be built by buying actual financial assets (mortgages, student loans, credit card receivables, and so on), combining them, and taking them apart in various ways to create new "asset-backed" securities. Or they can combine real assets with derivatives in increasingly complicated mixes.

Structured finance, in principle, serves two main purposes. First, it creates new assets that people can invest in. Instead of being limited to publicly traded stocks and bonds, investors can choose from a much broader menu of assets, each with unique characteristics to attract a particular investor; for example, securities can be manufactured to help investors match the timing of their assets and their liabilities.* Second, by creating assets that are more attractive to investors, structured finance should make it easier for businesses to raise money. While investors might demand a high rate of interest to invest in an airline route from Los Angeles to Shanghai, they might accept a lower rate if that route were packaged with an option to buy oil at a cheap price in the future. (If oil prices rise, hurting demand for long-distance flights, the option will increase in value.) Lower rates make it easier for businesses to raise money.

In theory, then, structured finance could increase the pie for everyone. More important, in practice it was sure to increase revenues for the banks arranging these complex transactions. The ordinary trajectory for most products and services in the business world is for profit margins to decline as competition increases. For example, the amount that a bank could make from a plain-vanilla loan to a highly rated company was minimal, because many other banks would be willing to make that loan. Like all businesses, banks needed to invent new products that were not yet commoditized and that could command high margins. Structured products were the perfect answer. They were complex products that bank customers could not arrange on their own. Moreover, because selling these products required the ability to hedge risks in multiple markets, it was difficult for new banks to break into the business, which became dominated by a small number of players who could charge hefty fees for their services. In his memoir, former trader Frank Partnoy described how Morgan Stanley earned $75 million on a single trade.[3]

In addition to pure derivatives such as interest rate swaps, currency swaps, and credit default swaps, asset-backed structured products were a mainstay of Wall Street derivatives desks in the early 1990s. The Repackaged Asset Vehicles that played a starring role for Morgan Stanley were structured products, in which a special-purpose vehicle (SPV, a new company that exists only on paper) bought a set of existing securities (say, bonds issued by the state electric utility of the Philippines) and paid for them by selling investors a new set of custom-designed securities.[4]

Asset-backed structured products became Wall Street's new cash cows, in the form of mortgage-backed securities (MBS) and their cousins, collateralized debt obligations (CDOs). The original mortgagebacked securities created by Ginnie Mae in the late 1960s were "pass-through" securities: mortgages were combined in a pool, and each security had an equal claim on the mortgage payments from that pool, spreading the risk evenly. Private MBS, however, are typically divided into different tranches, or classes, that have different levels of risk and pay different interest rates. Because the "senior" tranches have the first claim on all the mortgage payments, they have the least risk, and the credit rating agencies routinely stamped them with their AAA rating—the same rating given to U.S. government bonds. The "junior" tranches are riskier, but therefore pay higher interest rates to investors.*

A CDO is similar, except that instead of being built out of whole mortgages it is built out of mortgage-backed securities or securities backed by other assets (such as credit card loans, auto loans, or student loans).† By building CDOs out of junior, high-yielding MBS tranches, banks were able to engineer new securities that offered high returns with relatively little risk—at least according to their models. It was possible to combine low-rated MBS tranches, mix them together, and create a new CDO, 60 percent or even 80 percent of which was rated AAA; even though the MBS (the inputs) had low ratings, it was

unlikely that many of them would default at the same time—at least according to the models. Financial engineers even created CDO-squareds—CDOs whose raw material was other CDOs—and higher-order variants, in order to squeeze out higher yield at lower supposed risk.[5]

In the late 1990s, Wall Street became addicted to mortgage-backed securities and CDOs. As housing prices took off, it became easy to build models showing that MBS and CDOs had virtually no risk, because borrowers could always refinance their mortgages as long as prices were rising; even if they defaulted, rising prices meant that the investors would own valuable collateral. But because borrowers—especially subprime borrowers—were individually risky and paid interest rates to match, it was possible to manufacture AAA-rated securities that paid higher interest rates than other low-risk assets, such as U.S. Treasury bonds. Comforted by their AAA ratings, investors bought those CDOs without worrying about what was inside them. Most important, U.S. homeowners and homebuyers represented an enormous pool of potential borrowers that could be tapped over and over again as home prices rose and as they bought bigger houses or refinanced to turn their home equity into cash for home improvements or flat-screen televisions. Those mortgages and home equity loans were the raw material that Wall Street transformed into gleaming new CDOs for investors, taking a flat fee with each turn of the assembly line.

In comparison with MBS and CDOs, credit default swaps (insurance against default), introduced in chapter 3, are a relatively simple product, but they played a special role in the finance boom. Because the boom was based on creating, packaging, and selling debt, it depended on the assumption that borrowers would pay off their debts—or that someone else would pay in their place. Credit default swaps made it possible to insure *any* pool of mortgage loans or mortgage-backed securities, seemingly eliminating the risk of default.

In 1997, J.P. Morgan (part of today's JPMorgan Chase) pioneered the use of credit default swaps to shift the default risk of loans off of its balance sheet. In the "BISTRO" transaction, J.P. Morgan's derivatives team created a new special-purpose vehicle to insure loans the bank had made. J.P. Morgan paid insurance premiums to the SPV, and the premiums backed new bonds issued by the SPV to investors.[6] This complex piece of engineering had two benefits for the bank. First, because the risk of default on the underlying loans had been transferred from the bank to the SPV, the bank did not have to maintain capital reserves for those loans, so it could make more loans and hence more lending profits.

The other implication was more far-reaching. In effect, J.P. Morgan had created a new CDO out of thin air, without any of the raw material—loans or asset-backed securities—usually required. BISTRO was the first of what came to be known as "synthetic CDOs." If the borrowers paid off their loans, the SPV would receive a steady stream of insurance premiums from J.P. Morgan to pay off its investors; but if the borrowers defaulted, the SPV would have to make a large cash insurance payout to J.P. Morgan, and its investors would lose their money. From an economic standpoint, it was as if the SPV actually held the underlying loans. This meant that a bank could create a CDO based on the housing market without having to buy a pool of mortgages or mortgage-backed securities; instead, it only needed to find someone who would buy insurance (using credit default swaps) on securities that already existed in the market. No one, in other words, had to go to the trouble of lending new money.

In the 2000s, as demand from investors and Wall Street banks for subprime loans outstripped supply, credit default swaps were used to fill the gap. As hedge fund manager Steve Eisman said, "They weren't satisfied getting lots of unqualified borrowers to borrow money to buy a house they couldn't afford. They were creating them out of whole cloth."[7] This practice ultimately magnified the impact of mortgage defaults; as borrowers stopped paying, their defaults hurt not only the CDOs that held bits and pieces of their mortgages, but also the synthetic CDOs that mirrored them.

Credit default swaps also made possible another Wall Street business model. With a stable economy and rising housing prices, the default risk of the senior tranches of mortgage-backed securities and CDOs (the ones that got paid off first) seemed vanishingly small. Selling credit default swaps on these securities looked an awful lot like free money, and hedge funds stepped forward to take it. Notably, American International Group (AIG), the world's largest insurance company, had a Financial Products group that was willing to insure AAA-rated structured securities for almost nothing. In the late 1990s, AIG agreed to insure the "super-senior" portion of J.P. Morgan's CDOs—the part that was even safer than the AAA-rated bonds issued by the SPV[8]—for only two basis points (hundredths of a percentage point) per year. In other words, in return for insuring $100 million of loans against default, AIG would get $20,000 per year.[9] According to AIG's models, it was free money. From J.P. Morgan's perspective, because AIG was considered one of the world's safest companies—it had a AAA rating of its own at the time—it was fully insured, for a cheap price. Everyone was happy. Of course, risk never disappears, and in this case it would reappear with a vengeance in September 2008.

The third ingredient of this money machine was a wave of innovation in mortgages, often described as (but not confined to) subprime lending. Traditionally, since the 1930s, home mortgages had been relatively conventional products and mortgage lending a relatively staid business. Most mortgages were long-term, fixed-rate, "prime" mortgages, where the borrower met the

lender's standards for creditworthiness, capacity (income) to repay debt, and collateral (real property sufficient to protect the lender in case of default).[10] Subprime loans, where the borrower did not meet one of these criteria,* were relatively rare. In 1993, there were only 24,000 subprime mortgages used to purchase homes and 80,000 subprime refinance mortgages. By contrast, there were 2.2 million prime home purchase mortgages and 5.2 million prime refinance mortgages; in aggregate, there were seventy prime mortgages for every subprime mortgage.[12]

The 1990s and 2000s, however, saw an explosion in all types of mortgage lending, although most attention has focused on subprime lending (and "Alt-A," a new designation for higher-end subprime loans), in which lenders lowered their standards for creditworthiness, capacity, or collateral, or all three at the same time. Before the market for private mortgage-backed securities took off in the 1990s, subprime lending was constrained by the fact that subprime lenders wanted to be paid back. Subprime loans had to conform to underwriting standards, like all loans, and were used primarily to refinance prime mortgages for borrowers who had poor credit histories but otherwise had the capacity to repay the debt. In addition, subprime loans were generally made by nonbank mortgage lenders who could not raise funds by taking deposits from customers. With the advent of securitization, however, investors and the investment banks that served them became particularly hungry for subprime loans because of the higher interest rates they paid, which were crucial to manufacturing high-yielding CDOs.

Now that loans could be resold to Wall Street, mortgage lending became a fee-driven business, where volume was the key to profits. Lenders responded by inventing new mortgage products that made it easier for borrowers to afford their monthly payments, at least for the first few years. These products went beyond the standard adjustable rate mortgage to extreme forms such as "pay option" mortgages where borrowers could choose to pay *less* than the monthly interest on the loan, causing the principal balance to go up instead of down. Lenders relaxed traditional underwriting practices, such as verifying the income and assets of the borrower; in stated-income mortgages, the lender explicitly *did not* confirm that the borrower had the income he or she claimed, and told the borrower as much. They accepted smaller down payments, resulting in higher loan-to-value (LTV) ratios, or used second mortgages to eliminate the down payment entirely; this meant that the collateral would not be sufficient to protect the lender from default unless housing prices rose.[13]

Many of these innovations applied equally to prime and subprime loans, and business in both categories boomed. In 2005, 1.0 million subprime loans were used to buy houses and 1.2 million were used for refinancing—in aggregate, a twenty-fold increase over 1993.[14] The result—whether due to mortgage brokers who pushed borrowers into inappropriate loans, or due to house "flippers" who took on as much leverage as possible to buy as many houses as possible while the market was hot—was mortgages that many borrowers would have little chance of actually paying off out of their income.

But that no longer mattered—at least not to the lenders or the investment banks—because the lending business model detached itself from the requirement that borrowers pay back their loans. Lenders made fees for originating loans; the higher the interest rate, the higher the fees. Then, when interest rates reset and borrowers became unable to make their monthly payments, lenders could earn more fees by refinancing them into new, even-higher-rate mortgages. As long as housing prices continued to rise, a single borrower could be good for multiple loans, each time increasing his debt. (This business model had been pioneered by credit card issuers, who discovered that they could make money off of borrowers even if they never fully paid off their card balances.)[15] If he finally became unable to refinance, any loss would typically be taken by a CDO investor, not by the mortgage lender, and would be confined to the junior CDO tranches. As late as 2007, according to the International Monetary Fund, "Stress tests conducted by investment banks show that, even under scenarios of nationwide house price declines that are historically unprecedented, most investors with exposure to subprime mortgages through securitized structures will not face losses." (The stress test cited by the IMF was conducted by Lehman Brothers.)[16]

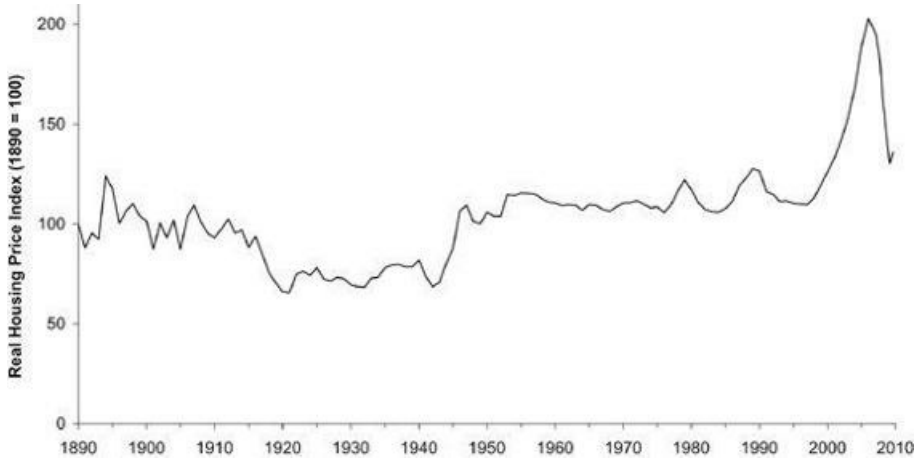
As the business boomed, the large banks dived in, snapping up subprime lenders. Among the top twenty-five subprime lenders, First Franklin was bought by National City and later by Merrill Lynch; Long Beach Mortgage was bought by Washington Mutual; Household Finance was bought by HSBC; BNC Mortgage was bought by Lehman Brothers; Advanta was bought by JPMorgan Chase; Associates First Capital was bought by Citigroup; Encore Credit was bought by Bear Stearns; and American General Finance was bought by AIG.[17] Not only did buyers want the lucrative fees available from originating subprime loans, but many of them wanted a captive source of loans for their mortgage securitization machines. Large banks also expanded their subprime operations by working with independent mortgage lenders and brokers. According to the head of Quick Loan Funding, a subprime lender, Citigroup provided the money for loans to borrowers with credit scores below 450 (at the time, the national median was about 720).[18] JPMorgan Chase aggressively marketed its "no doc" and "stated-income" programs to mortgage brokers and used slogans such as "It's like money falling from the sky!"[19] If subprime lending was pioneered far from Wall Street, by the 2000s Wall Street couldn't get enough of it.

Housing was not the only bubble made possible by cheap money, aggressive risk-taking, and structured finance. The 2000s saw a parallel bubble in the commercial real estate market, where banks were willing to finance purchases at ever-increasing valuations, in part because they were able to use commercial mortgage-backed securities to unload the large, risky loans they were making. There was also an enormous boom in takeovers of companies by private equity firms, again made possible by cheap loans advanced by banks and then syndicated to groups of investors or used as raw material for new structured products.

These bubbles overlapped in takeovers of real estate investment trusts (REITs), companies that invest in real estate. In February 2007, the Blackstone Group bought Equity Office Properties Trust for $39 billion in the largest leveraged buyout ever; Blackstone immediately flipped most of Equity Office's buildings to other buyers (who borrowed as much as 90 percent of the purchase price), many of whom took significant losses as the real estate market crashed.[20] In October 2007, Tishman Speyer spent $22 billion to buy Archstone-Smith Trust, much of it financed by a group of banks led by Lehman Brothers; losses on that deal would be one factor that helped lead to the downfall of Lehman less than a year later.[21]

But the emblematic bubble of the decade, and the one whose implosion led directly to the financial crisis, was the housing bubble, in which prices soared to almost twice their long-term average (see Figure 5-1).[22] The increased availability of mortgage loans, with lower initial monthly payments, increased homebuyers' ability to pay, pushing prices upward. Continually rising housing prices seemed to eliminate the risk of default, since borrowers could always refinance when their mortgages became unaffordable, making mortgage-backed securities and CDOs more attractive to investors and to the investment banks that manufactured them. Higher prices also induced existing homeowners to take out home equity loans, providing more raw material for asset-backed securities and CDOs. Lower risk lowered the price of credit default swaps on mortgage-backed debt, making CDOs and synthetic CDOs easier to create. Increased Wall Street demand for mortgages (to feed the securitization pipeline) funneled cheap money to mortgage lenders, who sent their sales forces out onto the streets in search of more borrowers; by the early 2000s, many prime borrowers had already refinanced to take advantage of low rates, and so subprime lending became a larger and larger share of the market. And the cycle continued.

Figure 5-1: Real U.S. Housing Prices, 1890–2009



Source: Robert Shiller, Historical Housing Market Series. Used by permission of Mr. Shiller. Data were originally used in Robert Shiller, *Irrational Exuberance* (Princeton: Princeton University Press, 2000).

Ordinarily, the instinct for financial self-preservation should prevent lenders from making too many risky loans. The magic of securitization relieved lenders of this risk, however, leaving them free to originate as many new mortgages as they could. Because mortgages were divided up among a large array of investors, neither the mortgage lender nor the investment bank managing the securitization retained the risk of default. That risk was transferred to investors, many of whom lacked the information and the analytical skills necessary to understand what they were buying. And the investors assumed that they didn't need to worry about what they were buying, because it was blessed by the credit rating agencies' AAA rating.

Ironically, even though securitization theoretically allowed banks to pass on all the default risk to their clients, some kept some of the risk anyway. Either they really believed that the senior tranches of their CDOs were risk-free, or there was more demand for the riskier junior tranches and they couldn't find enough buyers for the senior tranches. Here again, they depended on financial innovation in the form of structured investment vehicles (SIVs)—special-purpose entities that raise money by issuing commercial paper and invest it in longer-term, higher-yielding assets. Citigroup, for example, used SIVs to buy over $80 billion in assets by July 2007.[23] These vehicles allowed banks to invest in their own structured securities without having to hold capital against them; since SIVs were technically not part of the bank in question—even though they were wholly owned by that bank, which might even have promised to bail them out if necessary[24]—their assets were not counted when determining capital requirements. The result was that SIVs enabled banks to take on more risks with the same amount of capital.

SIVs were a Wall Street variation on one form of crony capitalism. In an emerging market, when a major family-owned conglomerate sets up a new company, it can legally walk away should things go bad. Because the new company has the family name behind it, however, the family will come under pressure to prop it up in a crisis.[25] And just as in emerging markets, when things did go bad in 2007 and 2008, many banks, including Citigroup, bailed out their SIVs, incurring billions of dollars of losses in the process. But as long as housing prices were soaring, SIVs were another way to make more profits using less

capital. In addition, by soaking up the senior tranches of CDOs, they helped keep the securitization machine going at full volume.

Rising housing prices created their own momentum, as bubbles do. As people saw their friends and neighbors cashing in on the housing boom, they rushed to get in on the action. The environment became so filled with stories about people making money in housing that even skeptics decided that everyone else couldn't be wrong, creating what Robert Shiller has called a "rational bubble."[26] Even investors who knew the boom could not last were betting that they could buy high and sell higher before the music stopped.

On a factory farm, when hens start laying fewer eggs, they are "force-molted"—"starved of food and water and light for several days in order to stimulate a final bout of egg laying before their life's work is done."[27] After 2004, when many qualified borrowers had already refinanced and houses were so expensive they could only be bought with exotic mortgages, the real estate and finance industries launched an all-out effort to get people into new houses and squeeze out a few last years of golden eggs. In the peak years, the bubble was sustained by brand-new mortgage products that only existed because they provided raw material for CDOs. At the height of the boom, over half of the mortgages made by Lennar, a national housing developer, were interest-only mortgages or optional-payment mortgages whose principal went *up* each month; in 2006, almost one in three had a piggyback second mortgage.[28] Between 1998 and 2005, the number of subprime loans tripled, and the number that were securitized (as measured by First American LoanPerformance) increased by 600 percent.[29] In 2005, a consortium of Wall Street banks created standard contracts for credit derivatives based on subprime mortgages, making it even easier to create synthetic subprime CDOs.[30] These developments all confirmed the predictions of economist Hyman Minsky, who had warned that "speculative finance" would eventually turn into "Ponzi finance."[31]

The end result was a gigantic housing bubble propped up by a mountain of debt—debt that could not be repaid if housing prices started to fall, since many borrowers could not make their payments out of their ordinary income. Before the crisis hit, however, the mortgage lenders and Wall Street banks fed off a giant moneymaking machine in which mortgages were originated by mortgage brokers and passed along an assembly line through lenders, investment banks, and CDOs to investors, with each intermediate entity taking out fees along the way and no one thinking he bore any of the risk.[32]

GREENSPAN TRIUMPHANT

An emerging market oligarchy uses its political power and connections to make money through such means as buying national assets at below-market prices, getting cheap loans from state-controlled banks, or selling products to the government at inflated prices. In the United States, the banking oligarchy (and its allies in the real estate industry) used its political power to protect its golden goose from interference and to clear away any remaining obstacles to its growth. The banks' objectives included both the elimination or nonenforcement of existing regulations and the prevention of new regulations that might stifle profitable innovations. Their sweeping success enabled them to take on more and more risk, increasing their profits but also increasing the potential cost of an eventual crash.

At the top of the major commercial banks' wish list was the repeal of the Glass-Steagall Act, which was finally achieved in 1999. By that point, the separation of commercial and investment banking had been severely weakened by a series of Federal Reserve actions that allowed commercial banks, through their subsidiaries, to underwrite many types of securities; in addition, the new business of derivatives fell outside Glass-Steagall altogether, and commercial banks such as Bankers Trust and J.P. Morgan were among the pioneers in that market.

In 1996, the Fed struck a major blow for deregulation, allowing bank subsidiaries to earn up to 25 percent of their revenues from securities operations, up from 10 percent.[33] That same year, the Fed overhauled its regulations to make it easier for banks to gain approval to expand into new activities. Congress also changed the rules for banks seeking to expand into new businesses, relieving banks of the need to obtain approval from the Federal Reserve and putting the onus on the Fed to actively disapprove of any new activities.[34] As long as Glass-Steagall remained on the books, however, the 25 percent revenue limit posed a barrier, and there was still the risk that Congress or the courts might overrule a friendly decision by the Fed.

When Travelers and Citicorp merged in 1998—bringing together a major commercial bank and a major insurance company that owned a major investment bank—Glass-Steagall required the new Citigroup to break itself up within two years. Citigroup's only recourse was to get the law repealed. Congress obliged in 1999 with the Gramm-Leach-Bliley Act, which created a new category of financial holding companies that are authorized to engage in any activities that are financial in nature, incidental to a financial activity, or complementary to a financial activity—including banking, insurance, and securities.[35] With this legislation, Donald Regan's dream of a true financial supermarket that could offer all financial services was not only legal, it seemed to be embodied in the new Citigroup.

The passage of Gramm-Leach-Bliley freed not only Citigroup but also Bank of America, J.P. Morgan, Chase, First Union, Wells Fargo, and the other commercial megabanks created by the ongoing merger wave to plunge headlong into the business of buying, securitizing, selling, and trading mortgages and mortgage-backed securities. Because there was no way to seal off the banks' securities operations from their ordinary banking operations, this meant that the government guarantee of the banking system, in place since the 1930s, was effectively extended to investment banking. Deposits that were insured by the Federal Deposit Insurance Corporation could be invested in risky assets, with the assurance that losses would be made up by the FDIC. The larger the bank, the stronger its government guarantee. In 1984, when Continental Illinois was bailed out, the comptroller of the currency said that the top eleven banks were too big to fail; by 2001, there were twenty banks that were as big relative to the economy as the eleventh-largest bank had been in 1984.[36] As in any capitalist system, bank employees and shareholders would enjoy the profits from their increasingly risky activities; but now the federal government was on the hook for potential losses.

A major test of Wall Street's power was regulation of derivatives. Because they did not directly involve either deposits or traditional securities, and because they defied conventional treatment on an accounting balance sheet, customized derivatives posed a new challenge to the existing regulatory framework. The first threat to this new profit center arose in 1994 because of the major derivatives losses suffered by Orange County, Procter & Gamble, and Gibson Greetings, among others.

In response, Congress took up the issue of derivatives regulation. The House Banking and Financial Services Committee conducted a major investigation, and several bills to regulate derivatives were proposed. The industry countered with a major lobbying effort coordinated by the International Swaps and Derivatives Association (ISDA), which was received sympathetically by Alan Greenspan and by the Wall Street–friendly Clinton administration. Treasury Undersecretary Frank Newman urged Congress not to regulate derivatives;[37] Treasury Secretary Lloyd Bentsen also backed the industry, saying, "Derivatives are perfectly legitimate tools to manage risk. Derivatives are not a dirty word. We need to be careful about interfering in markets in too heavy-handed a way."[38]

The Group of Thirty, an international advocacy group largely composed of private sector bank executives, central bankers, and sympathetic academics, chimed in with a study concluding that no new regulation was required and that the industry could

be trusted to regulate itself.[39] The study was overseen by Dennis Weatherstone, then chair of J.P. Morgan. *The New York Times* reported at the time, "Many of those people conducting the study work at businesses that have a stake in assuring the market's continued prosperity. They were trying to head off calls for greater regulation and supervision by addressing these concerns."[40] And they were entirely successful. By the end of 1994, the lobbying effort had killed off all congressional efforts at regulation. Some customers who had been burned by derivatives were able to win settlements from their derivatives brokers, but these isolated cases did little to stem the growth of the industry.[41]

This was only one of several high-profile battles over regulation in the last two decades (but perhaps the only one that Wall Street had any chance of losing). Another struggle was precipitated by Brooksley Born's campaign as chair of the Commodity Futures Trading Commission (CFTC) to *think about* regulating over-the-counter derivatives. Born was concerned that the buildup of large derivatives positions invisible to regulatory oversight could create risks for the financial system as a whole.[42] She was opposed not only by Greenspan, Rubin, and Summers, but also by Securities and Exchange Commission chair Arthur Levitt and House Banking Committee chair Jim Leach. On May 7, 1998, the same day that Born's "concept release" was published, Rubin, Greenspan, and Levitt went public with their "grave concerns … about reports that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives."[43] In June, they proposed draft legislation imposing a moratorium on regulatory action by Born's agency.

In July 1998, before the House Banking Committee, representatives from Treasury, the SEC, and the major banking regulators lined up with Greenspan and executives from several major banks to oppose Born and testify that derivatives markets were functioning effectively without additional regulation. Greenspan said, "professional counterparties to privately negotiated contracts also have demonstrated their ability to protect themselves from losses, from fraud, and counterparty insolvencies"; he concluded, "aside from safety and soundness regulation of derivative dealers under the banking or securities laws, regulation of derivatives transactions that are privately negotiated by professionals is unnecessary. Regulation that serves no useful purpose hinders the efficiency of markets to enlarge standards of living."[44] In October, the moratorium was approved. The next year, Born decided not to seek reappointment.

From the perspective of the derivatives industry, however, winning the battle was not enough. Not satisfied that derivatives were unregulated, the industry used its influence to ensure that derivatives would never be regulated. In November 1999, the President's Working Group on Financial Markets produced a report, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," signed by Summers (then treasury secretary), Greenspan, Levitt, and new CFTC chair William Rainer. That report concluded that, in order "to promote innovation, competition, efficiency, and transparency in OTC derivatives markets, to reduce systemic risk, and to allow the United States to maintain leadership in these rapidly developing markets," those derivatives should be exempted from federal regulation.[45]

The financial sector's supporters in Congress complied by passing the Commodity Futures Modernization Act (CFMA), introduced in May 2000 but held up in the Senate due to Senator Phil Gramm's desire for even stricter deregulatory language.[46] Ultimately, Gramm succeeded in foreclosing any possibility of regulation by the CFTC or the SEC; in the middle of December, the bill was inserted into the Consolidated Appropriations Act for Fiscal Year 2001, passed by a lame-duck Congress, and signed by a lame-duck president. The financial sector had succeeded in sealing off one of its profit-making engines from the possibility of government interference.

Another key goal of the Wall Street banks was to maximize their leverage, and structured finance was a key to their strategy. Leverage is an easy way to increase profits. If you invest $10 of your money at a 10 percent return, you will gain $1 in profits; but if you invest $10 of your money and $90 of borrowed money at a 10 percent return, your profits will be $10. Conversely, however, leverage increases the chances that you will be wiped out; a 10 percent loss on $10 of your own money is only $1, but a 10 percent loss on $10 of your money and $90 of borrowed money leaves you with nothing.

This is why regulators place limits on the amount of leverage a bank can take on, in the form of minimum capital requirements. Capital is the amount of money put up by the bank's owners (shareholders), and acts as a safety cushion in times of stress; the more capital, the more money the bank can lose before it becomes unable to return money to its depositors and repay its debts. Capital requirements are set as a percentage of the bank's assets. For every $100 in assets, a bank might have to hold $10 in capital, which means it can borrow only up to $90; this is the same as saying its leverage cannot be more than nine to one. Therefore, to maximize profits per dollar invested (capital), banks want to maximize their leverage; put another way, for the same assets, they want to hold as little capital as possible.

One motivation for securitization was to exploit a loophole in existing regulatory capital requirements. The amount of capital a bank had to hold depended on the type of assets it held; in theory, the riskier the asset, the more capital was required. The loophole was that these requirements were set somewhat arbitrarily—4 percent for home mortgages, 8 percent for unsecured commercial loans, and so on. As a result, a bank could take $100 of assets that required, say, $8 in capital; put them into a securitization pool; and, through the magic of structured finance, convert them into $100 of new securities that were

treated differently by capital regulations and therefore required only $5 in capital. The true risk of the assets hadn't changed, since the probability of default hadn't changed. But because financial engineers could create securities with just the right characteristics needed to get just the right credit ratings, they could control the amount of capital that was required. So a bank could use securitization to *keep* the economic risk of its loans while reducing its capital requirements (so it could go and make more loans).

In addition to securitization, credit default swaps could be used to reduce capital requirements and increase leverage. The same J.P. Morgan team that pioneered the synthetic CDO also first lobbied federal regulators for permission to use credit default swaps to reduce their capital requirements. In 1996, the Federal Reserve Board of Governors obliged.[47] With both securitization and credit default swaps in their arsenal, Wall Street's financial engineers could concoct increasingly elaborate mechanisms for repackaging risk in ways that reduced its regulatory footprint.

Federal regulators were well aware of these practices. In 2000, for example, Federal Reserve economist David Jones published a paper with detailed examples of how banks could engage in regulatory capital arbitrage (RCA). "[R]egulatory capital standards seem destined to become increasingly distorted by financial innovation and improved methods of RCA," he wrote, "at least for those large, sophisticated banks having the resources to exploit such opportunities." Jones argued that this could actually be a good thing: "Against the backdrop of regulatory capital requirements that are often quite arbitrary, in some circumstances RCA actually may improve a bank's financial condition and the overall efficiency of the financial system. Indeed, RCA is widely perceived as a 'safety valve' for mitigating the adverse effects of regulatory capital requirements."[48]

Instead of attempting to crack down on banks' attempts to get around minimal capital requirements, federal regulators went in the other direction and loosened those requirements. In 2001, the federal bank regulators issued a new rule standardizing the capital requirements for securitizations.[49] If the bank creating the securitization retained some of the risk of the assets involved (which it often did in order to attract investors), the new rule calculated the bank's capital requirements based on ratings set by credit rating agencies (or, in some cases, the banks' own internal models). The goal of this rule was to align capital requirements with the degree of economic risk taken on by the bank, which was supposedly measured by the rating agencies. Instead, however, it meant that banks could get away with anything, so long as they could convince a rating agency to approve it.[50]

Not surprisingly, "shopping for ratings" became a standard part of securitizations. Banks would tweak their models until they got the ratings that they needed in order to sell some of the tranches to investors and keep some tranches for themselves. Rating agencies—who were being paid by the banks to rate these securities—complied, granting AAA ratings to thousands of securities at a time when only a handful of companies enjoyed AAA ratings for their bonds.*[51] According to Jim Finkel of Dynamic Credit, which created structured products, "Wall Street said, 'Hey, if you don't [give me the rating I want], the guy across the street will. And we'll get them all the business.' And they just played the rating agencies off one another." One investment banker who worked on these securitizations said, "It makes me feel really bad actually, it's very hard for me to acknowledge.… I knew I was doing things to get around the rules. I wasn't proud of it but I did it anyway."[52] The rating agencies were hardly passive victims. A McClatchy investigation found that even as the housing market was starting to crumble, Moody's was forcing out executives who questioned the agency's high ratings of structured products and filling its compliance department with people who had specialized in giving those ratings.[53]

By making capital requirements dependent on credit ratings, the regulators put this critical aspect of oversight in the hands of a small number of rating agencies that themselves depended on the banks for their revenues. With limited competition and little ability for investors to understand the rating process, the agencies had little incentive to give accurate ratings; by contrast, they had a lot of incentive to keep their key clients—the investment banks—happy. In 2004 and 2005, some rating agencies modified their rating models in ways that made it easier to give higher ratings to CDOs, helping extend the structured finance boom. But when the bubble finally burst, they ended up downgrading over 75 percent of asset-backed CDOs that had gotten AAA ratings in 2006 and 2007.[54]

Regulators went even further and outsourced control over minimum capital requirements to the banks they were regulating. On April 28, 2004, the Securities and Exchange Commission agreed to a request by the five large investment banks—Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns—to use their own internal models, based on historical data, to calculate the "net capital" in their broker-dealer operations. The rule was explicitly intended to reduce the regulatory burden on the major investment banks by increasing their net capital, thereby enabling them to expand their business:

> These amendments are intended to reduce regulatory costs for broker-dealers by allowing very highly capitalized firms that have developed robust internal risk management practices to use those risk management practices, such as mathematical risk measurement models, for regulatory purposes. A broker-dealer's deductions for market and credit risk probably will be lower under the alternative method of computing net capital than under the standard net capital rule.[55]

Between 2003 and 2007, all five major investment banks increased their overall leverage, taking on larger and riskier

positions that increased their expected profits while increasing their overall risk.[56] Bear Stearns's leverage reached a ratio of thirty-three to one, meaning that if its assets fell by 3 percent the bank would be insolvent; it was the first to fall in 2008 when *rumors* that it might be insolvent caused its short-term funding to dry up in a matter of days.

In exchange for being allowed to increase their leverage, the investment banks gave the SEC new powers to monitor their operations through the Consolidated Supervised Entity program. However, the SEC declined to take effective action under this program. A 2008 investigation by the SEC inspector general found that

> [the SEC's Division of Trading and Markets] became aware of numerous potential red flags prior to Bear Stearns' collapse, regarding its concentration of mortgage securities, high leverage, shortcomings of risk management in mortgage-backed securities and lack of compliance with the spirit of certain Basel II standards, but did not take actions to limit these risk factors.[57]

By this point, many regulators had bought into the idea that the financial markets could police themselves, so there was no need to intervene.

Securitization, credit default swaps, and more flexible capital requirements all made it possible for banks to increase their leverage, increasing both profits and risks. Historically, regulators have set limits on leverage, because it increases the likelihood of failures that may require government intervention. In the past twenty years, Wall Street banks invented new ways of getting around those limits. More important, the regulators no longer felt the need to protect the financial system by defending those limits, instead acquiescing in the general belief that markets were best left to police themselves.

Another potential threat to Wall Street's golden goose was regulation of mortgage lending, and subprime lending in particular. The mortgage lenders were not unaware of this danger. Between 2000 and 2007, the lenders that lobbied most intensively against potential legislation restricting predatory lending were precisely those lenders who originated the riskiest mortgages (measured by loan-to-income ratios), grew the fastest, and grew the proportion of mortgages that they securitized the fastest.[58] (They were also hit the hardest by the eventual financial crisis.) But the industry was fortunate to be protected by powerful figures in Washington.

In 1994, back when subprime lending was off Wall Street's radar, Congress had passed the Home Ownership and Equity Protection Act, which amended the Truth in Lending Act to read, "A creditor shall not engage in a pattern or practice of extending credit to consumers under [high-cost refinance mortgages] based on the consumers' collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations and employment."[59] In other words, it banned predatory lending—loans where the lender doesn't care if the borrower can't make his or her payments, because then the lender can pick up the house cheaply. However, under the arcane structure of financial regulation, consumer protection statutes including the Truth in Lending Act were enforced by the Federal Reserve—headed throughout this entire period by Alan Greenspan, who not only opposed government regulation in general, but thought that even fraud would be deterred by the operation of a free market.

The Federal Reserve sidestepped its consumer protection responsibilities by claiming it lacked jurisdiction. Many subprime loans—52 percent of those originated in 2005, for example[60]—were made not by banks, but by nonbank consumer finance companies or mortgage lenders. By the late 1990s, however, many of these specialized lenders had been bought up by banks (through their holding companies) or had been started by banks as independent subsidiaries. Consumer groups amassed mounting evidence of abusive lending practices, particularly in low-income and minority communities, and pressed the Fed to investigate. In 1998, however, the Federal Reserve Board of Governors unanimously decided "to not conduct consumer compliance examinations of, nor to investigate consumer complaints regarding, nonbank subsidiaries of bank holding companies,"[61] claiming it could not regulate nonbank entities[62] (even though the Truth in Lending Act makes no distinction between banks and nonbanks).[63]

In 2000, a joint report issued by Treasury (then under Larry Summers) and the Department of Housing and Urban Development recommended restrictions on harmful sales practices and on abusive terms and conditions in the mortgage market.[64] The report also urged the Fed to investigate abusive lending practices, claiming it had authority to do so.[65] That same year, Edward Gramlich, a member of the Board of Governors, argued that the Fed should crack down on predatory lending by consumer finance lenders that were subsidiaries of bank holding companies. His proposal, like all the others, was shot down by Greenspan, who believed that subprime lending was an example of healthy financial innovation.[66] (Conforming to the usual practice of not airing disagreements among governors, Gramlich did not go public with his concerns while at the Fed. Shortly before he died in 2007, however, he wrote, "In the subprime market, where we badly need supervision, a majority of loans are made with very little supervision. It is like a city with a murder law, but no cops on the beat.")[67] As late as 2005, Greenspan was still celebrating the growth in subprime lending:

> Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in subprime mortgage lending; indeed, today subprime mortgages account for roughly 10 percent of the number of all mortgages outstanding, up from just 1 or 2 percent in the early 1990s.[68]

While the Federal Reserve was neglecting to protect consumers, other regulatory agencies were neglecting to ensure the soundness of the banks they supervised. At the peak of the subprime lending boom, the Office of Thrift Supervision (OTS) was allowing thrifts to *reduce* their capital levels, which fell to their lowest level in decades by 2006. Only in 2005 did the Office of the Comptroller of the Currency (OCC) initiate a proposal saying that lenders should have to make sure that borrowers could afford their monthly payments; even then, it was not actually issued until September 2006, by which point housing prices were already falling.[69] Material loss reviews conducted after many smaller banks had failed in 2009 showed that banking regulators were often aware of the risks that the banks were running, but failed to take any significant corrective action.[70]

While federal regulators were content to turn a blind eye to subprime lending—when they were not cheering it on—there remained the risk that state regulators might attempt to put an end to the party. In 1999, the North Carolina Predatory Lending Law subjected high-cost (subprime) loans to a number of constraints, such as limits on loan flipping (refinancing a borrower into a new loan after only a few years) and prepayment penalties; in 2002, the Georgia Fair Lending Act introduced similar restrictions.[71] Standard & Poor's responded by announcing that it would not allow any loans governed by the Georgia Fair Lending Act into securitizations that it rated; if similar laws had been enacted throughout the country, this would have brought the subprime mortgage securitization assembly line to a screeching halt.[72]

However, the primary federal bank regulators came to the industry's aid, ruling that state regulations are "preempted" by federal regulations.* In August 2003, the OCC ruled that state regulation of lending practices did not apply to national banks, preempting the Georgia Fair Lending Act and holding that federal regulators alone had the power to regulate lending activities by federally chartered institutions.[73] This decision followed letters by the chief counsel of the OTS concluding that federal law preempted both the Georgia Fair Lending Act and the New Jersey Home Ownership Security Act of 2002.[74] (Later in 2003, the OCC also preempted the New Jersey law; in January 2004, it exempted national banks from state mortgage regulations in general.)[75] The federal courts have usually sided with federal regulatory agencies on the issue of preemption, giving the OCC and the OTS the ultimate say on whether states may regulate banking operations.[76] During the subprime boom, the effect was to disarm state governments and give the mortgage lenders (and the investment banks securitizing their loans) free rein throughout the fifty states.

In addition to protecting the flow of subprime loans into the securitization market, the federal government also increased demand for subprime loans through its regulation of Fannie Mae and Freddie Mac. The financial crisis was not primarily due to Fannie and Freddie.[77] However, their purchases of securities that were backed by subprime loans did, at the margin, provide additional sales for the Wall Street banks manufacturing those securities.

Before 2008, Fannie Mae and Freddie Mac were governmentsponsored enterprises (GSEs)—private corporations with a government mandate to provide liquidity to the housing market. They did this by buying mortgages and mortgage-backed securities on the secondary market and by creating and guaranteeing mortgage-backed securities of their own. To protect themselves, they only bought loans or guaranteed mortgage-backed securities made out of loans that conformed to their relatively strict (by industry standards) underwriting standards and size limits—so-called conforming loans. (The upper limit on conforming loans for single-family houses grew from about $253,000 in 2000 to $417,000 in 2006, but still left many houses beyond its reach.)[78] Because Fannie and Freddie could borrow money cheaply, there was a ready supply of cash that could flow into mortgage lending.

The common indictment of Fannie and Freddie charges that Democrats in Congress, trying to expand homeownership among the poor and minorities, pushed the GSEs to buy more and more subprime loans, pumping up subprime lending and housing prices in the process. (The implication, of course, is that the financial crisis was caused by government intervention in the markets.) There is a grain of truth to this story. The targets set by HUD in both the Clinton and George W. Bush administrations (under a law passed in 1992) mandated that 42 percent, 50 percent, and finally 56 percent of the loans bought by Fannie and Freddie had to go to people with low or moderate incomes. In 2002, as part of the Bush administration's Blueprint for the American Dream, they committed to finance $1.1 trillion in loans to minority borrowers.[79]

The riskiest mortgages, however—the ones that pushed the housing bubble to dizzying heights—were simply off-limits to Fannie and Freddie. The GSEs could not buy many subprime mortgages (or securitize them) because they did not meet the conforming mortgage standards. As profit-maximizing private corporations, Fannie and Freddie tried to relax their underwriting standards in order to get into the party, reducing documentation requirements and lowering credit standards. But ultimately, regulatory constraints prevented them from plunging too far into subprime lending. As housing expert Doris Dungey

wrote, "[T]he immovable objects of the conforming loan limits and the charter limitation of taking only loans with a maximum [loan-to-value ratio] of 80% … plus all their other regulatory strictures, managed fairly well against the irresistible force of 'innovation.' "[80]

As a result, in 2004–2006, as subprime lending reached its peak in both volume and innovation, Fannie and Freddie were pushed out of large parts of the market, because the loans being made violated their underwriting standards and because the Wall Street banks were so eager to get their hands on those loans. After 2003, the GSEs' share of secondary market subprime loans was cut in half, while the volume of private mortgage-backed securities (those not issued by the GSEs) soared.[81] Fannie and Freddie could not have pushed mortgage lenders into the most extreme forms of subprime lending, because those were precisely the loans they could not buy. They created demand for conforming mortgages, which were precisely what the aggressive subprime lenders were *not* selling.

Instead, however, Fannie and Freddie were able to buy the senior (AAA-rated) tranches of private mortgage-backed securities backed by subprime debt. These securities could count as money loaned to people with below-average income, and they were supposed to be safe.[82] These purchases of MBS were a mechanism by which government pressure to increase lending to low-income Americans translated into greater demand for mortgage-backed securities and therefore greater profits for Wall Street. At the end of the day, government pressure on Fannie and Freddie contributed to the housing bubble by increasing the amount of money flowing into the securitization pipeline. The two GSEs were not the primary factor stoking the subprime fire, and were consistently behind the curve as both subprime lending and securitization heated up, out-hustled by the mortgage lenders and the Wall Street banks who built, expanded, and profited from the mortgage securitization money machine. But they were yet another way that Washington provided fuel for that machine.

Finally, the Federal Reserve hooked its massive air pump to the housing bubble by keeping interest rates historically low from 2001 well into 2005. The federal funds rate (the rate at which banks borrow money from each other overnight) stood at 6.5 percent for most of 2000, before a recession and the terrorist attacks of September 11, 2001, prompted the Fed to cut it to 1.75 percent by the end of 2001.* It fell as low as 1.0 percent in 2003 and only began climbing again in June 2004, by which point real housing prices were 58 percent above their levels of January 2000. The federal funds rate didn't reach 3.0 percent—the *lowest* level of the entire 1990s—until May 2005, when real housing prices were 77 percent above their levels at the beginning of the decade.[83]

Cheap money was important because low mortgage rates were a central ingredient in the housing and securitization boom. Low rates made it easier for people to afford larger mortgages, pushing up housing prices. Low rates also induced existing homeowners to refinance their mortgages, providing more raw material for the securitization pipeline. At any point in the decade, a sharp increase in interest rates could have punctured the housing bubble by making houses less affordable and forcing prices down. But the Federal Reserve, true to the conclusion of Greenspan's 1996 "irrational exuberance" speech—that the Fed should not attempt to identify bubbles but should simply clean up afterward—declined to act.

The irony is that the Fed's flood of cheap money did not even have the healthy effect that it should have had. Ordinarily, businesses should take advantage of low interest rates to make capital investments, which contribute to overall economic growth. In the 2000s, however, as Tim Duy notes, business investment in equipment and software grew more *slowly* than in the 1990s, despite the lower interest rates. The problem was that the cheap money was misallocated to the housing sector, resulting in anemic growth.[84] That misallocation was due to the new mortgage products that made it so easy to borrow large amounts of money, the voracious appetite of Wall Street banks and investors for securities backed by those mortgages, and a decade of government policies that encouraged the flow of money into housing. And the more money that flowed into new subdivisions in the desert, the less flowed into new factories where Americans could go to work. Ultimately, the price of the housing bubble and the financial crisis is not just trillions of dollars of losses on mortgages and mortgage-backed securities, but a decade of poor economic growth and declining real household incomes.*

Even before the financial crisis of 2007–2009, politicians and officials in Washington had opportunities to witness the potential consequences of financial innovation run riot. But they drew the wrong lessons each time, allowing the banks to take more risks and make more money. The derivatives scandals of 1994 had cost clients hundreds of millions or billions of dollars, but posed no real danger to the financial system as a whole. The same could not be said of the near collapse of Long-Term Capital Management in 1998, which led to its bailout by a group of New York banks (facilitated by the Federal Reserve Bank of New York).[86]

The LTCM bailout was the right move for the Fed to make in the short term. It protected the financial system without putting public money directly at risk. However, the successful rescue sent the message that the Fed would not let private market actors suffer the consequences of their own bad decisions; while the LTCM partners lost most of their money, the banks that had blindly lent money to the fund lost none of theirs. It is impossible to say just what effect the rescue had on the behavior of Wall

Street over the next decade. But it is clear that LTCM, with its $130 billion in debts and seven thousand open derivatives positions with a face value of $1.4 trillion,[87] was considered "too big to fail"—words that would become infamous almost exactly ten years later.

In addition, the ability of the Fed to avert disaster—and even to keep the stock market rising by cutting interest rates in September, October, and November 1998—undermined any incentive to do anything about the root causes of the LTCM near disaster. If this was the worst damage that unregulated financial institutions trading unregulated products could do, then perhaps regulation was unnecessary. Congress apparently agreed; it was in October 1998, only a month after LTCM had been saved, that it imposed the moratorium preventing the CFTC from regulating custom derivatives.

The collapses of Enron, WorldCom, and other high-flying companies in 2001–2002 also should have made clear that free markets did not deter fraud on their own. WorldCom committed straightforward accounting fraud that was missed by its auditors, the banks underwriting its new debt, and the credit rating agencies rating that debt.[88] Enron used special-purpose entities, derivatives, disguised loans, and aggressive accounting to shift revenues forward and backward in time, create phantom profits, and hide debts; while its intentions seemed to be fraudulent, the financial techniques it used were so novel that it was not clear which were illegal and which were merely innovative.[89] Some of its financial engineering techniques would reemerge in the financial crisis of 2007–2009, as would the banks it used—a class-action lawsuit named JPMorgan Chase, Citigroup, Credit Suisse First Boston, CIBC, Bank of America, Merrill Lynch, Barclays, Deutsche Bank, and Lehman Brothers as its enablers.[90]

Enron and WorldCom showed both the consequences of hyperactive financial innovation and the failure of "self-regulation" by the free market. Enron's creditors, who should have been lending money carefully, instead were helping it create fake transactions.[91] The credit rating agencies failed to disentangle Enron's web of special-purpose entities and maintained its investment-grade rating until well after the company's problems were front-page news. Old-fashioned regulation was also missing in action. In the wake of the Enron collapse, the Senate Governmental Affairs Committee concluded, "The Securities and Exchange Commission largely left the search for fraud to private auditors and boards of directors."[92]

Confronted with this wake-up call, Congress and the Bush administration limited themselves to bolting the particular barn door exploited by the Enron-WorldCom generation. The Sarbanes-Oxley Act of 2002 established new standards for corporate financial statements (and, by 2007, was under widespread attack from the business community for being too stringent). It did not occur to anyone in power that some of the ingredients that made Enron possible—financial innovations dreamed up by Wall Street banks hungry for large transaction fees, off-balance-sheet accounting, weak credit rating agencies, credulous investors, a largely fawning media, and ineffectual federal regulators—might already be recombining in a different form.

The SEC—the nation's chief regulator of the securities markets and investment banks—stepped up enforcement briefly after Enron, but enforcement actions declined again during the chairmanship of Christopher Cox from 2005 to 2009. Under Cox, the five-member commission that governed the agency often delayed action on opening investigations, delayed approval of settlements, or reduced penalties recommended by enforcement officials, resulting in an 84 percent decline in penalties.[93] Instead of focusing on enforcement, powerful commissioners such as Paul Atkins argued that the SEC should pare back regulations that were seen as imposing excessive costs on the free market.[94]

The SEC also failed to exercise its powers to oversee the securities industry. In the wake of the collapse of Bear Stearns, the SEC inspector general found that the agency not only took no meaningful action under the Consolidated Supervised Entity program, but also did a poor job implementing its Broker-Dealer Risk Assessment program (created in 1992 in response to the failure of Drexel Burnham Lambert). Under that program, the SEC received quarterly and annual reports from 146 broker-dealers—but generally only reviewed six of them.[95] Most famously, the SEC managed to overlook Bernie Madoff's $65 billion Ponzi scheme, despite tips and investigations going back to 1992.[96]

This failure to regulate the securities markets effectively was a consequence of the deregulatory ideology introduced by Ronald Reagan as well as the political influence of Wall Street. James Coffman, a former assistant director of the SEC's enforcement division, wrote,

> Elected deregulators appointed their own kind to head regulatory agencies and they, in turn, removed career regulators from management positions and replaced them with appointees who had worked in or represented the regulated industries. These new managers and, in many cases, the people they recruited and promoted, advanced or adhered to a regulatory scheme that, at least with respect to the most important issues, advanced the interests of the regulated.[97]

After all, the industry's mantra was that financial markets could self-regulate, so there was no need for the government. Once the government accepted this logic, it unilaterally disarmed in a sweeping abdication of its responsibility to the people it

served.

THE GOLDMAN SACHS SAFETY NET

As much as the Wall Street banks wanted Washington's hands off their moneymaking businesses, they still had no stomach for doing business without the protection of the U.S. government. This attitude is consistent with the history of the business-government relationship in the United States. While occasional libertarian academics and politicians have favored deregulation in its pure form, real companies see regulatory or deregulatory policies simply as a way to improve their market position or profit-making potential. And one benefit Wall Street banks wanted was the security of knowing that the government's effectively unlimited balance sheet and borrowing power would be there for them should they need it.

Did bank executives consciously take excessive risks because they expected taxpayers to cushion their potential losses? This is not something that a Wall Street CEO is likely to admit, and it is possible that on an individual level they simply underestimated the risks involved and expected their winning streaks to continue indefinitely. But the government safety net was on at least some bankers' minds. Andrew Haldane, executive director for financial stability at the Bank of England, has told the story of a meeting (prior to the recent crisis) where government officials asked private-sector bankers why they did not conduct rigorous "stress tests" of their own portfolios; the answer, according to one participant, was that in the event of a severe shock, "the authorities would have to step in anyway to save a bank and others suffering a similar plight."[98] In any case, the behavior of major financial institutions made sense largely because of implicit government guarantees. Increasing leverage, increasing the proportion of assets held for trading purposes, buying riskier assets, and selling out-of-the-money options (such as credit default swaps) are all strategies that increase returns in good times but increase losses in bad times; therefore, they make the most sense for banks that can shift those higher losses onto someone else. (Ordinarily, banks' creditors would prevent them from pursuing these risky strategies, because their money would be on the line; if creditors expect to be bailed out by the government, however, there is no need for them to monitor the banks closely.) And they are all strategies that were pursued during the recent boom by major global financial institutions, including those in the United States.[99]

We do know that executives of at least one major bank thought about the government safety net. Since 1932, Section 13 of the Federal Reserve Act had given the Fed the power, in "unusual and exigent circumstances," to make loans to anyone—but only if the collateral provided in exchange arose "out of actual commercial transactions."[100] This requirement specifically excluded investment securities, which meant that in a crisis, investment banks might not have any valid collateral with which to borrow from the Fed.

This danger worried the remarkably prescient executives at Goldman Sachs. At their suggestion, the "actual commercial transactions" requirement was dropped in a "miscellaneous provision" of the Federal Deposit Insurance Corporation Improvement Act of 1991, ensuring that the Fed could lend against *any* collateral in a time of crisis.[101] This change gave the Fed the power to widen its protective umbrella to encompass investment banks, at the same time that those banks were increasing the riskiness of their operations by expanding their derivatives and proprietary trading businesses and taking on additional leverage. This seemingly minor change would be of crucial importance seventeen years later; when the housing bubble of the 2000s ended—and with it the seemingly unlimited supply of money flowing from novel and largely unregulated financial products—not only investment banks but a major insurance company would have to be rescued with government money.

* For example, pension funds with long-term liabilities should prefer to invest in long-term assets, so they are getting their money back at the same time that they need to make payouts.

* In a stylized example, an MBS offering might be composed of 85 percent senior MBS and 15 percent junior MBS. If 5 percent of the underlying mortgages default, the junior investors will lose one-third of their money, but the senior investors will lose nothing. The senior investors only lose if over 15 percent of the underlying mortgages default. By contrast, in a pass-through MBS, there are no tranches; if 5 percent of the mortgages default, all investors lose 5 percent of their money.

† There is not universal agreement on terminology. A mortgage-backed security with tranches is sometimes called a CDO. A CDO backed by mortgage-backed securities is sometimes classified as a mortgage-backed security (because ultimately it, too, is backed by mortgages).

* Contrary to popular belief, not all subprime loans are loans to poor people. The classification of a loan depends on the relationship between the borrower, the property, and the size of the loan. Chris Mayer and Karen Pence have found that "subprime mortgages are not only concentrated in the inner cities, where lower-income households are more prevalent, but also on the outskirts of metropolitan areas where new construction was more prominent."[11]

* In 2005, only eight U.S. companies had AAA bond ratings: AIG, Automatic Data Processing, Berkshire Hathaway, ExxonMobil, General Electric, Johnson & Johnson, Pfizer, and United Parcel Service.

* Preemption is a legal doctrine holding that certain areas regulated by the federal government may not be regulated by

the states—even if they wish to enact more stringent requirements than those prescribed by federal regulators.

* The Federal Reserve controls the federal funds rate by buying and selling Treasury securities, which decreases or increases the amount of money available to banks, thereby affecting the rate at which banks lend to each other. The federal funds rate has an important though indirect influence on all interest rates in the economy.

* Average real annual growth has been lower in the 2000s (through 2008) than in any decade since the 1930s; real median household income (in 2008 dollars) has fallen from $52,587 in 1999 to $50,303 in 2008.[85]

6
TOO BIG TO FAIL

> To paraphrase a great wartime leader, never in the field of financial endeavour has so much money been owed by so few to so many. And, one might add, so far with little real reform.
>
> —Mervyn King, governor of the Bank of England, October 20, 2009[1]

On October 13, 2008, their stock prices in tatters and the short-term viability of their firms in doubt, the heads of nine major banks—Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Merrill Lynch, Morgan Stanley, State Street, and Wells Fargo—arrived at the Treasury Department for a meeting with Treasury Secretary Henry Paulson.* Each was given a term sheet agreeing to sell shares to the government, and Paulson told them to sign it.[2]

This might seem like a government takeover of the financial sector—a seizure of ownership interests in nine major banks. And given the stakes—a near-total freeze of credit markets, a plunge in the stock market, the potential collapse of those and yet more banks—that would not have seemed too far-fetched. But the remarkable thing about this meeting was not that the government was stepping in to protect the U.S. financial system and, by extension, the global economy. What was remarkable was something that Vikram Pandit, CEO of Citigroup, noticed instantly: "This is very cheap capital!"[3] It was such a good deal that John Mack, CEO of Morgan Stanley, signed the term sheet immediately, even before consulting his board of directors.[4]

Few people at the time were arguing that the government should sit on its hands and let the financial sector implode. But few also expected Paulson, Federal Reserve chair Ben Bernanke, and Federal Reserve Bank of New York president Tim Geithner to rescue the banks on such generous terms. The October 13 deal was structured as a purchase of preferred shares, which effectively meant that Treasury loaned the banks money, at an initial 5 percent annual interest rate (a rate that was not available in the market), that never had to be repaid.[5] (Treasury also received options to buy a small amount of common shares at a predetermined price.) The purchases theoretically meant that the government now owned part of the banks, but Treasury promised that it would not influence the management of the banks and would not vote for members of their boards of directors.* It was close to free money.

Why was this such a sweet deal? Although banks borrow most of their money, all banks need capital—money that cannot be demanded back by creditors. Capital serves as a buffer that prevents a bank from failing when its assets fall in value. In good times, when capital is readily available, banks prefer to borrow as much as possible in order to maximize their profits, keeping their capital levels low; but in bad times like October 2008, when banks most need additional capital, it is at its most expensive—because who wants to invest in a bank that may fail the next day?

But as Pandit recognized, the government was giving the banks capital cheaply; Warren Buffett, by contrast, had just invested in Goldman Sachs at a 10 percent interest rate. (Buffett also received more options than Treasury, and at a bigger discount to the then current market price.) In short, Paulson, a former CEO of Goldman Sachs, was pushing free money at his former colleagues. Phillip Swagel, then a Treasury assistant secretary, later wrote, "This had to be the opposite of the 'Sopranos'—not a threat to intimidate banks but instead a deal so attractive that banks would be unwise to refuse it."[6] According to Swagel, the government had to offer attractive terms because it could not force the banks to agree to any investment, and it is true that some bankers claimed that they did not need government capital.[7] However, the government did have considerable negotiating leverage, thanks to its regulatory authority, its ability to threaten *not* to bail out banks later should they need it, and the fact that banks would be taking a risk by walking away without money that their competitors had. And the government officials involved fully appreciated the strength of their position. During the meeting, Paulson responded to an objection by saying, "Your regulator is sitting right there," referring to the director of the Office of the Comptroller of the Currency and the chair of the Federal Deposit Insurance Corporation. "And you're going to get a call tomorrow telling you you're undercapitalized and that you won't be able to raise money in the private markets."[8]

The government's largesse was not limited to capital at a bargain basement rate. At the October 13 meeting, officials also revealed that the government would begin guaranteeing debt issued by the banks, allowing them to raise money by selling bonds to private investors who now knew that the government would protect their investments. Together, these two measures constituted an extraordinary gift from the government, on behalf of taxpayers, to the financial sector.

At the time—with Lehman Brothers bankrupt, Bear Stearns and Merrill Lynch sold, and Goldman Sachs and Morgan Stanley fleeing for the safety of bank holding company status (which gave them increased access to emergency lending from the Federal Reserve)—many observers thought the financial crisis signaled the demise of Wall Street. For the onetime "masters of the universe," being forced to accept government money was a humbling blow. And even with the cushion of a large government subsidy, the banks seemed unlikely to return to the high-flying ways of the boom. America's leading business newspaper put its

name on a book entitled *The Wall Street Journal Guide to the End of Wall Street as We Know It.* [9] An era, it seemed, was ending.

Today, however, it is clear that Wall Street did not end. While some fabled institutions have vanished, the survivors have emerged larger, more profitable, and even more powerful. The vague expectation that the government would bail out major financial institutions when necessary has become official policy. The connections between Wall Street and Washington have become stronger. A Democratic administration has done everything in its power to restore a private, profitable financial sector. A casual observer would be forgiven for thinking that Washington has behaved like an emerging market government in the 1990s—using public resources to protect a handful of large banks with strong political connections. Whether this was due to political capture or to unbiased economic policymaking, the result was the same: Wall Street only became stronger as a result of the financial crisis.

The story of the financial crisis of 2007–2009 has been told many times.[10] Policymakers, economists, and commentators have pointed to many causes and contributing factors, ranging from "oversaving" in China to basic human psychology.[11] However, few would deny that a U.S. financial system that inflated an asset bubble with cheap lending, manufactured colossal amounts of complex and potentially toxic securities, levered up with debt to maximize profits, and binged on short-term funding played a central role in bringing on the crisis. Even under the theory (popular among Americans) that a glut of saving in China created a flood of cheap money in the United States, leading to overborrowing and the housing bubble, that money had to flow through the American financial system, which did a phenomenally poor job of allocating it efficiently.

This system was made possible by the rise of the financial sector over the past three decades. Members of the Washington establishment bought into Wall Street's vision of free-flowing capital and unfettered innovation. Whether they were true believers or cynics out to maximize their campaign contributions or their future earning potential, policymakers helped the major banks by relaxing regulations, declining to enforce existing regulations, or neglecting to regulate new markets. This is why mortgage originators were allowed to make loans that got bigger over time, making them harder to pay off; why those mortgages could be packaged into securities that masked their intrinsic risk; why banks could stash those securities in off-balance-sheet vehicles and pretend they didn't own them; why they could use fancy risk models that said that nothing could go wrong with those securities; why trillions of dollars of side bets could be placed on those same securities; and ultimately why trillions of dollars of assets ended up precariously perched on top of a bubble of debt.

In 2006, the air began leaking out of that bubble, housing prices began to fall, and borrowers unable to refinance their mortgages started defaulting in sharply rising numbers. In 2007, the mountain of assets based on housing values began to crumble as increasing defaults torpedoed the prices of mortgage-backed securities and collateralized debt obligations (CDOs). In 2008, the resulting avalanche almost brought down the global financial system. Key government policymakers made admirable efforts to save the financial system. But the actions they took ultimately demonstrated the importance of a particular worldview in Washington—the idea that big, risk-loving banks are crucial to our economy and our way of life.

ON THE EDGE OF THE CLIFF

The financial crisis played out in a series of increasingly frightening episodes on Wall Street. Each scare prompted concern in Washington. But the three men who dominated economic policy through the end of the Bush administration—Paulson, Bernanke, and Geithner—hoped to avoid direct government intervention, preferring the approach of cushioning the downturn through increased liquidity and lower interest rates. Only in 2008 did they recognize that they were dealing with the kind of collapsing debt bubble common to emerging market crises in the 1990s—a scenario that required stronger measures.

Problems became widely visible in summer 2007, when Bear Stearns and then BNP Paribas revealed problems with internal hedge funds that had invested heavily in subprime mortgages. The disclosures made investors wonder how many other funds might contain ticking time bombs. The Federal Reserve responded with additional liquidity, lowering the discount rate and the federal funds rate* in an attempt to encourage lending and head off a credit contraction.

Fear only grew, however, as investors next became concerned about the structured investment vehicles (SIVs) that many banks had spawned in order to profit from structured securities while minimizing their capital requirements. As rumors spread that SIVs would either go bankrupt or infect the balance sheets of their sponsoring banks, the government attempted to engineer a backroom deal involving money from private banks. The theory was that the SIVs only faced a short-term liquidity crisis—given time, their assets would recover their value—and therefore deep-pocketed banks could buy them out safely. In October 2007, at the urging of the Treasury Department, several major banks announced a Master Liquidity Enhancement Conduit (MLEC) that would buy several hundred billion dollars' worth of securities from troubled SIVs. However, the idea was quietly dropped in December. Most likely the banks realized that using their own money to bail out their own SIVs—or, as some suspected, pooling the money of many banks to bail out Citigroup's SIVs—did not represent a real solution.

The failure of the MLEC implied that the major banks might be facing more than a simple liquidity crisis and might need more capital. At this point, sovereign wealth funds (investment funds owned by other countries) were still willing to supply that capital. Between October 2007 and January 2008, CITIC (China) committed to invest in Bear Stearns, the Abu Dhabi Investment Authority and the Government of Singapore Investment Group invested in Citigroup, China Investment Corporation invested in Morgan Stanley, and Temasek (Singapore), the Korean Investment Corporation, and the Kuwait Investment Authority invested in Merrill Lynch.[12] But the next time banks needed capital, it would be much harder to find.

The next firestorm erupted in March 2008 with the collapse of Bear Stearns, then considered the weakest of the big five stand-alone investment banks. Bear Stearns was brought down by a modern-day bank run.[13] On a proportional basis, it was more exposed to structured mortgage-backed securities than its rivals, and it was also highly dependent on short-term funding—cash that came from very short-term borrowing, much of it overnight.[14] This meant that its creditors could refuse to roll over their loans from one day to the next and demand their money back instead. If that happened, there was no way Bear could pay them back, since many of its assets were illiquid; structured securities can be hard to sell on short notice, and selling them under pressure would cause their prices to collapse. If some creditors thought that this might happen, they would try to get their money out first, which would provoke other creditors to do the same, triggering a bank run as everyone scrambled to avoid being last in line.

All banks have this potential weakness, since they borrow short and lend long—they borrow money that they promise to return on short notice (deposits), and lend it out for long periods of time (mortgages). The rush by creditors to get their money out first is a classic feature of financial crises around the world, particularly in emerging markets. In the United States since the 1930s, deposit insurance has generally prevented bank runs by depositors—but that insurance did not cover the institutions lending money overnight to Bear Stearns and the hedge funds who parked their securities at Bear.

In early March, rumors surfaced that Bear Stearns was in trouble. Those rumors quickly became self-fulfilling as nervous creditors and hedge fund clients began cutting their exposure to the bank, causing Bear's cash to drain away. Treasury and the Fed faced the prospect that a major investment bank might go bankrupt, tying up its assets in bankruptcy court for months or years and leaving its creditors and counterparties without access to their money. The Fed first attempted to lend Bear money by using JPMorgan Chase as an intermediary (as an investment bank, Bear was not eligible for direct loans from the Fed). When this failed to bolster confidence, Paulson, Bernanke, and Geithner brokered the sale of Bear to JPMorgan for a paltry $2 per share. Even at that price, JPMorgan refused to go along without a government backstop, so the New York Fed agreed to assume all the losses on $30 billion of Bear's illiquid securities.

The deal was soon renegotiated to a purchase price of $10 per share, with JPMorgan now assuming the first $1 billion of losses on the $30 billion pool, which was parked in a special-purpose entity named Maiden Lane.[15] But it remained a coup for JPMorgan, which was paying for Bear Stearns approximately what its *building* was worth[16]—and for its CEO, Jamie Dimon, who happened to be on the board of directors of the New York Fed. The day the acquisition was announced, hoping to prevent the remaining stand-alone investment banks from suffering the same fate as Bear Stearns, the Federal Reserve also announced the creation of the Primary Dealer Credit Facility—a program allowing investment banks for the first time to borrow money

directly from the Fed.[17] This constituted a dramatic expansion in the government's safety net for the banking system.

But the financial epidemic continued to spread as the fall in housing prices accelerated. Because of the complex way in which CDOs and other structured securities had been manufactured, falling housing prices and increasing defaults had a disproportionate impact on the prices of many such securities, which fell in value by 50 percent or more.* For example, in July 2008, Merrill Lynch sold a portfolio of CDOs with a face value of $30.6 billion to Lone Star Funds for only $6.7 billion, or 22 cents on the dollar—and even loaned Lone Star $5 billion to close the deal.[18]

No one knew how many of these toxic assets were sitting on major banks' balance sheets, or how much they would lose if they were forced to sell. Each quarter, banks were taking major write-downs—reducing the accounting value of those assets to reflect their deteriorating quality.† In 2007, Citigroup took $29 billion in write-downs, Merrill Lynch $25 billion, Lehman $13 billion, Bank of America $12 billion, and Morgan Stanley $10 billion.[19] But no one knew if the assets were being written down to their true values, or how long the write-downs would continue. In 2008, Citigroup would take another $63 billion in write-downs, Merrill $39 billion, Bank of America $29 billion, Lehman $14 billion, JPMorgan Chase $10 billion, and Morgan Stanley $10 billion. The suspicion was spreading that if they were forced to acknowledge the true decline in value of their assets, some major banks might turn out to be insolvent.

The next major institutions to come under pressure were Fannie Mae and Freddie Mac, the privately owned but government sponsored enterprises (GSEs) that backed up the housing market. Although Fannie and Freddie had been relatively late to the subprime party, their balance sheets were completely exposed to the housing market, and falling housing prices tore a widening hole in those balance sheets, threatening their survival. This spooked the housing market, which was unlikely to continue functioning without their guarantees. It also frightened foreign governments, China first among them, that had bought hundreds of billions of dollars of bonds from Fannie and Freddie and were counting on the U.S. government to protect them from default.

In July 2008, Paulson asked for and obtained the right to back up Fannie and Freddie with taxpayer money, betting that this alone would stem the panic; "If you've got a bazooka, and people know you've got it, you may not have to take it out," he said at the time.[20] But it was not enough. On September 7, Fannie and Freddie were taken over by the government and placed in a conservatorship—the equivalent of a managed bankruptcy.[21] The government promised to keep the GSEs in operation, and in exchange got a controlling ownership share and the right to manage them. Shareholders lost most of their money and the CEOs were replaced. In effect, the federal government took over two pillars of the financial system because they were too big to fail. Reactions were generally positive, in part because no one wanted to defend the quasi-private, quasi-public status of the GSEs. Other financial institutions had long complained about the unfair advantage that Fannie and Freddie enjoyed because of their government relationship, which made it cheaper for them to borrow money.

In the end, this was the last bailout that everyone could agree on. And it bought Paulson, Bernanke, and Geithner precisely one week.

Until September, most government support had been provided by the Federal Reserve in the form of new lending programs (the guarantee for Bear Stearns's assets was structured as a loan) and lower interest rates. By acting as a lender of last resort, the Fed hoped to engineer a "soft landing" from the boom—the goal its founders sought back in 1913. However, this strategy was about to reach its limits, leaving Paulson, Bernanke, and Geithner with the choice between letting the free market take its course and end in financial and economic disaster, or engineering a massive government intervention in the financial system. The terms of that intervention would reveal the lasting influence and power of the Wall Street ideology—that big, private, lightly regulated financial institutions are good for America.

The precipitating factor was again the collapse of an investment bank—Lehman Brothers, now the smallest of the big four stand-alone investment banks. As with Bear Stearns, rumors emerged that Lehman was short on cash, and those rumors quickly became self-fulfilling. Over the weekend of September 13–14, the government cast about for a buyer. But this time, Paulson and Geithner made clear that they did not want to step in with taxpayer money. Paulson complained, "I'm being called Mr. Bailout. I can't do it again"; more circumspectly, Geithner observed, "There is no political will for a federal bailout."[22] On Saturday night, knowing that no federal money would be available, Jamie Dimon said to his troops at JPMorgan Chase, "We just hit the iceberg. The boat is filling with water, and the music is still playing. There aren't enough lifeboats. Someone is going to die."[23] When a plan for Barclays to acquire Lehman fell through on Sunday, the backup plan was bankruptcy early Monday morning.

Paulson, Bernanke, and Geithner declined to orchestrate a massive rescue that would have required a large loan from the Fed guaranteed by a claim on most of the bank's assets. (The principals have all insisted that they did not have the legal authority to rescue Lehman, because the bank did not have sufficient collateral to support an emergency loan from the Fed—but that argument only appeared weeks later.) They hoped that, since the Bear Stearns emergency in March, financial institutions had prepared themselves for the possibility of Lehman's collapse. As Bernanke said in congressional testimony, "[W]e judged that investors and counterparties had had time to take precautionary measures."[24] Unfortunately, those institutions had learned

the opposite lesson—that the government would *not* let Lehman collapse. As Andrew Ross Sorkin wrote, describing the days before the Lehman bankruptcy, "[M]ost people on Wall Street … assumed that the government would intervene and prevent [Lehman's] failure."[25] The financial sector assumed it could have its cake and eat it too: the government would give it unlimited license to make money in the boom, *and* would shelter it from harm in the bust. But it turned out that the government did not have the resources to protect all of the major banks; this time, the resource in short supply was the political capital necessary to bail out another bank in the face of congressional and public criticism.

The Lehman bankruptcy triggered a chain reaction that ripped through the financial markets. American International Group, which was already struggling with the consequences of its derivatives trades, faced downgrades by all three major credit rating agencies, which would trigger collateral calls that could force it into bankruptcy.* On Tuesday, with the collateral damage caused by Lehman's failure beginning to spread, the Fed stepped in with an $85 billion credit line to keep AIG afloat, fearing that if the insurer defaulted on its hundreds of billions of dollars in credit default swaps, its counterparties would suffer devastating losses—or, at the least, fear of those losses would cause the financial markets to grind to a halt.

Also on Tuesday, the Reserve Primary Fund, one of the largest money market funds, announced that it would "break the buck"; because of losses on Lehman debt, it could not return one dollar for each dollar put in by investors. As a result, money flooded out of money market funds, forcing Treasury to create a new program to provide insurance for those funds. The flight from money market funds dried up demand for the commercial paper used by corporations to manage their cash, raising the specter that major corporations might not be able to make payroll. This forced the Fed to establish a program to buy commercial paper from issuing corporations—in effect lending money not just to banks, but directly to nonfinancial companies.

Banks that relied heavily on short-term funding saw their sources of cash dry up as investors realized that *any* financial institution could fall victim to a bank run. Washington Mutual collapsed as depositors pulled out their money, causing the largest bank failure in U.S. history, and Wachovia, on the brink of failure, was acquired by Wells Fargo. Desperate to hold on to the cash they had, banks stopped lending. Money essentially moved in only one direction, toward U.S. Treasury bills—the presumed safest of all investments—and it stayed there. No one else could get any credit, and without credit the financial system cannot function.

On Thursday, September 18, the financial crisis burst onto the American political stage. Paulson and Bernanke went to Congress asking for $700 billion to buy toxic securities. A controversial three-page summary of their proposal gave the treasury secretary virtually unlimited power to use the money as he saw fit. Congress responded by passing the Emergency Economic Stabilization Act, but not until October 3, after its initial defeat in the House of Representatives triggered a frightening run on the stock market. That bill's central provision, the Troubled Asset Relief Program (TARP), gave Treasury $700 billion to buy "troubled assets" from financial institutions.

In the October 13 meeting at Treasury that opened this chapter, $125 billion of TARP money was committed to nine major banks. In addition to investments in smaller banks, another $40 billion was invested in Citigroup and Bank of America, two of the original nine banks, in later rescue operations; more TARP money was used to finance Federal Reserve guarantees of toxic assets held by those two banks; and $70 billion was invested in AIG to allow it to pay down its credit line from the Fed.[26] In addition, the FDIC promised to insure up to $1.5 trillion of new bank debt, and the Federal Reserve committed trillions of dollars to an ever-expanding list of liquidity programs intended to provide cheap money to the financial system: the Term Auction Facility, the Term Asset-Backed Securities Loan Facility, the Money Market Investor Funding Facility, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, and so on.

Never before has so much taxpayer money been dedicated to save an industry from the consequences of its own mistakes. In the ultimate irony, it went to an industry that had insisted for decades that it had no use for the government and would be better off regulating itself—and it was overseen by a group of policymakers who *agreed* that government should play little role in the financial sector.

OTHER PEOPLE'S MONEY

Although the financial crisis was similar to earlier meltdowns,[27] especially in emerging markets, it was unique in its complexity and scale. A vigorous government response was necessary, particularly after the Lehman bankruptcy. Given the panic that seized financial markets, it was possible that a sudden evaporation of credit, coupled with rapid de-leveraging by financial institutions and corporations everywhere, could have led to a second Great Depression. However, at each point, the government had choices in how it responded to the crisis. To understand the nature of the government response, it is necessary to understand the options that were available.

The core problem was that various financial institutions were in trouble. The immediate threat was a panic-induced bank run, but the underlying issue was that the toxic securities held by banks had plummeted in value. If the banks had to liquidate those assets at current market prices, they would run the risk of becoming insolvent. In short, they needed more cash, or they needed insurance against those assets falling further in value. Broadly speaking, the government's choices lay on a spectrum between two main options.

The first was the "blank check" option. The government, as a source of potentially unlimited money, could keep financial institutions afloat and prevent a systemic collapse by simply giving them the money they needed (by investing new capital, overpaying for banks' assets, or insuring those assets at below-market rates). The second was the "takeover" option. The government could take over failing financial institutions and either clean them up, with the goal of ultimately returning them to private ownership, or shut them down. This is what the FDIC routinely does with smaller banks that become insolvent: it seizes their assets and then operates them in a conservatorship or sells the assets to another bank.

There has been considerable debate over whether the government had the legal authority to take over bank holding companies, as opposed to their commercial banking subsidiaries. While the takeover of holding companies was not anticipated by the regulatory scheme, the government had considerable power to dictate the terms of support to any troubled bank, both because regulators had the power to revoke the license of an insolvent bank and because the government was the only source of financing available to struggling banks.* Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, argued that the government could have placed conditions on any financial support that enabled it to place failing institutions into conservatorship.[28]

Under both the blank check and the takeover scenarios, someone must take the losses. A bank is fundamentally a pile of money that is invested in a set of assets. Some of the money comes from the banks' shareholders and the rest is borrowed from depositors and other creditors. If the assets increase in value, the bank can pay back its depositors and creditors (with interest) and the shareholders keep the gains. If the assets fall in value, the shareholders take the losses, since the bank's debts do not change; if assets continue to fall after the shareholders have lost all their money, depositors (if they are uninsured) and creditors take a "haircut" because the bank cannot pay them back in full.

In the blank check scenario, the government keeps the bank afloat in its current form: managers keep their jobs, shareholders keep some value, and creditors are kept whole, so taxpayers bear most of the losses. Shareholders own all the "upside," meaning that if the bank recovers and increases in value, they will reap the benefits. In the takeover scenario, by contrast, managers lose their jobs, shareholders are wiped out, and any remaining losses are shared between taxpayers and creditors. (In a crisis, creditors' haircuts may have to be modest in order to protect those creditors from failing in turn.) Since the government now owns the bank, taxpayers can claim all the upside.

The takeover option was what the Treasury Department of Rubin and Summers (and Geithner, as treasury assistant secretary and then undersecretary for international affairs) strongly recommended for emerging market countries in the 1990s. Sick banks, they counseled, were at best a potential brake on economic recovery and at worst a serious macroeconomic risk; when investors fear a country's banks will collapse, they often abandon its other assets as well, triggering a sharp depreciation in its currency. Even if these banks happened to be run by close friends or relatives of the ruling elite, they could not be allowed to carry on in their existing form. Either they needed to be cut loose from government support, or they needed to be taken over and cleaned up, for the good of the economy.

After the Lehman bankruptcy, it became axiomatic that another major financial institution could not be allowed to fail in an uncontrolled manner that would spark panic in the markets. The question was whether the United States would follow the advice it had handed out a decade before and thousands of miles away. Ultimately, however, it was the taxpayer who would pay to rescue the financial sector—without getting very much in return.

Over the course of the financial crisis, the principal economic policymakers—first Paulson, Bernanke, and Geithner, then Geithner (as treasury secretary), Bernanke, and Summers (as director of the National Economic Council)—devised an impressive range of schemes to shore up the banking system. Their hard work and creativity cannot be doubted. But the common feature of these schemes was that they attempted to fill the gaping hole in bank balance sheets with government

subsidies, more or less crudely obscured.

The original purpose of TARP was to buy toxic assets from financial institutions. This would have the salutary effect of transferring risk from banks, which were choking on it, to the federal government, which is big enough to absorb it; besides, the official government theory was that the banks only faced a liquidity crisis, and that with its long time horizon the government could simply wait until the markets recovered. But this scheme faced a fundamental problem: if Treasury offered to pay the current market price for these assets, the banks would refuse to sell, since that would lock in losses they could not afford;* if Treasury paid enough to solve the banks' problems, that would constitute a massive subsidy from the taxpayer.[29]

Instead, the government chose to recapitalize banks by giving them cash in exchange for preferred shares (exploiting an ambiguity in the TARP legislation), beginning with the October 13 meeting. They were forced to do so by the markets, which were not convinced by the plan to buy toxic assets, and by announcements from the United Kingdom and several other European countries that they would recapitalize their banks. Putting government money into some banks is standard practice in emerging market financial crises, but the money typically comes with strict conditions in order to begin the reform process. In the United States, however, those conditions were missing. The government did not insist on market prices for its investments (as set by Warren Buffett with his investment in Goldman Sachs), fearing that some banks would decline to participate. Instead, the government bent over backward to make the deal attractive for the banks, charging below-market interest and eschewing any significant ownership—so shareholders, not taxpayers, would benefit when the banks recovered. As a result, for every $100 committed by Treasury at the October 13 meeting, $22 was a subsidy to the banking sector, according to a later report by the TARP Congressional Oversight Panel.[30] (One thing that was similar to emerging markets, however, was that politically connected banks were more likely to get their hands on cheap TARP capital, according to an analysis by Jowei Chen and Connor Raso.)[31]

As opposition to taxpayer-funded bailouts increased, the subsidy mechanisms became more complex. In November 2008, with Citigroup struggling to fend off concerns about its viability, the government announced a second bailout package. In addition to another $20 billion investment, the government agreed to guarantee a $306 billion pool of Citigroup assets against falls in value (after the bank absorbed the first $29 billion in losses). The government received additional preferred stock in exchange for the guarantee, but there is no question that the guarantee was a subsidy; if Citigroup had had to buy such a guarantee on the open market, it could not have afforded the price.

A similar asset guarantee was provided to Bank of America in January, apparently in exchange for its agreeing—under government pressure—to complete the acquisition of Merrill Lynch in December.[32] This time, the government guaranteed a $118 billion pool of assets in exchange for $4 billion in preferred stock. But in a bizarre twist, even though the deal was announced—reassuring the bank's creditors and stabilizing its financial position—it never actually closed (because of technical difficulties in identifying the specific assets to be guaranteed). As a result, the government never got the $4 billion in preferred stock, and when Bank of America's outlook improved it was allowed to walk away from the deal for a fee of $425 million.[33]

The government bailout of AIG, justified as a way of preventing complete chaos in the market for credit default swaps, turned out to be another subsidy to the banking sector. AIG's counterparties for those credit default swaps were primarily large banks. By committing $180 billion to keep AIG afloat, the government ensured that those counterparties would be paid in full for their winnings on the bets they had made with AIG. In March 2009, under pressure from lawmakers, AIG finally released some details of who had been made whole by government money: Goldman Sachs received $12.9 billion from AIG, Merrill Lynch $6.8 billion, Bank of America $5.2 billion, and Citigroup $2.3 billion, along with several major foreign banks.[34] This was cash that these banks would not have received had AIG gone bankrupt, or had it been subjected to an FDIC-style conservatorship.*

The AIG bailout illustrated the ability of major banks to take advantage of the government's situation. A handful of major banks had purchased credit default swaps from AIG to insure $62 billion in CDOs. The AIG bailout included a plan for the New York Fed to finance a new entity (Maiden Lane III†) to buy the CDOs so that AIG could then settle the credit default swaps.‡ Maiden Lane III paid $30 billion (the market price) to buy the CDOs from the banks, and AIG, under instructions from the New York Fed, then paid the banks $32 billion to retire the credit default swaps. The result was that the banks received 100 cents on the dollar in what amounted to a backdoor bailout—even though AIG, prior to its bailout, had been negotiating in an attempt to get the banks to accept as little as 60 cents on the dollar.[36] The banks were confident that the government would not force AIG into bankruptcy, and simply refused requests that they accept anything less. Neil Barofsky, the special inspector general for TARP, later criticized the New York Fed, which he said "refused to use its considerable leverage" to negotiate better terms.[37]

While TARP-funded recapitalizations and the AIG conduit managed to keep calamity at bay, they did little to address the major source of fear: the toxic assets that remained on bank balance sheets. In March, Geithner announced the Public-Private Investment Program (PPIP), another attempt to relieve banks of these assets. As always, the sticking point was the gap between the price that buyers were willing to pay for these assets and the price that banks were willing to accept. The PPIP closed the

gap through public subsidies. Private investors could lever up their own money with loans from the government. If the assets they bought fell in value, they could dump those assets on the government instead of paying back the loan; this limited their downside while giving them the amplified upside created by leverage.[38]

However, the PPIP failed to get off the ground. When the first transaction finally occurred in September, it was a sale by the FDIC of assets that it had inherited from a failed bank. (This made no sense, since the justification for the PPIP was to relieve *banks* of their toxic assets.) The banks themselves decided that they would be better off holding on to their toxic assets and hoping for the best, aided by an April 2 decision of the Financial Accounting Standards Board that made it even easier to set their own values for assets.

What finally turned the tide were the "stress tests" (officially the Supervisory Capital Assessment Program) that federal regulators conducted on nineteen leading banks in spring 2009, with results released on May 7.* The stated purpose of the exercise was to test whether the banks could withstand a severe economic downturn, quantify the amount of capital they would need in a worst-case scenario, and force them to raise that capital. But the more important purpose was to bolster confidence in the financial system. On one level, the exercise failed; many people doubted that the tests painted a true portrait of the banks' potential losses, especially when it came out that the Fed actually negotiated the results with the major banks, in some cases dramatically improving the banks' performance at the last minute.[39] (*Saturday Night Live*'s parody of Geithner, to some, seemed not too far from the truth: "Eventually, at the banks' suggestion, we dropped the asterisk and went with a pass/pass system. Tonight, I am proud to say that after the written tests were examined, every one of the nineteen banks scored a pass.")[40]

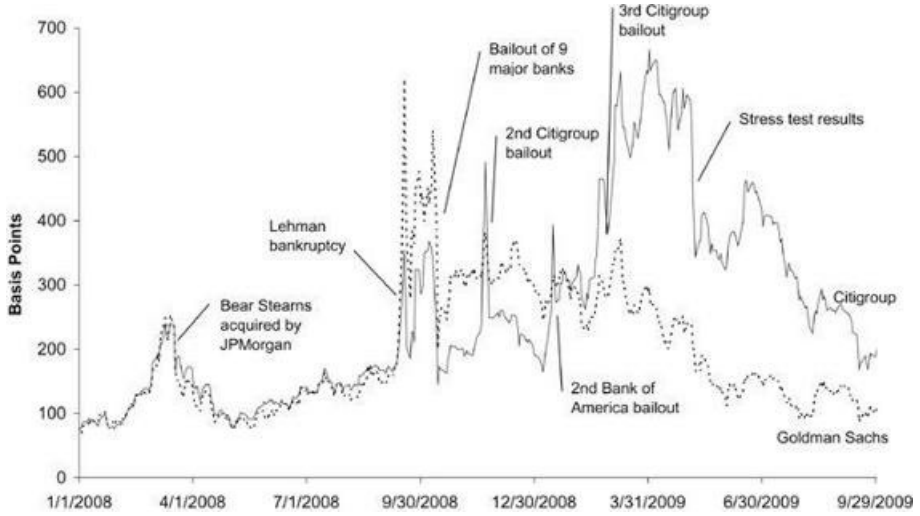
But on another level, the stress tests worked. For months, leading government figures had repeatedly assured the public that the banking system was secure. On April 21, Geithner testified, "Currently, the vast majority of banks have more capital than they need to be considered well capitalized by their regulators."[41] The stress tests were a way of committing the government to back those words with money. Once the government had certified the banks' balance sheets, and once the banks had raised the capital the government demanded, the government would have no excuse not to bail them out if needed. This was not entirely a good thing: once the pressure to get their houses in order was off, the banks were in no rush to unload their toxic assets.

The strengthened government guarantee was one ingredient pulling the megabanks back from the abyss. Another was reduced competition. Not only did Bear Stearns, Lehman Brothers, Merrill Lynch, Washington Mutual, and Wachovia all vanish, but an entire class of nonbank mortgage lenders evaporated with the housing bubble. With fewer competitors, the survivors could sweep up larger shares of the market and demand higher margins and fees. And a third factor was the cheap money being pumped into the economy by the Federal Reserve. Banks' primary raw material is money. Less competition and cheap money meant higher revenues and lower costs at the same time.

With low interest rates, banks could raise money from depositors virtually for free; they could borrow cheaply from each other; they could borrow cheaply at the Fed's discount window; they could sell bonds at low interest rates because of FDIC debt guarantees; they could swap their asset-backed securities for cash with the Fed; they could sell their mortgages to Fannie and Freddie, which could in turn sell debt to the Fed; and on and on. Because so much cash was easily available to the banks, they could not suddenly run out of money. And because short-term interest rates fell further than long-term interest rates, the basic business of banking—borrowing short and lending long—became more profitable. The indefinite government lifeline gave the banks time to recapitalize themselves with profits from current operations.

Effectively, the government's strategy was to bail the banks out of their problems by helping them make large profits, juiced by reduced competition and cheap money, to plug the ever-widening hole created by their toxic assets. As part of its stress tests, the Federal Reserve concluded that the four largest banks—Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo—stood to lose another $425 billion on existing assets through the end of 2010, but would fill more than half of that hole with $256 billion in profits over the same period.[42] For the stronger banks, such as JPMorgan Chase and Goldman Sachs, the result was a quick return to profitability and the appearance of health; the weaker ones, such as Citigroup and Bank of America, gained time to wait for an economic recovery to bail them out of their bad loans.

Figure 6-1: Credit Default Swap Spreads, 5-Year Senior Debt



Source: Bloomberg Finance LP

Repeated public assurances, the stress test results, and the earlier emergency bailouts of Citigroup and Bank of America made it clear not only that the government would not let a major bank fail, but that the government would bail out banks in their existing form, with their existing management, and without imposing haircuts on bank creditors. Figure 6-1 shows the perceived likelihood that major banks would go bankrupt, as measured by the price of credit default swap protection on their debt; each time the government intervened, the market's fears ebbed, until finally the stress tests broke the year-long fever. That was what Wall Street needed to hear: they could go back to doing business as usual, and Washington would be there if things went wrong. A panic that began with an attempt to reduce moral hazard by letting Lehman fail only ended when everyone was convinced that the government would not let another major bank fail—magnifying moral hazard to an unprecedented degree. And as the real economy began to bottom out over the summer, it became easier and easier to make money again. But this was only true for the major banks; in the real economy, it became harder and harder to get a loan. According to the Federal Reserve's survey of bank loan officers, every type of loan became harder to get in every quarter of 2008 and through the first three quarters of 2009.[43]

In short, Paulson, Bernanke, Geithner, and Summers chose the blank check option, over and over again. They did the opposite of what the United States had pressed upon emerging market governments in the 1990s. They did not take harsh measures to shut down or clean up sick banks. They did not cut major financial institutions off from the public dole. They did not touch the channels of political influence that the banks had used so adeptly to secure decades of deregulatory policies. They did not force out a single CEO of a major commercial or investment bank, despite the fact that most of them were deeply implicated in the misjudgments that nearly brought them to catastrophe. Summers was aware of the irony, although he disagreed that the situations were exactly parallel. "I don't think I would quite accept the characterisation that we're in the position that the Russians were in in 1998," he said in a 2009 interview, because the United States did not face the problem of foreign capital flight. But, to his credit, he acknowledged,

> There have been moments, certainly, when I understood better some of the reactions of officials in crisis countries now than one was able to from the outside at the time. It is easier to be for more radical solutions when one lives thousands of miles away than when it is one's own country.[44]

The total cost of all those blank checks is virtually incalculable, spread across the more or less direct subsidy programs (preferred stock purchases, asset guarantees, and so on) and the emergency liquidity and insurance programs to unfreeze the markets for commercial paper, asset-backed securities, or bank debt. It is incalculable because the different types of support—lending commitments, asset guarantees, preferred stock purchases, and such—cannot simply be added up. At the upper end of the relevant ballpark, the special inspector general for TARP estimated a total potential support package of $23.7 trillion, or over 150 percent of U.S. GDP.[45] This represents the theoretical potential liabilities of the government; the net cost will be far lower, since not all lending commitments will be used up, most loans will be paid back, most preferred shares will be bought back, most of the assets the government has guaranteed will not become worthless, and so on.

In the end, the government's strategy succeeded in bringing the financial system back from the brink of ruin, although not in restoring that system to health and stimulating lending to the real economy. There are three crucial steps in responding to a financial crisis: ending the panic, preventing economic activity from collapsing, and laying the groundwork for a sustainable recovery. The government largely succeeded in the first step, and the stimulus package passed in early 2009 helped with the second step. But the unconditional support provided to the financial system only exacerbated the weaknesses and incentives

that had created the crisis in the first place.

Despite the tremendous cost of bailing out the financial system, the cost of letting the system collapse would probably have been even higher. But was bailing out Wall Street the only way to avoid disaster?

The beginning of 2009 saw a raging public debate between the blank check option and the takeover option. The key question was not whether to intervene; virtually everyone involved acknowledged that the megabanks were too big to fail, because if any one of them collapsed the system as a whole might collapse. The question was what to do about it. The government argued that the banks' fundamental situation was not that bad—banks faced a "liquidity crisis" caused by short-term fear, not a "solvency crisis" caused by severe economic losses—and that the best way to contain that fear was to keep the banks going in their current form; anything more drastic would only cause panic.

The opposing view, put forward by many people including Nobel Prize laureates Paul Krugman and Joseph Stiglitz (and non–Nobel laureates like us), was that some major banks were deeply sick and that successive bailouts amounted to vast giveaways of taxpayer money that would do little to solve either the short-term or the long-term problems in the financial sector. As Krugman said, "Every plan we've heard from Treasury amounts to the same thing—an attempt to socialize the losses while privatizing the gains."[46] But because the government only had enough money to keep the banks afloat, it was not actually restoring them to the health necessary for them to start lending again. The problem was both political and economic. In Krugman's words:

> As long as capital injections are seen as a way to bail out the people who got us into this mess (which they are as long as the banks haven't been put into receivership), the political system won't, repeat, won't be willing to come up with enough money to make the system healthy again. At most we'll get a slow intravenous drip that's enough to keep the banks shambling along.[47]

By leaving the banks in the hands of their existing managers and going out of its way to minimize its own influence, the government was ensuring that it had no way to encourage banks to do anything other than hoard their cash, and no way to affect bank behavior in the future. Attempts by the Federal Reserve to stimulate the economy were absorbed by what Richard Fisher, president of the Federal Reserve Bank of Dallas, called "the Blob" of large, sick banks. "Those banks with the greatest toxic asset losses were the quickest to freeze or reduce their lending activity," Fisher said; in addition, "the dead weight of [the megabanks'] toxic assets diminished the capacity of markets to keep debt and equity capital flowing to businesses and scared investors away."[48] Although bank bailouts did prevent economic calamity, they would do little to ensure financial stability or economic prosperity.

Krugman, Stiglitz, and others argued that the government should take over banks, clean them up so they would function normally, and sell them back into private hands when possible, as in an FDIC intervention. In a February 2009 interview, Stiglitz said, "Nationalization is the only answer. These banks are effectively bankrupt."[49] Other prominent supporters of a government takeover included economics professors Nouriel Roubini and Matthew Richardson and Dean Baker of the Center for Economic and Policy Research.[50] While takeovers would be a form of temporary nationalization, no one ever refers to FDIC takeovers that way; instead, they are thought of as a government-managed bankruptcy process. A major bank such as Citigroup might have required government conservatorship for months or years, but the goal would have been to restore private ownership when economic conditions allowed. There were both economic and political arguments for this course of action.

The immediate economic argument was that sick banks could only be thoroughly cleaned up via a takeover. Toxic assets needed to be removed from bank balance sheets; but as long as a bank remained independent, any such transaction had to be negotiated, and the bank's managers (representing the shareholders) could simply hold up the government for a high price, knowing that if the bank failed, other people would be left holding the bag. If the government took over a bank, however, it could transfer the toxic assets to a separate government entity without negotiation, restore the bank to health by adding new capital, and return it to normal operation. Management would be replaced and shareholders wiped out, leaving the bank in the hands of taxpayers, who would get at least some of their money back when the bank could be sold into private hands. (Alternatively, the government could have simply bought a struggling bank at market value; at one point in March 2009, the market value of all of Citigroup's common stock fell below $6 billion.)[51] The toxic assets could be parked on the balance sheet of the U.S. government, which could hold them indefinitely and, if necessary, absorb the losses they entailed.

The longer-term economic argument was that a takeover was necessary to remove moral hazard—the temptation for bank executives (and shareholders) to take risky gambles, knowing that they would benefit from success but that taxpayers would bear the losses in case of failure. After the Lehman bankruptcy, the government's policy was that no major bank would be allowed to fail—and every bank CEO knew it—even while smaller banks were failing by the dozens. By contrast, major bank takeovers would send the message that there was a penalty for failure, giving executives and shareholders the incentive to avoid excessive risk, and giving creditors the incentive to be more careful with their money.

Taking over sick megabanks would also have political benefits. As in Korea a decade before, effective reform would require confronting the political roots of the crisis—the disproportionate political power of Wall Street. The right time for that confrontation was when the banks were at their weakest and most dependent on government aid. Bailing out the banks unconditionally put the government in the position of having to ask for favors later—favors that the banks would have no reason to return. By contrast, taking them over would have weakened or eliminated their ability to resist the regulatory reforms necessary to ensure long-term financial stability and economic growth.

Finally, takeover was only fair. Bankers who had run their institutions into the ground would no longer collect seven- or eight-figure bonuses made possible only by government bailouts. Shareholders who had gambled on highly leveraged banks would lose their money. Creditors who had lent blindly would lose part of their money. Taxpayers footing the largest part of the bill would at least have the possibility of making money as banks recovered. This is how capitalism is supposed to work. Failure should be punished, not rewarded. The government should be the backstop protecting society against a financial collapse, but it should exact a price for that protection. Reflecting on the emerging market crises of the 1990s in his 2000 American Economics Association lecture, Summers had emphasized, "Prompt action needs to be taken to maintain financial stability, by moving quickly to support healthy institutions and by intervening in unhealthy institutions. The loss of confidence in the financial system and episodes of bank panics were not caused by early and necessary interventions in insolvent institutions."[52] Instead, by providing serial bailouts with no meaningful conditions attached, the Bush and Obama administrations both rewarded failure and backed away from the tough medicine needed to restore a well-functioning financial sector.

As we wrote in *The Atlantic* in March 2009, "The challenges the United States faces are familiar territory to the people at the IMF. If you hid the name of the country and just showed them the numbers, there is no doubt what old IMF hands would say: nationalize troubled banks and break them up as necessary."[53] However, the administration took pains to deny that this was even a plausible option. In a February interview, when asked about "nationalization," Geithner responded, "It's not the right strategy for the country for basic practical reasons that our system will be stronger if it remains in private hands with support from the government to make sure those institutions can play their critical role going forward."[54] Then and elsewhere, Geithner carefully avoided even using the word "nationalization," as if saying it might unnerve the private sector. The administration was successful in sending the message that no major banks would be taken over on its watch, and it was a message that Wall Street heard loud and clear.

Another issue that Wall Street cared deeply about was executive compensation. By the time the Obama administration came into office, one sore point with the public was that banks receiving government assistance were subject only to weak limits on compensation (boards of directors had to ensure that senior executives' compensation packages did not motivate them to take excessive risks, bonuses based on materially inaccurate information had to be clawed back, and golden parachutes to top executives were prohibited[55]). To the public, that meant that taxpayer money could pass straight through to bankers' Ferraris and vacation homes in the Hamptons. Some administration insiders, including top political adviser David Axelrod, pressed for greater restrictions on compensation.[56] Because of a provision of the economic stimulus package passed by Congress in February, the final rule issued in June 2009 was slightly stricter—limiting the bonuses payable to certain executives, requiring that they be paid in long-term restricted stock, and requiring a nonbinding shareholder vote on executive compensation[57]—but tight restrictions and close monitoring applied only to a handful of companies receiving "exceptional assistance" from the government.[58] Even the relatively mild limits were too much for most of the megabanks, who rushed to pay back their TARP money as quickly as possible—weakening their balance sheets (by paying back cash they didn't need to pay back) so they could say they were free of government support, even as they profited from the cheap money supplied by the Federal Reserve. The main effect of the rule was to tilt the playing field against the banks that had received exceptional assistance (Citigroup and Bank of America) and therefore were subject to stricter compensation limits, making it harder for them to attract and retain key people. Any systematic attempt to curb the perverse incentives created by banking industry compensation practices was kicked down the road to a future regulatory reform bill.

The Obama administration did not uniformly support banks' interests, but what the banks could not win in the White House, they often won in Congress. On February 18, President Obama announced his "Homeowner Affordability and Stability Plan," which contained a provision allowing judges to modify the terms of home mortgages for borrowers who were in bankruptcy. The idea was that if a borrower's house was worth far less than the mortgage, a bankruptcy judge should be able to reduce the mortgage—just as the judge could reduce the amount owed to almost all other creditors. The banking lobby succeeded in killing this "cramdown" provision in the Senate, with the banks and their industry associations refusing even to negotiate with Senator Richard Durbin while the Obama administration remained on the sidelines. Instead, the bill contained a separate provision *reducing* the amount that banks had to pay the FDIC for deposit insurance.[59] This exercise in legislative muscle-flexing showed the continuing power of the big banks on Capitol Hill. Even as they depended on government investments, debt guarantees, and liquidity programs for their survival, they actually increased their lobbying expenditures to fight off potential regulatory reforms.[60]

On issue after issue, the big banks got what they wanted, and the taxpayer got the bill. The justification for these policies was that anything that threatened to weaken the banks might trigger a resurgence of the panic of September-October 2008. But the result was the same. The large banks used their political power to protect their money machines from government interference, and when those machines exploded they used their size and importance to force the government to bail them out.

BUSINESS AS USUAL

In the end, the major banks got business as usual. The shakeout of 2008 left the big banks even bigger. Bank of America absorbed Countrywide and Merrill Lynch and saw its assets grow from $1.7 trillion at the end of 2007 to $2.3 trillion in September 2009. JPMorgan Chase absorbed Bear Stearns and Washington Mutual and grew from $1.6 trillion to $2.0 trillion. Wells Fargo absorbed Wachovia and grew from under $600 billion to $1.2 trillion.[61] This growth occurred against a backdrop of falling asset values and de-leveraging, which meant that most banks were cutting their new lending and getting smaller.

Consolidation among the big banks and the collapse of the nonbank mortgage lenders meant much larger market shares for the fewer but bigger megabanks. Bank of America, JPMorgan Chase, and Wells Fargo all had to be exempted from a federal rule prohibiting any single bank from holding more than 10 percent of all deposits in the country, and from Department of Justice antitrust guidelines intended to limit monopoly power in specific metropolitan regions. By mid-2009, those three banks and Citigroup together controlled half the market for new mortgages and two-thirds of the market for new credit cards.[62] Derivatives, which had always been dominated by fewer than twenty dealers, became even more concentrated. At the end of June 2009, five banks together had over 95 percent of the market for derivatives contracts traded by U.S. banks, led by JPMorgan Chase's 27 percent share.[63]

The government's insistence that large banks would not be allowed to fail worked only too well. Large banks were able to borrow money at rates 0.78 percentage points more cheaply than smaller banks, up from an average of 0.29 percentage points from 2000 through 2007. In the banking business, where profits depend on the spread between the interest rate you receive and the interest rate you pay, 0.78 percentage points are a huge financial advantage.[64] And what were large banks doing with their newfound market power? They were boosting profits any way they could—increasing fees on deposit accounts, even while their smaller competitors were reducing fees.[65]

For JPMorgan Chase, the payoff was blowout profits fueled by both its huge footprint in consumer banking and its growing investment banking business. Bank of America and Citigroup, though still fundamentally troubled, managed to keep up the appearance of profits, in part through one-time asset sales, in part through accounting gimmicks. Most surprisingly to the casual observer, the investment banking business, which had seemed on the brink of death in September 2008, roared back to life (even if the major stand-alone investment banks were now technically bank holding companies). In the first quarter of 2009, bond trading departments took advantage of high volatility in the markets to rake in large fees and make money in proprietary trading. There was also widespread speculation (difficult to confirm, given the secretive nature of trading operations) that bank trading profits were boosted by taking advantage of the fact that AIG was trying to unwind its large positions rapidly—which meant that the banks were making money at the expense of a taxpayer-owned company.*

In the second quarter, things got even better. Goldman Sachs reported its largest quarterly profit ever—$3.4 billion—on the backs of a record performance from its bond trading division and $700 million in stock underwriting.[67] Those bond trading profits were given a helping hand by the Federal Reserve, which was buying large volumes of securities (to provide liquidity and stimulate the economy) while telegraphing its moves to Wall Street. As one asset management executive said, "You can make big money trading with the government. The government is a huge buyer and seller and Wall Street has all the pricing power."[68] And the $700 million was in part the result of federal bailouts; as the government ordered other banks to issue new stock to raise capital, they were forced to turn to the few remaining investment banks. JPMorgan Chase, Goldman Sachs, and Morgan Stanley alone accounted for 42 percent of the market for equity underwriting in the first half of 2009.[69] Finally, Goldman was making money the oldfashioned way—by taking on more risk. As the bank's president, Gary Cohn, said in August 2009, "Our risk appetite continues to grow year on year, quarter on quarter, as our balance sheet and liquidity continue to grow."[70] And Goldman's value-at-risk—a quantitative measure of the amount it stood to lose on a given day—after dipping slightly in summer 2008, continued to climb throughout the crisis to levels in 2009 five times as high as in 2002.[71]

However, the clearest indication that Wall Street was back to business as usual was the amount of money earmarked for bonuses. In the first half of 2009, Goldman Sachs set aside $11.4 billion for employee compensation—an annual rate of over $750,000 per employee and near the record levels of the boom. Even if the government's strategy was to let the banks earn their way out of their problems, that strategy was being undermined by a bonus culture that diverted the excess profits to employees rather than to capital reserves. High risk and huge payouts—nothing changed, except a strengthened government guarantee. Defending the huge bonuses in St. Paul's Cathedral in London in October 2009, Goldman Sachs executive Brian Griffiths went Gordon Gekko one better by invoking Jesus: "The injunction of Jesus to love others as ourselves is a recognition of self-interest.… We have to tolerate the inequality as a way to achieving greater prosperity and opportunity for all."[72] Goldman CEO Lloyd Blankfein even claimed to be "doing God's work" (because banks raise money for companies who employ people and make things).[73]

The rest of us were not so lucky. While a second Great Depression was averted, the collateral damage to the real economy

was enormous. The collapse of the housing bubble tipped the economy into recession in December 2007, leading to the loss of 1.1 million jobs in the first eight months of 2008.[74] The fall of Lehman Brothers in September 2008 and the ensuing panic triggered a severe economic contraction, leading to the loss of another 5.8 million jobs over the next twelve months as the economy shrank by 4 percent.[75] The unemployment rate doubled from 4.9 percent at the beginning of the recession to 10.2 percent by October 2009; the broadest measure of unemployment, including people who gave up looking for a job and people working part-time who would prefer to work full-time, doubled from 8.7 percent to 17.5 percent—more than one in every six people in the broad workforce.[76]

As the economy declined sharply, the sudden collapse in tax revenues left government finances in disarray. State and local governments resorted to severe cutbacks in services. The federal government dedicated $800 billion in new spending and tax cuts to stimulate the economy. However, stimulus spending and lower tax revenues pushed the 2009 federal deficit up to $1.6 trillion, or 11 percent of GDP, more than doubling the previous postwar record.[77] The long-term effect of the financial crisis and recession is even greater. In January 2008, just as the economy was tipping into recession, the Congressional Budget Office (CBO) projected that, by the end of 2018, U.S. government debt would fall to $5.1 trillion, or 22.6 percent of GDP. Surveying the wreckage in August 2009, the CBO projected that debt at the end of 2018 would rise to $13.6 trillion, or 67.0 percent of GDP—a difference of $8.5 trillion.[78] This should come as no surprise; Carmen Reinhart and Kenneth Rogoff have shown that, on average, modern banking crises lead to an 86 percent increase in government debt over the three years following the crisis.[79]

The financial crisis and the government's emergency response also increased the likelihood of two bleak scenarios. First, the enormous amount of liquidity that the Federal Reserve poured into the economy created the long-term potential for high inflation; if the Fed cannot "mop up" that liquidity when the economy recovers, all that excess money could make dollars less valuable, driving up prices.

Second, the vast increase in the total national debt brought us closer to the point where it could become more difficult to raise money by issuing new government debt. Should that happen, the government will have to pay higher interest rates to borrow money, and those higher interest rates will spread throughout the entire economy, slowing economic growth. In a worst-case scenario, the government may have to raise money in foreign currencies, undermining one of our traditional advantages over much of the rest of the world. This is unlikely to occur solely as a result of the recent financial crisis; before the crisis, the United States was only moderately indebted by international standards and had the capacity to absorb one shock without seriously affecting our ability to borrow money. Whether we can absorb another such shock is another question. The United States did not look like an emerging market when the crisis began, but it has already become more like one.

J. Paul Getty is reputed to have said, "If you owe the bank $100, that's your problem. If you owe the bank $100 million, that's the bank's problem." The bank cannot afford a loss of $100 million, and therefore will do anything to help you avoid default—and that gives you power.

In 2008–2009, the tables turned. It was the major banks who were struggling with their debts, and it was the U.S. government that could not afford to let them fail, because of the damage that would inflict on the real economy and on tens or hundreds of millions of people. (Small banks, however, were like people who owed $100.) This meant that when the banks faced off with the government, they held all the cards. As Barney Frank put it, "All these years of deregulation by the Republicans and the absence of regulation as these new financial instruments have grown have allowed them to take a large chunk of the economy hostage. And we have to pay ransom, like it or not."[80]

The fact that their failure could entail the loss of millions of jobs gave the banks the power to dictate the terms of their rescue. If the government insisted on paying market prices for toxic assets, or insisted on taking majority control, the banks could simply refuse to go along, secure in the knowledge that the government would have to come back to the table. In the end, the government had more to lose from major bank failures than did the bankers themselves, who had already made their money. Citigroup CEO Vikram Pandit, for example, made $38 million in 2008[81] on top of the $165 million he made by selling his hedge fund to Citigroup in 2007.[82] At most they would suffer a reputational blow should their banks fail—which they could always blame on market conditions and the failure of the government to come to their aid. This was the problem with the strategy of negotiating with Wall Street; Wall Street held all the cards.

But that is not a complete explanation, because there is little evidence that the government attempted to force the issue. It was not only that the government had a weak hand; it was that the government negotiators came to the table largely in agreement with the bankers' view of the world. And it wasn't just a few key people. Paulson, of course, was the former head of Goldman Sachs, and his aides at Treasury included Robert Steel, Steve Shafran, and Neel Kashkari from Goldman. In summer 2008, when he realized he needed reinforcements to fight the financial crisis, he summoned Dan Jester and Ken Wilson, also Goldman veterans.[83] When faced with the potential insolvency of Fannie Mae and Freddie Mac in August 2008, Paulson hired Morgan Stanley (for a nominal fee) to analyze the two GSEs; Morgan Stanley was also hired by the Federal Reserve Bank of

New York to advise on the AIG bailout.[84] Given the urgency of the situation and the technical details involved, it made sense for the government to hire outside help. But that help could only come from one place: Wall Street.

What is more remarkable is that the policies of the Bush administration were largely carried over into the Obama administration, despite the enormous policy differences between George W. Bush and Barack Obama on almost every issue. This is because by 2009, the economic policy elite of the *Democratic* Party was fully won over to the idea that finance was good.

During the Democratic primary campaign, Obama's chief economic adviser was Austan Goolsbee, an economics professor without a long track record as a party insider. But after Obama won the election, he turned to a Democratic establishment that was formed in the Clinton years, largely under the tutelage of Robert Rubin. Michael Froman, who was Rubin's chief of staff at Treasury and followed him to Citigroup, and James Rubin, Rubin's son, were both members of Obama's transition team.[85] (Froman was also an associate of Obama's from their law school days, independently of Rubin; after the transition, he became a member of both the National Economic Council and the National Security Council.) Geithner, who had built close relationships with Wall Street CEOs during his five years as president of the New York Fed,[86] became treasury secretary. Summers, most recently a managing director of the hedge fund D.E. Shaw, became director of the NEC. Peter Orszag, Clinton economic adviser and director of Rubin's Hamilton Project, became head of the Office of Management and Budget; Gary Gensler, treasury undersecretary for domestic finance under Summers (and former Goldman partner), became head of the CFTC; Mary Schapiro, first head of the CFTC under Clinton and later head of the Financial Industry Regulatory Authority, the financial industry's chief *self-regulatory* body, became head of the SEC; Neal Wolin, treasury deputy counsel and general counsel under Rubin and Summers, became deputy treasury secretary; Michael Barr, special assistant and deputy assistant secretary in the Rubin Treasury, became assistant secretary for financial institutions; Jason Furman, director of the Hamilton Project after Orszag, became deputy director of the NEC; and David Lipton, treasury undersecretary for international affairs during the Asian financial crisis and later Citigroup executive, also became one of Summers's deputies at the NEC. Even President Obama's chief of staff, Rahm Emanuel, had a similar background, having worked both as a Clinton adviser and as an investment banker at Wasserstein Perella.

Geithner's counselors as treasury secretary included Lee Sachs from the Clinton Treasury (and most recently a New York hedge fund) and Gene Sperling, Rubin's successor as director of the NEC (and most recently a highly paid adviser to a Goldman Sachs philanthropic project). The new blood that did not come from the Clinton establishment came largely from Wall Street. Mark Patterson, Goldman Sachs's chief lobbyist, became Geithner's chief of staff; Geithner's counselors also included Lewis Alexander, chief economist at Citigroup, and Matthew Kabaker from the Blackstone Group.[87] Assistant secretary for financial stability Herbert Allison was president of Merrill Lynch before heading TIAA-CREF (an asset manager) and Fannie Mae. Meanwhile, at the New York Fed, the board of directors picked William Dudley, a Goldman partner and then one of Geithner's lieutenants, to replace Geithner as president.

There is nothing sinister about the appointment of so many veterans of the Rubin Treasury; according to usual Washington practice, Obama and his lieutenants were calling on people who had gained experience in the previous Democratic administration.[88] And the fact that people worked under Rubin does not mean that they automatically sided with Wall Street on every issue. Some of them spent 2009 fighting for policies that were not friendly to Wall Street. Michael Barr, for example, was a strong advocate for a new Consumer Financial Protection Agency (CFPA), and Gary Gensler worked to plug loopholes in financial regulation bills as they worked their way through Congress.[89] But the economic brain trust was largely shaped in two complementary environments: Wall Street and the Rubin Treasury. And while the Obama administration did not close ranks with the major banks, it also does not seem to have strongly considered policies that seriously threatened the power and profits of the major banks (with the possible exception of the CFPA).

The administration also included Democratic economists from outside the Wall Street–Washington corridor, but they were outnumbered and generally (though not always) placed in less central positions. Respected academic macroeconomist Christina Romer became chair of the Council of Economic Advisers; Alan Krueger, an economics professor who served in the Labor Department under Robert Reich, became a treasury assistant secretary; Jared Bernstein became chief economic adviser to Vice President Joseph Biden; and Goolsbee became director of the President's Economic Recovery Advisory Board, a new organization that failed to gain any real influence. Even Paul Volcker, perhaps the most respected Democratic economist available, who endorsed Obama back in January 2008 when most of the establishment was backing Hillary Clinton, became chair of the Economic Recovery Advisory Board and seemed to fade from sight; in October 2009, responding to reports that his influence was fading, Volcker said, "I did not have influence to start with."[90]

Not only did key policymakers have long-standing ties to Wall Street, but during the crisis they gave tremendous access to their Wall Street contacts. In his first seven months in office, Geithner's calendar shows more than eighty contacts with Goldman CEO Lloyd Blankfein, JPMorgan CEO Jamie Dimon, Citigroup CEO Vikram Pandit, or Citigroup chairman Richard Parsons.[91] While it is necessary for the treasury secretary to talk to Wall Street executives during a financial crisis, he had more contacts with Blankfein than with Senate Banking Committee chair Christopher Dodd and more contacts with Citigroup

than with House Financial Services Committee chair Barney Frank. (This was a far cry from the tone of the Roosevelt administration in 1933, of which Arthur Schlesinger wrote, "When one remembered both the premium bankers put on inside information and the chumminess they had enjoyed with past Presidents and Secretaries of the Treasury, the new chill in Washington was the cruelest of punishments.")[92] In a world where access is a prerequisite for influence, Wall Street had access to the people who mattered, when it mattered.

As a result, economic policy in 2009, just as in 2008, was set by a group of people who, despite their considerable intelligence, experience, and integrity, seemed to believe that the banks were fundamentally sound and only needed an injection of confidence; that each subsidy to the banking sector was justified because the costs of not making the subsidy would be worse; that government takeover of major banks was so anathema to the American way that it would trigger panic; that meaningful constraints on banks' activities would inhibit economic growth; and that meaningful constraints on bankers' compensation would send them fleeing to unregulated hedge funds or overseas, leaving the American economy to suffer as a result. But this is not surprising, because everybody believed all these things—everybody, that is, in the New York and Washington elite. Over thirty years, Wall Street had plied Washington with tantalizing tales of financial innovation and efficient markets while pouring rivers of money into politicians' campaign funds and lobbyists' expense accounts. In 2008 and 2009, it all paid off.

As Michael Lewis put it in 2009,

> It does feel a lot to me like the process has been queered by political influence, and it's a very curious kind of political influence. Because it isn't maybe always as simple as bribery, campaign contributions, and that kind of thing. I think that we've had twenty-five years of the Goldman Sachses of the world ruling the world, and the people like Tim Geithner, when they leave office, the way they make their living … is to go to work for a financial institution for huge sums of money; that people have trouble getting their mind around a world where that's not the way the world works, and there is maybe a slight quickness to believe that the world can't function without Goldman Sachs.[93]

Can it?

* All nine banks were also represented at the March 27, 2009, meeting discussed in the Introduction, except for Merrill Lynch, which was acquired by Bank of America in the interim.

* Only if the bank failed to pay its dividends six times would the government have the right to elect directors.

* The discount rate is the rate at which banks may borrow money directly from the Federal Reserve; the federal funds rate is the rate at which banks borrow money from each other overnight.

* The junior tranches of a CDO bore the first losses from the entire pool of mortgages or mortgage-backed securities that went into the CDO, so a default rate of only 6 percent could render an entire tranche of CDO securities worthless. Although securitization spread risk among many investors, it also concentrated risk into the junior tranches.

† A bank's balance sheet is supposed to record what its assets are worth; a write-down is a reduction in the recorded value of an asset. In practice, the rules on what values to use for assets can vary depending on many factors. Only some assets need to be "marked to market," meaning that their values should be adjusted to current market prices.

* AIG's derivatives contracts gave its counterparties the right to demand collateral to protect them against the possibility that AIG might not be able to honor those contracts. The amount of collateral the counterparties could demand went up as AIG's credit rating went down.

* In the case of General Motors, the government used its power as the only source of financing to force out CEO Rick Wagoner and to dictate "haircuts" for creditors—steps it did not take with any major commercial or investment bank.

* Commercial banks could record some assets on their balance sheets at high "book values" even if they could not actually sell them at those prices. So on paper, banks remained solvent—their assets exceeded their liabilities, whether or not they could actually sell the assets for enough to cover the liabilities. Selling assets would force banks to recognize their losses; not selling them allowed them to pretend that the assets had not deteriorated in value.

* Goldman Sachs insisted that it received no net benefit from the money it received from AIG, because it was fully hedged, primarily via credit default swaps on AIG itself; this claim has been disputed.[35]

† Maiden Lane II was the vehicle for a separate component of the AIG bailout.

‡ The purpose of the transaction was to limit AIG's potential losses. With the credit default swaps outstanding, it could have been liable for the full face value of the CDOs. After the credit default swaps were retired, the remaining risk in the CDOs was held by Maiden Lane III; AIG's losses on Maiden Lane III were limited to its contribution of $5 billion, with any further losses being taken by the New York Fed.

* The stress tests included eleven of the thirteen banks present at the March 27, 2009, meeting at the White House: American Express, Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan

Stanley, PNC, State Street, US Bank, and Wells Fargo (Freddie Mac and Northern Trust were omitted). The other eight institutions subjected to the tests were BB&T, Capital One, Fifth Third, GMAC, KeyCorp, MetLife, Regions Bank, and SunTrust.

* If a trader wants to exit a large position quickly, he is at the mercy of the people he is trading with, who can essentially name their price. An e-mail from one trader, published by the blog *Zero Hedge,* included this excerpt: "During Jan/Feb AIG would call up and just ask for complete unwind prices from the credit desk in the relevant jurisdiction. These were not single deal unwinds as are typically more price transparent—these were whole portfolio unwinds. The size of these unwinds were [*sic*] enormous, the quotes I have heard were 'we have never done as big or as profitable trades—ever.' "[66]

7
THE AMERICAN OLIGARCHY

Six Banks

> What all this amounts to is an unintended and unanticipated extension of the official "safety net." … The obvious danger is that with the passage of time, risk-taking will be encouraged and efforts at prudential restraint will be resisted. Ultimately, the possibility of further crises—even greater crises—will increase.
>
> —Paul Volcker, September 24, 2009[1]

> If they're too big to fail, they're too big.
>
> —Alan Greenspan, October 15, 2009[2]

Between 1985 and 1992, over 2,000 banks failed in the savings and loan crisis, a consequence of deregulation, mismanagement, and fraud. Those S&Ls had been largely overseen by the Federal Home Loan Bank Board, which had failed to shut down struggling thrifts early in the 1980s, instead hoping that they could grow into solvency by expanding into more profitable (and riskier) businesses.[3] In response, Congress passed the Financial Institutions Reform, Recovery, and Enhancement Act of 1989. Among other things, it abolished the Federal Home Loan Bank Board and replaced it with the Office of Thrift Supervision (OTS). On August 9, 1989, President George H. W. Bush signed the bill, saying, "This legislation will safeguard and stabilize America's financial system and put in place permanent reforms so these problems will never happen again."[4]

NPR correspondent Chana Joffe-Walt tells the story:

> I talked to several people who worked for that predecessor agency, the Bank Board, and they describe that on that day, the day the OTS was created, they left the office, these agency employees, and they walked across the street to a hotel. They turned on the TV, and they sat and watched the first President Bush stand up at a podium and declare, "Never again will America allow any insured institution [to] operate without enough money." And then the agency employees watched as the President trashed their agency. The press conference ended, they turned off the TV, left the hotel, crossed the street, and went back to work. Pretty soon someone came by and changed the sign: The Office of Thrift Supervision.[5]

This, of course, is the same Office of Thrift Supervision that would be responsible for American International Group, Countrywide, and Washington Mutual in the 2000s.

At this crucial juncture in our history, as America emerges from a deep recession into an uncertain economic future, and in the wake of an epochal bailout of our largest banks, we must reform the financial system that made possible the financial and economic crisis that cost millions of people their jobs and added trillions of dollars to the national debt. The last few years have proven that our financial sector and its political influence are a serious risk to our economic well-being, and without significant change there is no reason to believe we will not soon experience the next boom, the next bust, and the next president explaining to the American people that he must rescue Wall Street in order to save Main Street. And significant change will require addressing the disproportionate wealth and power of a handful of large banks at the pinnacle of the financial sector.

Simply asking bankers to behave differently will not work; the solution can only come by changing the rules of the financial system, which requires government action. Five days after President Obama's election, his chief of staff, Rahm Emanuel, said, "Rule one: Never allow a crisis to go to waste. They are opportunities to do big things."[6] But more than a year after the collapse of Lehman Brothers, even relatively moderate legislation to reform the financial sector was still stuck in Congress.

The Obama administration attempted to show that it was serious about change. "The industry needs to show that they get it on the compensation issue," Obama said at the March 27, 2009, White House meeting discussed in the Introduction. "Excess is out of fashion." (According to *The New York Times,* "The bankers nodded, but made no firm commitments.")[7]

On June 17, 2009, President Obama unveiled what he called "a sweeping overhaul of the financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression."[8] He proposed stricter oversight of financial institutions, new regulations for securitization and over-the-counter derivatives, increased consumer protections, and new government powers to cope with a crisis.[9] Three months later, standing in the heart of the Manhattan financial district, Obama promised:

> We will not go back to the days of reckless behavior and unchecked excess that was at the heart of this crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses.… [T]he old ways that led to this crisis cannot stand. And the extent that some have so readily returned to them underscores the need for change and change now.

History cannot be allowed to repeat itself.[10]

But despite the president's lofty language, many of his proposals represented only incremental reform. They did little to address the problem at the heart of the financial system: the enormous growth of top-tier financial institutions and the corresponding increase in their economic and political power. In place of bold measures, the administration preferred technical solutions (increased capital and liquidity requirements for large banks), regulatory deck-chair-shuffling (merging the oversight functions of the OCC and the OTS in a new National Bank Supervisor), or marginally strengthened corporate governance (nonbinding shareholder votes on executive compensation packages).[11] *The New York Times'* Joe Nocera called the Obama plan "little more than an attempt to stick some new regulatory fingers into a very leaky financial dam rather than rebuild the dam itself."[12]

Nonetheless, Wall Street fought tooth and nail to block new regulation and preserve the favorable environment that emerged after the government rescue of 2008–2009, with less competition, a strengthened government guarantee, and no new restrictions on the pursuit of profits. As of October 2009, 1,537 lobbyists representing financial institutions, other businesses, and industry groups had registered to work on financial regulation proposals before Congress—outnumbering by twenty-five to one the lobbyists representing consumer groups, unions, and other supporters of stronger regulation. Even Citigroup, 34 percent owned by the government, hired forty-six lobbyists of its own. In the first nine months of 2009, the industry spent $344 million on lobbying. Senior Obama adviser David Axelrod observed, "You would hope after American taxpayers stepped in to save these companies from a disaster of their own making they would be deploying their army of lobbyists to strengthen and not thwart financial reform," but that was far from the case.[13] Instead, in the words of one congressional staffer, the industry launched "an orchestrated, well-funded effort by the banks to manipulate our legislation and leave no fingerprints."[14]

For example, the regulatory bill introduced in the House Financial Services Committee initially exempted a wide range of derivatives trades by nonfinancial companies from the new requirements proposed by the administration.[15] Michael Greenberger, a veteran of the Commodity Futures Trading Commission, claimed that the draft legislation "had to be written by someone inside the banks, because buried every few pages is a tricky and devilish 'exception.' It would greatly surprise me if these poison pills originated from anyone on Capitol Hill or the Treasury." Journalist William Greider reached the same conclusion after talking to a congressional insider.[16] Although the exemption was subsequently narrowed, this example demonstrates the ability of Wall Street to take advantage of technical complexity to advance its interests.

Wall Street also benefited from the administration's decision to defer actual reform until after the crisis had ebbed—despite Emanuel's "rule one." In part because of the debate over health insurance reform, financial regulation did not receive serious public consideration until fall 2009—after the economy had started growing again, the banking sector had returned to profitability, and months of Republican attacks had reduced Obama's approval ratings and increased skepticism about government action of any kind. By the time battle was joined, both Wall Street and Washington were back to business as usual.

DISMANTLING THE WALL STREET MODEL

For Wall Street's megabanks, business as usual now means inventing tradable, high-margin products; using their market power to capture fees based on trading volume; taking advantage of their privileged market position to place bets in their proprietary trading accounts; and borrowing as much money as possible (in part by engineering their way around capital requirements) to maximize their profits. Before 2008, they benefited from the general expectation that the government would step in if necessary to prevent a catastrophic failure. That expectation did not save Lehman Brothers. But since then, the idea that certain banks are "too big to fail" has virtually become government policy; as a result, they can take on more risk than their competitors, since creditors and counterparties know that the government will clean up after them.

Subprime lending, mortgage-backed securities, collateralized debt obligations (CDOs), and credit default swaps all flowed naturally from this business model, and absent fundamental reform, there is no reason to believe bankers will refrain from inventing new toxic products and precipitating another crisis in the future. What's more, given the growth in the size of the leading banks, the next crisis is likely to be even bigger. As *The Financial Times*' Martin Wolf wrote in September 2009, "What is emerging is a slightly better capitalised financial sector, but one even more concentrated and benefiting from explicit state guarantees. This is not progress: it has to mean still more and bigger crises in the years ahead."[17]

When the next crisis comes, either the government will ride to the rescue once again, costing taxpayers hundreds of billions of dollars, or popular revulsion at bailing out megabanks yet again will prevent Congress and the administration from saving the financial system—with potentially disastrous economic consequences.

The time for change is now. While the crisis was largely wasted in the short term, we have more than a single session of Congress or a single presidential term to fix our financial system. After the Panic of 1907, six years passed before the Federal Reserve was created, and it took another two decades (and the Great Depression) to put the financial system on a sound footing.

Public anger at Wall Street remains high. In an October 2009 poll, only 7 percent of respondents thought that major financial institutions were doing a good job at avoiding another crisis, 75 percent thought that Wall Street would "return to business as usual," 58 percent thought Wall Street had too much influence over government policy, and 59 percent favored more government regulation.[18] But that anger remains diffuse, in part because it is spread across the political spectrum, shared by progressives and conservatives who disagree on the solution. Financial regulation remains a complex topic that many people, including Washington insiders, think should be left to the experts—most of whom were formed on Wall Street or in the Wall Street–friendly climate of the past few decades. Real change will take years, and it will only happen when the conventional wisdom in Washington changes—from the idea that financial innovation and free financial markets are necessarily good, to the idea that concentrated economic and political power can have devastating effects on society.

There are many regulatory policies that could be beneficial, and some of them are included in the various proposals put forward by the Obama administration. But effective reform must address the two basic elements that created the last crisis and, absent change, will create the next one. The first is reckless borrowing and lending, which create a debt bubble that must eventually burst; the second is financial institutions that are so big or systemically important that, when the bubble bursts, they must be bailed out by the government to prevent economic disaster. The first objective should be to protect individual participants in the real economy, both households and businesses, from the potentially abusive behavior of powerful banks. But this is not sufficient to ward off a future crisis, since banks are free to load up on risky assets overseas, out of reach of U.S. protections. Therefore, the second and most important objective must be to protect the economy as a whole from the systemic risk created by enormous banks. Excess optimism, debt bubbles, and overextended banks will likely be with us forever; our goal must be a financial system where those banks can fail without being able to hold up the entire economy.

“RIPPING THE FACE OFF” THE CUSTOMER

Basic microeconomic models assume that the world is made up of rational actors who make accurate decisions, based on perfect information, to maximize their expected utility (benefits to themselves). Given these assumptions, regulation is unnecessary because parties will only engage in transactions that are good for them.

Because lawmakers have long recognized that information available in the market may not be perfect, the consumer protection regime that existed prior to the financial crisis was based on *disclosure*. The Securities Act of 1933 and the Securities Exchange Act of 1934 require companies that sell securities to the public to disclose material information in periodic reports. The Truth in Lending Act of 1968 requires lenders to disclose loan information in standardized form, such as the annual percentage rate, in order to facilitate comparison by borrowers. However, in both cases the legislation does not attempt to determine whether a given financial product is harmful to the consumer; that is left to the market. This is why, for example, there have been no interest rate caps for first mortgages since the Depository Institutions Deregulation and Monetary Control Act of 1980.

The recent financial crisis has exposed the danger of relying on markets to protect consumers. Exotic subprime loans with artificially low initial payments became a vehicle for mortgage brokers to get families into houses they had no realistic hope of affording. While some homebuyers may have consciously used these mortgages to speculate on housing prices, mortgage brokers and lenders also pushed borrowers into unnecessarily high-cost loans. The Center for Responsible Lending found that subprime borrowers ended up paying the equivalent of 1.3 percentage points of interest more for loans obtained through mortgage brokers than they would have paid borrowing directly from a retail lender.[19] The city of Baltimore sued Wells Fargo, alleging that the company systematically targeted minority borrowers through such policies as offering bonuses for steering borrowers who would have qualified for prime loans into subprime loans instead.[20] According to Shaun Donovan, secretary of housing and urban development, 33 percent of subprime mortgages in New York City went to borrowers who could have qualified for conventional loans.[21] These examples demonstrate that unscrupulous brokers and lenders, armed with dense fine print, can induce consumers to choose products that are not in their best interest.

Subprime loans are hardly the only example of the market’s inability to prevent malfeasance. In 2005, the Federal Reserve ruled that overdraft “protection” is not covered by the Truth in Lending Act, allowing banks to charge overdraft fees without their customers’ permission and without disclosing the effective interest rate (although the existence of the programs is typically included in fine-print disclosure statements). In 2009, banks were expected to earn $27 billion in overdraft fees—amounting, on average, to a $34 fee for a $20 transaction.[22] Credit card issuers have also become increasingly adept at maximizing revenues by adopting complex pricing structures that are hard for consumers to understand. For example, universal cross-default provisions (failing to pay one bill to a different company can count as a “default” on your credit card bill) can cause your interest rate to jump up to the “penalty” rate—even retroactively, thanks to two-cycle billing.[23] Universal cross-default and two-cycle billing policies are included in the disclosure statements that card issuers slip into monthly bills, but are often difficult to understand.

Even those who do read the fine print often fail to understand the impact it will have on them individually, due to cognitive biases that lead people to underestimate their usage of credit and the price of credit. For example, 58 percent of people say that they usually pay off their credit cards each month—but only 37–42 percent actually do.[24] The result is that people take on more debt than they intend to and pay a higher price for it than they realize. These errors are by no means confined to low-income, supposedly less sophisticated consumers. The reverse convertibles discussed in chapter 4 were largely sold to relatively affluent investors, for the simple reason that complex financial products have to be sold (few people wake up in the morning suddenly wanting to buy complex structured notes), and larger transactions translate into larger commissions. And the harm caused by deceptive pricing structures goes beyond damage to individual consumers. When it is difficult to assess the likely cost of financial products, even a competitive market does not lead to lower prices for everyone; instead, financial institutions compete by thinking of new tricks to ensnare consumers, and those that refuse to take advantage of their customers lose market share.

Ultimately, simple microeconomic models break down for a few basic reasons. First, innovation leads to financial products that are too complex for even an intelligent, financially savvy person to understand. As former Federal Reserve governor Edward Gramlich wrote of subprime lending, “[I]t is complicated and confusing for borrowers to search out all their available options, to understand all the terms of the loans, and to avoid getting misallocated into a lower credit category than may be appropriate.”[25] Second, people are not rational actors, and financial institutions are more than willing to prey on this weakness. A simple cognitive fallacy such as optimism bias—the tendency to think that you won’t miss a payment on your credit card or overdraw your checking account—causes people to choose financial products that are bad for them. As Shailesh Mehta, former CEO of Providian, said in an interview, “When people make the buying decision, they don’t look at the penalty fees, because they never believe they’ll be late. They never believe they’ll be over limit.”[26] Third, the negotiating table is

tilted in favor of financial services providers, not consumers. Individuals have no ability to negotiate the terms of their mortgages or their credit cards. And the people that they turn to for help with these confusing products, such as mortgage brokers, do not necessarily have their best interests in mind.

These problems were exacerbated by the regulatory structure in place prior to the financial crisis. Enforcement of consumer protection statutes was entrusted to the Federal Reserve, whose priorities have historically been managing the overall economy and ensuring the soundness of bank holding companies. Banks were also subject to various federal bank regulators—the OCC, the OTS, and the Federal Deposit Insurance Corporation—but their primary mission was to prevent banks from failing, not to protect consumers. The patchwork nature of financial regulation, particularly the limited oversight of nonbank lenders, made it possible for financial institutions to engage in their most questionable practices through their least regulated subsidiaries. And with regulators competing for fees from the banks they regulated, consumers' interests were often an afterthought.

The need for stronger consumer protection in the financial arena motivated law professor Elizabeth Warren's 2007 article "Unsafe at Any Rate." Warren began:

> It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance an existing home with a mortgage that has the same one-in-five chance of putting the family out on the street—and the mortgage won't even carry a disclosure of that fact to the homeowner.[27]

Warren called for the creation of a Financial Product Safety Commission, modeled on the Consumer Product Safety Commission, with the power not only to establish disclosure requirements but also to study financial products, review them for safety, and require that dangerous products be modified before being made available to the public.

In 2009, Warren's idea became the Obama administration's proposed Consumer Financial Protection Agency. In its original form, the CFPA would have jurisdiction over almost any financial product sold to individuals, and would have the power to regulate "unfair, deceptive, or abusive acts or practices for all credit, savings, and payment products," including the ability to ban specific practices such as prepayment penalties or yield-spread premiums (the practice of paying mortgage originators higher commissions for generating higher-cost mortgages). The CFPA would also be able to demand that financial service providers offer "plain-vanilla" versions of products, such as a thirty-year fixed rate mortgage, alongside whatever more complicated products they chose, so that consumers could buy a product that they knew was free of hidden traps.[28]

The banking lobby and its defenders closed ranks against the CFPA. Peter Wallison of the American Enterprise Institute claimed that some consumers would be "denied the opportunity to buy products and services that are available to others," restating the textbook assumption that free choice is always good and restrictions on choice are always bad—but neglecting to ask whether meaningful choice exists when it comes to complicated products offered by a handful of oligopolists, such as credit cards.[29] Small community savings banks joined forces with Wall Street, fearful that new regulations would increase their cost of doing business.[30] The incumbent regulators also took a united stand against ceding any authority to a new agency, with Ben Bernanke of the Federal Reserve, John Dugan of the OCC, and Sheila Bair of the FDIC all taking aim at the CFPA before Congress.[31]

The full-court lobbying press had an impact. In September 2009, in order to improve the bill's chances of passage, Barney Frank, the chair of the House Financial Services Committee, eliminated the proposed "plain-vanilla" requirement.[32] (The version of the CFPA proposed in November by Christopher Dodd, chair of the Senate Banking Committee, also left out this requirement.) Small banks also won an exemption in the House from direct examination by the CFPA under most circumstances. But despite the best efforts of the financial sector, the CFPA did emerge intact from the House of Representatives in December 2009. In this case, the Obama administration was willing to confront the banking industry head-on, and Frank was willing to use enough muscle to push it through. The bill introduced by Dodd also includes an independent CFPA, but the sixty-vote threshold in the Senate (to defeat a filibuster) and the apparently unified opposition of the Republican Party's forty-one senators could mean that the banking lobby will still get its way. The large banks' grip on Congress has weakened a little, but perhaps not enough.

By consolidating regulatory authority in an agency that is dedicated to consumer protection, the CFPA would have the potential to deter some of the abusive practices that resulted in families losing their homes and fueled the debt bubble of the 2000s. Even if it does become law, however, the CFPA would still face significant obstacles. At the urging of business groups, both the House and Senate versions of the legislation exempted many businesses that provide credit to their customers, such as auto dealers, and even the administration's original proposal exempted insurance products. These gaps provide opportunities for financial institutions to dodge regulation by redefining their products to fit existing loopholes.

In addition, a consumer protection agency cannot prevent all predatory behavior by financial institutions. The unwitting losers in the financial crisis included many municipalities, pension funds, and other supposedly sophisticated investors who did not understand the products they were buying from their bankers. On the advice of their investment bank, Stifel Nicolaus, five Wisconsin school districts invested $200 million—$165 million of it borrowed from Depfa, an Irish bank—in what they (and their Stifel Nicolaus banker) thought were CDOs. In fact, their $200 million was the collateral for a synthetic CDO,

meaning that the school districts were selling insurance on a portfolio of bonds. When the bonds began defaulting, the school districts ended up losing their $35 million and unable to pay off their loan from Depfa. As financial expert Janet Tavakoli said, "Selling these products to municipalities was pretty widespread. They tend to be less sophisticated. So bankers sell them products stuffed with junk."[33] While businesses, local governments, and institutional investors may not require the same protections as consumers, it is foolish to assume that they will always be able to protect themselves from toxic financial products.

Despite these reservations, a strong, motivated, independent Consumer Financial Protection Agency would serve as a powerful constraint on the ability of financial institutions to take advantage of their customers, discouraging innovations that do not benefit customers and channeling competition into innovations that reduce costs or create new services. The CFPA should also serve as a counterweight within the government to a set of regulatory agencies that have historically seen the world from the perspective of the banks they regulate rather than the customers served by those banks.

However, consumer lending is only one means by which financial institutions can mine the raw material needed for securitization and structured finance. There will always be an unregulated frontier, within our borders or outside them, where banks can place large bets with the potential to go spectacularly badly. A new agency also cannot reverse the political momentum of the last thirty years and dislodge Wall Street from its position of power in Washington. That will require stronger medicine.

TOO BIG TO EXIST

"Too big to fail" was the slogan of the financial crisis. It was the justification for bailing out Fannie Mae, Freddie Mac, AIG, Citigroup, and Bank of America (and, extended into the auto industry, General Motors, Chrysler, and GMAC as well). It was the problem that administration officials and congressmen swore they would fix; even bank CEOs agreed, including Jamie Dimon of JPMorgan Chase, who wrote, "The term 'too big to fail' must be excised from our vocabulary."[34] The phrase has been around at least since the 1984 government rescue of Continental Illinois, and was the subject of a 2004 book by the president and vice president of the Federal Reserve Bank of Minneapolis.[35] But only in 2008 did it become a pillar of government policy.

Most observers of the financial crisis agree on the basic outlines of the "too big to fail" (TBTF) problem. Certain financial institutions are so big, or so interconnected, or otherwise so important to the financial system that they cannot be allowed to go into an uncontrolled bankruptcy; defaulting on their obligations will create significant losses for other financial institutions, at a minimum sowing chaos in the markets and potentially triggering a domino effect that causes the entire system to come crashing down. The bankruptcy of Lehman Brothers in September 2008 accelerated the collapse of American International Group, forcing it into the arms of the Federal Reserve; Lehman's failure also forced the Reserve Primary Fund to "break the buck," causing a sudden loss of confidence in all money market funds; in turn the flood of money out of money market funds caused the commercial paper market to freeze, endangering the ability of many corporations to operate on a day-to-day basis. The failure of Lehman also caused large cash outflows from the remaining stand-alone investment banks, Goldman Sachs and Morgan Stanley. The sequence of falling dominoes was only stopped by massive government rescue measures, and the panic that occurred despite the government's intervention helped transform a mild recession into the most severe recession of the postwar period.

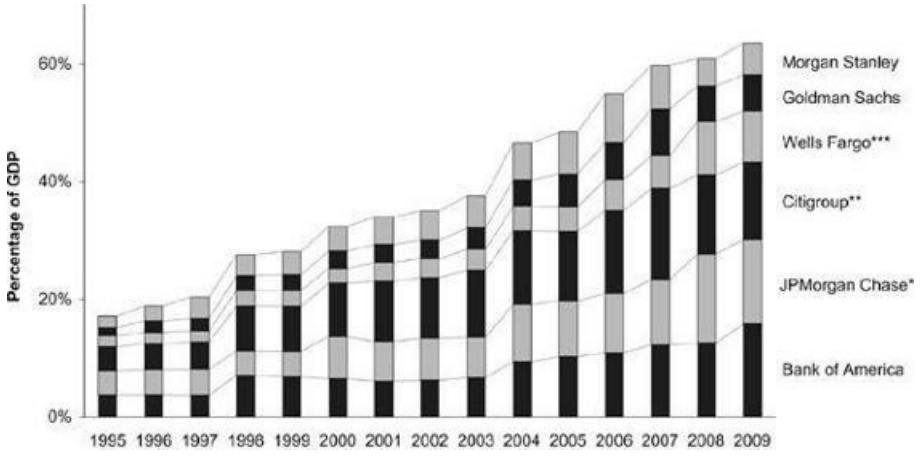
What makes a financial institution too big to fail is the amount of collateral damage that its uncontrolled failure could cause. This damage can take several different forms. If a bank defaults on its debt, other institutions holding its debt will lose money, as happened to the Reserve Primary Fund. Although financial institutions generally attempt to avoid holding too much debt from a single issuer for precisely this reason, the problem is magnified by derivatives. Since credit default swaps allow any company to insure any amount of debt issued by any other company, a bank default can cause losses that exceed its actual debt.

Another problem is that a failing institution could have thousands of open transactions with its counterparties, which are largely other financial institutions. (At the time of its collapse, the face value of AIG's open derivatives contracts was $2.7 trillion—$1 trillion of it with only twelve financial institutions.)[36] For example, a failing bank might have sold credit default swap protection on various securities; its counterparties are assuming that they are perfectly hedged because of those swaps. But when the bank fails, suddenly those hedges vanish, and the counterparties have to take large losses on the underlying securities.* These open transactions can take an almost infinite number of forms; in the modern financial world, any financial institution's position at the end of any given day depends on its counterparties being in business the next day.

Finally, the failure of one bank can cause investors or counterparties to lose confidence in another, similar bank. Because all banks borrow short and lend long, a loss of confidence can kill even a bank that is healthy on paper. After Bear Stearns was sold to JPMorgan Chase in March 2008, all eyes turned to Lehman Brothers; after Lehman failed in September, lack of confidence in Morgan Stanley almost brought it down, and Goldman Sachs was assumed to be next in line.[37] (Merrill Lynch avoided becoming a domino only by selling itself to Bank of America as Lehman collapsed.)

For these reasons, many people have said that the real problem is not the size of a bank (conventionally measured by the total value of its assets), but its interconnectedness.[38] But whatever the term—"too big to fail," "too interconnected to fail," "systemically important" (preferred by Ben Bernanke),[39] "tier 1 financial holding company" (preferred by the Treasury Department)[40]—the fact remains that certain financial institutions cast a sufficiently large shadow over the financial system that they cannot be allowed to fail. As of early 2010, there are at least six banks that are too big to fail—Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo (Figure 7-1)—even leaving aside other institutions such as insurance companies.

Figure 7-1: Growth of Six Big Banks



* Chase Manhattan through 1999
** Travelers through 1997
*** First Union through 2000; Wachovia 2001–2007
Source: Company annual and quarterly reports. 2009 is at end of Q3.

Not only is there widespread agreement that several financial institutions are too big to fail, but there is also widespread agreement that this is not good for the financial system or for the economy as a whole. "Too big to fail" creates three major problems for society.

The first problem is that when TBTF institutions do come to the brink of failure, they have to be bailed out, and that usually means they have to be bailed out by the government (and by taxpayers). Even if the government were to decide to wipe out shareholders and replace management, it would still have to bail out the creditors who lent money to the failing bank, since the whole point of the rescue is to limit collateral damage to other financial institutions. A TBTF bank cannot be allowed to go into an ordinary bankruptcy procedure because its creditors and counterparties would be cut off from their money for months, which could be fatal. This means that the government must keep the failing bank afloat and, without a credible threat of bankruptcy to negotiate with, must honor all of the bank's obligations; in other words, the money the bank lost has to be made up with public funds. This was the case with the AIG bailout, where the government eventually committed $180 billion in various rescue packages to keep AIG alive and pay off its counterparties. This need to protect creditors means that even a government takeover (through an FDIC-style conservatorship) will still result in significant losses to taxpayers.

The second problem is that TBTF institutions have a strong incentive to take excess risk, since the government will bail them out in an emergency. All banks are highly leveraged institutions, which means that they are betting with other people's money. There are many strategies available to banks that increase returns for shareholders (and executives) while shifting potential losses onto someone else, such as increasing leverage and holding riskier assets. Ordinarily, creditors should refuse to lend money to a bank that takes on too much risk; but if creditors believe that the government will protect them against losses, they will not play this supervisory function. (This is similar to the decision made by foreign investors in emerging markets: it's always best to lend to the oligarchs, because they are the most likely to be bailed out by the government in a crisis.) There is of course some chance that top executives would lose their jobs in a bailout, but this is more than balanced by the increased upside they gain from taking on more risk. The result is that the largest banks have the most incentive to take risks, and to take risks that would make no economic sense without the government guarantee they get because they are too big to fail. As Larry Summers said in 2000, "It is certain that a healthy financial system cannot be built on the expectation of bailouts."[41]

This problem only gets worse over time. Each time a government bails out its banks, it says, "Never again," hoping to deter the banks from repeating their past sins. But as Piergiorgio Alessandri and Andrew Haldane of the Bank of England argue, this stance becomes less and less credible: "The ex-post costs of crisis mean such a statement lacks credibility. Knowing this, the rational response by market participants is to double their bets. This adds to the cost of future crises. And the larger these costs, the lower the credibility of 'never again' announcements. This is a doom loop."[42]

The third problem is that TBTF banks are bad for competition and therefore bad for the economy. Bond investors realize that megabanks have an implicit government guarantee, and therefore they are willing to lend them money at lower interest rates than their smaller competitors. This is why large banks could pay 0.78 percentage points less for money than small banks in the wake of the financial crisis, giving them a huge competitive advantage. Dean Baker and Travis McArthur calculate that this hidden subsidy was worth up to $34 billion for eighteen large banks in 2009, accounting for roughly half of their profits.[43] This subsidy makes it harder for smaller banks to compete, deterring new entrants and only strengthening the long-term process of consolidation and concentration in the financial sector.

Where people disagree is what to do about the problem. The Obama administration initially put its faith in various technical regulatory fixes. One is to increase regulatory supervision of systemically important financial institutions. Another is to give the government "resolution authority" over holding companies that are too big to fail, similar to the power the FDIC currently has to take over and clean up insolvent banks.[44] A third proposal is to increase capital requirements for large banks in an effort to make the most systemically dangerous institutions a little safer.[45] A fourth idea floated by the administration is requiring large banks to raise "contingent capital"—debt that, in the event of a crisis, converts into equity capital at a predetermined trigger point.* The legislation introduced in the House of Representatives and the Senate in fall 2009 largely followed the administration's incrementalist approach.

These regulatory fixes make sense on paper, and it would be better to enact most of them than to do nothing. Resolution authority over holding companies would have given Treasury and the Federal Reserve another option during the financial crisis—the option to take over insolvent institutions, fire management, wipe out shareholders, and impose haircuts on creditors. Some experts insist that the government could already have used its negotiating power to obtain a similar result,[46] but the proposed legislation would settle the question once and for all. The ability to impose some degree of pain on managers, shareholders, and creditors should have some deterrent effect on excessive risk-taking during a boom. (Contingent capital, however, might actually reduce the stability of the financial system, because reaching the conversion trigger point could itself cause a bank run; as *The Financial Times*' Gillian Tett has pointed out, these instruments are called "death spiral bonds" in Japan.)[47]

However, the belief that these regulatory refinements alone will solve the TBTF problem and prevent the next financial crisis reflects excessive faith in technocracy. Crises, by their nature, are difficult to predict with any degree of precision. The first problem with increased capital requirements or with contingent capital is estimating how much capital will be enough in the next crisis. Both Bear Stearns and Lehman had sufficient capital on paper—five days before its bankruptcy, Lehman had a Tier 1 capital ratio* of 11 percent[48]—yet were overwhelmed by market fears about their viability. A month after the Lehman bankruptcy, the settlement auction for Lehman credit default swaps valued Lehman debt at only 9 cents on the dollar—meaning that liquidating the firm's assets was only expected to yield 9 percent of the money needed to repay unsecured creditors.[49] How much *more* capital would have been needed to prevent panic or to keep creditors whole—and how much capital will our banks need next time? The truth is that no one knows. And it is highly likely that any increases in capital requirements will be modest. In November 2009, Morgan Stanley analysts predicted that new regulations would result in Tier 1 capital ratios of 7–11 percent for large banks—still below Lehman's pre-bankruptcy level.[50]

Resolution authority is also far from a magic bullet, especially in the global world of modern finance. Some of the most severe complications of the Lehman bankruptcy occurred not in the United States, but in other countries, each of which has its own laws for dealing with a failing financial institution. When a bank with assets in different countries fails, it is in each country's immediate interest to have the strictest rules on freezing assets to pay off domestic creditors. For a resolution process to have any chance of succeeding, it must be cross-border in scope; yet there are strong political reasons to believe that such an international agreement will be difficult or impossible to achieve—and that countries would be unlikely to comply with it in a serious financial crisis.

More important, solutions that depend on smarter, better regulatory supervision and corrective action ignore the political constraints on regulation and the political power of the large banks. The idea that we can simply regulate large banks more effectively assumes that regulators will have the incentive to do so, despite everything we know about regulatory capture and political constraints on regulation. It assumes that regulators will be able to identify the excess risks that banks are taking, overcome the banks' arguments that they have appropriate safety mechanisms in place, resist political pressure (from the administration and Congress) to leave the banks alone for the sake of the economy, and impose controversial corrective measures that will be too complicated to defend in public. And, of course, it assumes that important regulatory agencies will not fall into the hands of people like Alan Greenspan, who believed that government regulation was rendered largely unnecessary by the free market.

The technocratic approach assumes that political officials, up to and including the president, will have the backbone to crack down on large banks in the heat of a crisis while the banks and the administration's political opponents scream about socialism and the abuse of power. Under the administration's proposal, taking over a major bank would require a decision by the treasury secretary, consultation with the president, and the approval of two-thirds of the Federal Reserve Board of Governors,[51] which means that it would be a political decision of the first order. Even leaving aside the issue of direct pressure from bank executives who happen to be major political donors,[52] it would be politically difficult for any president to order a government takeover of an iconic American bank that was insisting through the media and its lobbyists that it was perfectly healthy. FDIC takeovers currently do not face this challenge because the banks involved are small and have little political power; the same cannot be said of JPMorgan Chase or Goldman Sachs.

Not only does the "better regulation" approach ignore the impact of politics, but it fails to solve the underlying problem—the existence of TBTF institutions. Even if the government were able to use resolution authority to take over a large bank, it is

virtually certain that taxpayer funds would be necessary to finance the takeover, because of both the size of the bank and the urgency of the situation.[53] Although the government might be able to impose small haircuts on creditors and counterparties, they would have to be small, since large losses would trigger the domino effect that has to be avoided at all costs, and taxpayers would be left bearing most of the losses. In short, this approach assumes that TBTF institutions must exist, and then attempts to deal with them as well as possible—and not very well at that.

The right solution is obvious: do not allow financial institutions to be too big to fail; break up the ones that are.

This is a controversial idea. It is a virtually unquestioned assumption in the American business world that bigger is better. Banking executives have spent the last twenty years making their banks as big as possible by entering new businesses, expanding into new geographic regions, and above all acquiring other banks. The idea that the United States, as the world's largest economy, should also have its largest banks seems self-evident to most people.

Not surprisingly, the CEOs of large banks are not in favor of having their empires divided. In *The Washington Post,* Jamie Dimon wrote, "While the strategy of artificial limits may sound simple, it would undermine the goals of economic stability, job creation and consumer service that lawmakers are trying to promote."[54] In an interview, Lloyd Blankfein of Goldman Sachs said, "Most of the activities we do, and you can be confused if you read the pop press, serve a real purpose. It wouldn't be better for the world or the financial system [to change the firm's activities]."[55]

The Obama administration agreed. Diana Farrell, a member of the National Economic Council, said in an interview, "We have created [our biggest banks], and we're sort of past that point, and I think that in some sense, the genie's out of the bottle and what we need to do is to manage them and to oversee them, as opposed to hark back to a time that we're unlikely to ever come back to or want to come back to."[56] Larry Summers said, "I don't think you can completely turn back the clock."[57]

Some economists and commentators recognized early on that breaking up the big banks was the only way to prevent a repeat of the financial crisis. Testifying before Congress in April 2009, Joseph Stiglitz said,

> We know that there will be pressures, over time, to soften any regulatory regime. We know that these too-large-to-fail banks also have enormous resources to lobby Congress to deregulate.… Accordingly, I think it would be far better to break up these too-big-to-fail institutions and strongly restrict the activities in which they can be engaged than to try to control them.[58]

The Wall Street–Washington establishment at first attempted to portray this as a naive idea supported only by outsiders who didn't understand the world of modern finance (even if some of them had won the Nobel Prize). However, cracks in the consensus began to appear in fall 2009. In testimony before Congress, Paul Volcker, the legendary Fed chair of the 1980s and an Obama administration adviser, said, "I would exclude from commercial banking institutions, which are potential beneficiaries of official (i.e., taxpayer) financial support, certain risky activities entirely suitable for our capital markets," including internal hedge funds, internal private equity funds, and proprietary trading.[59] In an October interview, he argued unequivocally for an updated version of the Glass-Steagall separation of commercial and investment banking. "People say I'm old-fashioned and banks can no longer be separated from nonbank activity," he said. "That argument brought us to where we are today."[60]

In October, Mervyn King, head of the Bank of England (the world's oldest central bank), gave a speech arguing for the separation of the "utility" aspects of banking—processing payments and transforming savings into investments—which should be offered government support, from riskier activities such as proprietary trading, which should not. A key element of his argument was that regulation would be insufficient to keep banks from taking on excessive risk: "The belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion."[61] A stronger version of King's position is *Financial Times* columnist John Kay's proposal for "narrow banking," which limits banks to taking deposits and processing payments and regulates them as utilities.[62] Similarly, economics professor Laurence Kotlikoff has argued for "limited purpose banking," a model in which banks are not allowed to borrow short and lend long, and all risky assets must be held in mutual funds.[63] In November, Richard Fisher, president of the Federal Reserve Bank of Dallas, argued for getting rid of banks that are too big to fail: "This means finding ways not to live with 'em and getting on with developing the least disruptive way to have them divest those parts of the 'franchise,' such as proprietary trading, that place the deposit and lending function at risk and otherwise present conflicts of interest."[64]

But the most surprising break with the conventional wisdom came from Alan Greenspan, who perhaps more than any other person had made the age of the megabanks possible. In an October speech, he said, "The critical problem that we have, which we've got to resolve, is the too-big-to-fail issue." Asked how to solve this problem, he responded,

> If they're too big to fail, they're too big. I—this one has got me. And the reason it's got me is that we no longer have

the capability of having credible government response which says, henceforth no institution will be supported because it is too big to fail.…

At a minimum, you've got to take care of the competitive advantage they have, because of the implicit subsidy, which makes them competitively capable of beating out their smaller competitors, who don't get the subsidy. And if you don't neutralize that, you're going to get a moribund group of obsolescent institutions, which will be a big drain on the savings of this society.…

I don't think merely raising the fees or capital on large institutions or taxing them is enough. I think that'll—they'll absorb that; they'll work with it; and they will still be inefficient; and they'll still be using the savings.

So I mean, radical things, as you—you know, break them up, you know. In 1911, we broke up Standard Oil. So what happened? The individual parts became more valuable than the whole. Maybe that's what we need.[65]

The reasons to break up the big banks are simple. If there are no financial institutions that are too big to fail, there will be no implicit subsidies favoring some banks as opposed to others; creditors and counterparties will play their necessary role of ensuring that banks do not take on too much risk; banks will be less likely to engage in the excessive risk-taking that could cause the next financial crisis; and banks that do fail will not have to be bailed out at taxpayer expense. Additional regulations preventing banks from abusing their customers or exploiting loopholes to minimize their capital requirements are also necessary, of course; we do not want to relive the savings and loan crisis of the 1980s, when thousands of banks failed due to excessive risk-taking and inadequate supervision. But breaking up the big banks will help level the playing field and make the financial system better able to withstand the next crisis.

Opponents argue that big banks provide benefits to the economy that cannot be provided by smaller banks. A common argument, put forward by Dimon, Scott Talbott of the Financial Services Roundtable, and finance professor Charles Calomiris, is that large corporations require financial services that only large banks can provide.[66] Related to this is the idea that the global competitiveness of U.S. corporations requires that American banks be at least as big as anyone else's banks. Another argument is that large financial institutions enjoy economies of scale and scope that make them more efficient, helping the economy as a whole. Finally, supporters argue that large, global banks are necessary to provide liquidity to far-flung capital markets, making them more efficient and benefiting companies that raise money in those markets.

These arguments suffer from a shortage of empirical evidence. Large multinational corporations have large, global financing needs, but there are currently no banks that can supply those needs alone; instead, corporations rely on syndicates of banks for major offerings of equity or debt. For example, Johnson & Johnson used eleven banks to manage its most recent debt offering in 2008 (and thirteen banks for the offering before that, in 2007).[67] And even if there were a bank large enough to meet all of a large corporation's financial needs, it would defy business logic for that corporation to restrict itself to a single source of financial services, instead of selecting banks based on their expertise in particular markets or geographies. In addition, U.S. corporations already benefit from competition between U.S. and foreign banks, which can provide identical financial products; there is no reason to believe that the global competitiveness of our nonfinancial sector depends on our having the world's largest banks.

There is little evidence that large banks gain economies of scale above a very low size threshold. A review of multiple empirical studies found that economies of scale vanish at some point below $10 billion in assets.[68] The 2007 Geneva Report, "International Financial Stability," co-authored by former Federal Reserve vice chair Roger Ferguson, also found that the unprecedented consolidation in the financial sector over the previous decade had led to no significant efficiency gains, no economies of scale beyond a low threshold, and no evident economies of scope.[69] Finance professor Edward Kane has pointed out that since large banks exhibit constant returns to scale (they are no more or less efficient as they grow larger), and we know that large banks enjoy a subsidy due to being too big to fail, "offsetting diseconomies must exist in the operation of large institutions"—that is, without the TBTF subsidy, large banks would actually be less efficient than midsize banks.[70] As evidence for economies of scope, Calomiris cited a paper by Kevin Stiroh showing that banks' productivity grew faster than the service sector average from 1991 to 1997, "during the heart of the merger wave."[71] However, the paper he cites, and other papers by Stiroh,[72] imply or argue that the main reason for increased productivity was improved use of information technology —not increasing size or scope.

There is an element of truth to the argument that large banks are necessary in certain types of trading businesses such as customized (over-the-counter) derivatives, where a corporate client may want a hedge that spans multiple markets (currencies, interest rates, and jet fuel, for example). To manufacture such a hedge cheaply, a derivatives dealer has to have significant trading volume in each of the underlying markets, which implies some minimum efficient scale. However, this alone cannot explain the enormous growth in leading investment banks over the last ten years. Goldman Sachs, for example, grew from $178 billion in assets in 1997 to over $1.1 trillion in 2007,[73] while Morgan Stanley grew from $302 billion to over $1.0 trillion.[74]

Despite the widespread assumption in both New York and Washington that big banks provide societal benefits, there is no proof that these benefits exist and no quantification of their size—certainly no quantification sufficient to show that they

outweigh the very obvious costs of having banks that are too big to fail. Instead, defenders of the status quo portray our current banking system, despite its obvious failures, as a fact of nature that must be accepted, and that at best we can hope to tame through better regulation—despite the unquestioned failure of regulation in the decades leading up to the financial crisis.

It seems likely that any financial reform legislation will largely conform to the Obama administration's approach of tightening regulation of large financial institutions without tackling the underlying problem: the existence of TBTF institutions. It is possible that new legislation will empower regulators to take corrective action against such firms. In the House of Representatives, an amendment introduced by Paul Kanjorski would give the proposed Financial Services Oversight Council the power to order a TBTF institution to cut back its activities or divest some of its assets.[75] The bill introduced by Christopher Dodd in the Senate similarly allowed the new Agency for Financial Stability and the new Financial Institutions Regulatory Administration to prune back institutions that pose a risk to overall financial stability.[76] Even if some version of this provision survives into the final bill, it will be hedged in by conditions; for example, in the Kanjorski Amendment, the treasury secretary must approve any action that would result in a divestiture of $10 billion in assets, and the president effectively must approve any divestiture of more than $100 billion in assets. More important, there will be no requirement for the regulators to take action. Given the political constraints, it is unlikely that these powers would actually be used to significantly reduce the size and riskiness of megabanks.

Whatever the final form of the legislation, the problem of too big to fail will probably remain with us. But this does not mean that it cannot be solved. It only means that it may take several years, and several sessions of Congress, to solve.

The solution must be economically simple, so it can be effectively enforced; the more complex the scheme, the more susceptible it is to regulatory arbitrage, such as reshuffling where assets are parked within a financial institution's holding company structure. And the solution must change the balance of political power, so it will last.

The simplest solution is a hard cap on size: no financial institution would be allowed to control or have an ownership interest in assets worth more than a fixed percentage of U.S. GDP.* Determining the exact percentage is a technical problem that we do not claim to have solved, but the problem can be simply stated: the percentage should be low enough that banks below that threshold can be allowed to fail without entailing serious risk to the financial system. As a first proposal, this limit should be *no more than 4 percent of GDP,* or roughly $570 billion in assets today. U.S. banks could choose to operate globally or only in the United States, but in either case the size limit would be set relative to the U.S. economy, and offshore activities would count toward the limit. (U.S. subsidiaries of foreign banks would also have to comply with the size cap and with all U.S. financial regulations.) Existing megabanks would have to break themselves up in a way that maximizes value to their shareholders; the resulting smaller institutions would be free to compete fiercely for customers and profits.

Hard limits on the size of financial institutions have a precedent. Since 1994, the United States has had a rule prohibiting any single bank from holding more than 10 percent of total retail deposits—an arbitrary cap designed to prevent any one entity from becoming too central to the financial system. This rule had to be waived in 2009 for JPMorgan Chase, Bank of America, and Wells Fargo, demonstrating how recent growth and consolidation have rendered our previous safety measures obsolete.[77]

An overall asset cap is a necessary condition for financial stability, but it is not a sufficient condition. The acute phase of the recent crisis was triggered not by mammoth commercial or savings banks, although some of them collapsed or nearly collapsed during the crisis, but by (modestly) smaller, risk-seeking investment banks; Bear Stearns had only $400 billion of assets at the end of 2007.[78] Because a financial institution could load up on $570 billion of the riskiest assets it can find, there must also be lower limits for banks that take greater risks, and these limits must take into account derivatives, off-balance-sheet positions, and other factors that increase the damage a failing institution could cause to other financial institutions. That way financial institutions that engage in riskier activities will have to be smaller than institutions that hold safer assets, in order to limit the collateral damage their failure could cause. This will require a technical formula that goes beyond the scope of this book,* but again the goal is simple: all banks, including risk-seeking ones, should be limited to a size where they do not threaten the stability of the financial system. As an initial guideline, an investment bank (such as Goldman Sachs) should be effectively limited in size to *2 percent of GDP,* or roughly $285 billion today. (If it were to choose a riskier mix of activities in the future, its effective maximum size would fall accordingly.)

Determining where to set these limits is a problem shared by all parties to this debate. Every proposed solution assumes that regulators have some way of identifying TBTF institutions so that they can take special precautions against them—which means that there must be a way of calculating the systemic importance of different institutions. If the problem is simply and clearly stated—establish limits such that no bank is too big or too important to fail—it can be solved by people with access to the right data about the financial system. These limits should not be set by regulatory agencies, which could then nudge them upward as memories of the crisis fade and faith in free markets returns. The limits should be set by Congress, with sufficient expert input, and then enforced by regulators.

To be clear, size limits should not replace existing financial regulations. A world with only small banks, but small banks with minimal capital requirements and no effective oversight, would not be dangerous in the same way as today's world of

megabanks, but it would be dangerous nonetheless; it was the collapse of thousands of small banks that helped bring on the Great Depression. More generally, it would be naive to assume that we can predict today all the ways that financial institutions will find to take on more risk and get into more trouble. Therefore, enhanced capital requirements and closer prudential regulation, as proposed by the Obama administration, are also necessary. Size limits, however, provide protection against both the systemic risk and the competitive distortions created by financial institutions that are too big to fail, which are not adequately addressed by existing regulations. We believe these limits should work out to no more than 4 percent of GDP for all banks and 2 percent of GDP for investment banks, but that is a debate we are willing to have.

Why 4 percent and 2 percent? The fundamental tradeoff is between safety and efficiency. A lower size limit makes the financial system safer, because it will be less vulnerable to the failure of a single bank or a handful of banks; however, draconian size limitations could introduce unintended consequences if, for example, investment banks are no longer able to maintain sufficient trading volume in global markets. Personally we would prefer even lower limits, for two main reasons. First, Bear Stearns had only $400 billion in assets—implying that, for a risk-loving investment bank, $285 billion may still be large enough to threaten the financial system. Second, lower limits would increase competition and reduce the potential political power of any single company.

However, we think that 4 percent and 2 percent present a reasonable compromise with people who believe that the real economy needs large banks. Members of the Obama administration, as described above, have said that it is impossible to "turn back the clock." A 4 percent cap would only roll back the clock to the mid-1990s. At that time, the largest commercial banks—Bank of America, Chase Manhattan, Citibank, NationsBank—each had assets roughly equivalent to 3–4 percent of U.S. GDP. On the investment banking side, Goldman Sachs and Morgan Stanley only passed the 2 percent threshold in 1997 and 1996, respectively; at the time, they were the two premier investment banks in the world, and no one thought they were unable to meet their clients' needs.[79]

On the one hand, it can be argued that the world has changed since the mid-1990s. But by how much? Thomas Philippon has estimated how much of the growth of the financial sector (measured by its share of GDP) can be explained by increasing demand for corporate financial services from the nonfinancial sector. His analysis shows that demand for finance around 2007, after a spike around 2000, was only 4 percent higher (as a share of GDP) than in the 1986–1995 period (while the corporate finance share of GDP had grown by 31 percent).[80] On the other hand, there is no reason why increased demand for finance can only be met by larger firms, rather than more firms. There is also no proof that the mid-1990s economy required commercial banks as large as 4 percent of GDP—which were already the product of what seemed then like blockbuster mergers—or investment banks as large as 2 percent of GDP.

Finally, these size limits would only affect *six banks*—Bank of America (16 percent of GDP), JPMorgan Chase (14 percent), Citigroup (13 percent), Wells Fargo (9 percent), Goldman Sachs (6 percent), and Morgan Stanley (5 percent) (and none of Wells Fargo's predecessor companies was bigger than 4 percent of GDP until a few years ago).[81] Saying that we cannot break up our largest banks is saying that our economic futures depend on these six companies (some of which are in various states of ill health). That thought should frighten us into action.

Some commentators worry that smaller banks would hurt the competitiveness of our financial system; a cap on the size of U.S. banks would lead our banks to relocate overseas and do nothing to prevent the growth of megabanks based in other countries. In an interview, law professor Hal Scott said, "If we break up our banks and Europe doesn't break up theirs and the Chinese don't break up theirs, this is going to have an immense impact on who are the players in the international banking system."[82] But this does not mean that American companies would be starved of capital. In a free market, financial intermediation is driven by real economic activity; smaller U.S. banks (and a bank with $500 billion in assets is by no means a small bank), or the U.S. subsidiaries of foreign banks, would step in to fill the gap. U.S. banks already face foreign competition in many financial markets; U.S. companies are perfectly happy buying their interest rate swaps from Deutsche Bank rather than JPMorgan, and the products work just as well.

The more serious issue is not that competition from foreign megabanks will hurt American nonfinancial companies (those foreign banks will be competing *for* the business of U.S. companies), but that foreign megabanks will continue to pose a risk to the global financial system. The ideal solution would be for all major countries to implement similar limits on bank size. One avenue for international coordination could be the World Trade Organization; any government that tolerates domestic banks that are too big to fail is subsidizing them (by allowing them to borrow money more cheaply than foreign competitors that do not have implicit government guarantees), which is a form of protectionism.

However, it is never safe to bet on international agreement, and there is no need for the United States to wait for an international solution. First, U.S. subsidiaries of foreign banks will continue to be subject to U.S. prudential regulation—which should take into account whether that subsidiary would be able to withstand a global financial crisis. If a large European bank were to fail, our financial system would be safer if it did *not* include banks that were too big to fail; the whole point of size limits is to increase the ability of the system to withstand a shock, no matter where it originates. And if European countries want to keep banks that are too big to fail, then their taxpayers will have to bail them out in case of a crisis. In effect, foreign governments would be taking on the role of insuring the global financial system against disaster—a role that the Federal

Reserve and the Treasury Department played in 2008–2009.

Relying on foreign government bailouts alone would not make us invulnerable to crises originating overseas. For example, Switzerland may not be able to afford to bail out UBS should it suffer a major crisis. For this reason, our financial regulators need to evaluate the potential risks created by foreign megabanks and, if necessary, take action to limit our exposure to those banks. But in any case, we would be less exposed than we are today. And the way to start is to create a financial system that is not vulnerable to the collapse of a few towering dominoes.

A real cap on bank size will not only level the economic playing field and reduce the incentive for banks to take excess risks predicated on the government safety net, but it will also weaken the political power of the big banks and begin to undo the takeover of Washington by Wall Street that we have chronicled in this book. Without a privileged inner core of thirteen (or fewer) bankers, the financial sector will be composed of thousands of small companies and dozens or hundreds of medium-to-large companies, including hedge funds and private equity firms. The financial lobby will continue to be strong by virtue of its sheer size, and the community bankers will retain their clout in Congress. But the distortion of the playing field in favor of a small number of megabanks will come to an end.

This fragmentation of the banking industry should also help dethrone Wall Street from its privileged place in the U.S. economy. The end of "too big to fail" will reduce large banks' funding advantage, forcing them to compete on the basis of products, price, and service rather than implicit government subsidies. Increased competition will reduce the margins on fee-driven businesses such as securitization, trading, and derivatives, putting pressure on large banks' profits. A larger group of competitors will also make it harder for major banks to divert such a large proportion of their profits to employee compensation; bonuses for traders and investment bankers should fall from the historically obscene to the merely outrageous. With more competition, it will be harder for a handful of firms to dominate the cultural landscape like Salomon Brothers and Drexel Burnham Lambert in the 1980s or Goldman Sachs today, and perhaps smart college graduates will find Wall Street a little less compelling. Finance will never go back to being boring—globalization and computers have seen to that—but it should become a little less exciting.

This will create a virtuous cycle. As the major banks become a little poorer, their domination of the campaign finance system will wane, as will the allure of the revolving door. As high finance becomes less glamorous and a little more like just another business, its ideological sway over the Washington establishment will begin to fade. Fewer top administration officials will come from a handful of megabanks, and more will come from other parts of the financial industry, or from nonfinancial industries. The financial crisis has made at least some people think that everything is not right with the Wall Street view of the world; weakening the big banks will help fuel that healthy skepticism. Finance will never be just another industry. It is too big and too central to the economy, and there is something seductive about a business that deals in nothing but money. But reducing the size, profits, and power of the big banks will begin to restore balance both to our economy and to our political system.

These ideas will not be adopted overnight. In 1900, almost no reasonable person thought there was any basis for capping the size of private businesses—no well-developed economic theory supporting such a position, no common law tradition, and nothing in the U.S. Constitution (as interpreted by the Supreme Court).[83] When Theodore Roosevelt sued Northern Securities in 1902, the conventional wisdom was that the industrial trusts were a fact of nature. There was little precedent for the idea of using the Sherman Antitrust Act against a large corporation (although it was used against labor unions in the 1890s). In addition, the trusts had strong backers in Washington, including the key power brokers in Roosevelt's own Republican Party. For Roosevelt, however, any economic benefits that might be provided by the trusts did not outweigh the costs they imposed on society, both by charging monopoly prices and by stifling competition.

By 1910, the consensus view had shifted dramatically. The power of the industrial trusts and the details of their anticompetitive behavior were sufficiently obvious to provoke a political backlash. The middle class became afraid that its hard-won status and relative affluence were endangered by the rise of the super-rich, and that increasing economic inequality would undermine the dream of upward mobility. Because President Roosevelt was willing to confront the trusts, he helped change the conventional wisdom. That change was also shaped by the findings of the Pujo Committee and the writings of Louis Brandeis. And the shift in the consensus was a major reason why the antitrust movement had such lasting effect; today, few people think that unrestrained monopolies are good either for our economy or for our political system.

Our goal today is to change the conventional wisdom about enormous banks. In the long term, the most effective constraint on the financial sector is public opinion. Today, anyone proposing to end the regulation of pharmaceuticals or to suspend government supervision of nuclear power stations would not be taken seriously. Our democratic system allows the expression of all views, but we filter those views based on a collective assessment of which are sensible and which are not. The best defense against a massive financial crisis is a popular consensus that too big to fail is too big to exist.

This is at its heart a question of politics, not of economics or of regulatory technicalities. The challenge we face today is similar to the one faced by President Roosevelt a century ago; the antitrust movement was originally a *political* movement, although today antitrust law has become a field for technocratic analysis of pricing power and consumer welfare.[84] The

conventional wisdom, shaped during the three decades of deregulation, innovation, and risk-taking that brought us the recent financial crisis, is that large, sophisticated banks are a critical pillar of economic prosperity. That conventional wisdom has entrenched itself in Washington, where administration officials, regulators, and legislators agree with the Wall Street line on intellectual grounds, or see their personal interests (financial or political) aligned with the interests of Wall Street, or simply do not feel qualified to question the experts in the thousand-dollar suits. Challenging this ideology is ultimately about politics. The megabanks used political power to obtain their license to gamble with other people's money; taking that license away requires confronting that power head-on. It requires a decision that the economic and political power of the new financial oligarchy is dangerous both to economic prosperity and to the democracy that is supposed to ensure that government policies serve the greater good of society.

The Obama administration and Congress have so far chosen to dance around this confrontation. It remains too early to tell if occasional outbursts of anti–Wall Street rhetoric will translate into substantive reform. It is likely that our government will use this legislative cycle to declare victory over the financial crisis, without addressing its most fundamental cause. The result will be a financial sector that is more concentrated than ever, has a more robust guarantee of government assistance than ever, and takes more risks than ever. With the same conditions in place that led to the last financial crisis, it would be folly to expect any other result. No one can predict what market will produce the next financial crisis, or when it will occur, but no one with any memory should bet against it. And when that crisis comes, the government will face the same choice it faced in 2008: to bail out a banking system that has grown even larger and more concentrated, or to let it collapse and risk an economic disaster.

But there is another choice: the choice to finish the job that Roosevelt began a century ago, and to take a stand against concentrated financial power just as he took a stand against concentrated industrial power. That is a choice that Barack Obama could make. It is a choice that the American people need to make—and sooner rather than later. The Panic of 1907 only led to the reforms of the 1930s by way of the 1929 crash and the Great Depression. We hope that a similar calamity will not be a prerequisite to action again.

Even when it goes out of fashion, Thomas Jefferson's suspicion of concentrated power remains an essential thread in the fabric of American democracy. The financial crisis of 2007–2009 has made Jefferson a little less out of fashion. It is that tradition of skepticism that, if anything, can shift the weight of public opinion against our new financial oligarchy—the most law-abiding, hardworking, eloquent, well-dressed oligarchy in the history of politics. It is to help reinvigorate that spirit of Jefferson that we have written this book.

* This problem can be mitigated through collateral requirements, which mean that if a derivatives trade moves against one party, it has to give collateral to the other party to protect against its own failure. However, it is not feasible to fully collateralize a credit default swap, because when a bond defaults the value of a credit default swap on that bond suddenly jumps to almost the full face value of the bond.

* Raising equity capital makes a bank safer, since it increases the cushion of losses it can absorb before going bankrupt. However, bank shareholders do not like raising additional capital, since that reduces leverage and profits. Contingent capital is debt, so it increases leverage, but in the event of a crisis, the holders of the contingent capital can be forced to exchange it for equity capital—increasing the bank's safety cushion when it needs it most, while diluting existing shareholders' claim on profits.

* A capital ratio is a bank's capital divided by its assets. Tier 1 capital is one common regulatory definition of capital. Eleven percent was considered a healthy amount of Tier 1 capital prior to the crisis.

* The most commonly discussed alternative basis for a size cap is a fraction of total financial assets in the economy. However, this number can rise dramatically in a bubble. In addition, as financial development progresses, financial assets tend to rise relative to GDP and relative to the government's budget, which ultimately bears the brunt of any bailout.

* Risk-based size limits would require an approach similar to risk-weighting of assets. This is already a common feature of existing capital regulations, which prescribe different amounts of capital based on the riskiness of different types of assets. We propose using a similar approach to calculate the maximum allowable size for a given bank, based on its risk profile.

EPILOGUE*

> The success of this landmark reform effort will ultimately depend on the individuals who become the regulators. The key lesson of the last decade is that financial regulators must use their powers, rather than coddle industry interests.
>
> —Congressman Paul Kanjorski, June 30, 2010[1]

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act—Washington's answer to the financial crisis.[2] Standing in the Ronald Reagan Building, President Obama said,

> These reforms represent the strongest consumer financial protections in history.… Reform will also rein in the abuse and excess that nearly brought down our financial system. It will finally bring transparency to the kinds of complex and risky transactions that helped trigger the financial crisis. Shareholders will also have a greater say on the pay of CEOs and other executives, so they can reward success instead of failure. And finally, because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes.[3]

The Dodd-Frank Act was the culmination of the bitter, yearlong political battle that we described in chapter 7, ultimately passing in the Senate by the thinnest of possible margins. As the bill moved through the Senate in the spring, the lobbying campaign by the financial sector only intensified as the big banks dropped any pretense of supporting reform and chose all-out war instead, hiring fifty-four lobbying firms to do their bidding.[4] In private, Wall Street executives called President Obama—whose Treasury Department had pushed for a moderate reform package to begin with—"hostile to business," "antiwealth," "anticapitalism," a "redistributionist," a "vilifier," and a "thug."[5] On the record, even Jamie Dimon, who only a year before had been the toast of both Wall Street and Washington, was reduced to complaining that banks needed *more* influence on politicians so they could give them the "right facts."[6] And a JPMorgan Chase managing director lashed out at Congress for "an unnerving ignorance of fundamental principles of market economics" and said it was "time for the grown-ups to step in."[7]

But a curious thing happened. Instead of getting weaker in the face of a full-court lobbying press, the financial reform bill actually got modestly *stronger* during the Senate debate, carried along by a cresting wave of anger and frustration aimed at the big banks that were reporting resurgent profits and compensation even as the country as a whole remained mired in high unemployment and a fitful economic recovery. That wave was fueled by the release in March of the report by the examiner in the Lehman bankruptcy documenting how the bank had used highly questionable accounting techniques to massage its financial statements in the months prior to its collapse.[8] But it became impossible to ignore the following month, when the Securities and Exchange Commission filed a civil suit against Goldman Sachs, the informal godfather of the markets, for misleading investors in a complicated subprime-backed synthetic CDO that the bank had concocted just as the subprime market was beginning to collapse.[9] The CDO in question had been designed with considerable input by John Paulson, a hedge fund manager who intended to bet *against* the CDO; the SEC alleged, in short, that Goldman had misled investors in the CDO by failing to disclose Paulson's role. (When the subprime market collapsed, Paulson's fund cleared a $1 billion profit on the deal.) The central character in the SEC's suit was Goldman vice president Fabrice Tourre, who had the misfortune to write in a January 2007 e-mail, "The whole building is about to collapse anytime now.… Only potential survivor, the fabulous Fab[rice Tourre] … standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstruosities [*sic*]!!!"[10]

The SEC-Goldman lawsuit followed closely on the heels of an investigative report by *ProPublica* into Magnetar, a hedge fund that made phenomenal profits by betting that the subprime mortgage market was on the verge of collapse.[11] The *ProPublica* report went national as the main story on the radio show *This American Life*.[12] Both the Magnetar story and the Goldman-Paulson story seemed to encapsulate everything that was wrong with the financial system. On the one hand, hedge funds were pushing investment banks to create highly toxic CDOs precisely so they could bet against them, thereby actually increasing the flow of capital into subprime lending and increasing the eventual costs of collapse. On the other hand, the investment banks were so eager for the up-front fees available that not only did they allegedly mislead their clients, but they sometimes held on to the toxic waste they should have known they were creating; in one transaction, JPMorgan Chase earned a fee of $20 million but ended up losing $880 million when the CDO collapsed.[13] The problem wasn't just that fund managers and bankers wanted to make a lot of money; the problem was that the banks' own internal incentive structures and risk management "systems" had allowed short-term profits to become completely unmoored from any kind of long-term economic value.

As disgust with Wall Street mounted, senators responded with amendments that were more far-reaching than anything put forward by the Treasury Department or passed by the House of Representatives, including proposals to prohibit banks from engaging in proprietary trading, to force them to spin off their derivatives trading operations, and even to break up the largest banks.[14] This placed the Obama administration and the Treasury Department in particular in the slightly awkward position of having to work, largely behind the scenes, to defeat or water down measures they feared would be too restrictive or onerous for the big banks.[15] Ultimately, however, this turned out to be ideal for the administration. The mounting pressure from reformers helped counterbalance the lobbying efforts of the banking industry, allowing the administration to claim the prized middle ground in the debate and ensuring that the final bill turned out roughly the way it wanted.

In the end, the Dodd-Frank Act was both a significant step forward and a missed opportunity. One of the bill's most important achievements was the creation of a new, nearly independent Consumer Financial Protection Bureau (CFPB), largely similar to the agency that Elizabeth Warren had envisioned in 2007 and that we argued for in chapter 7. Any regulatory agency is only as effective as the people who staff it, and there is always the possibility that a future, pro-finance president will appoint a head of the CFPB who is opposed to consumer protection. But the creation of a new agency dedicated solely to consumer protection, with broad authority to prohibit abusive practices by all financial institutions, is an undoubted benefit for the ordinary people whom existing bank regulators had largely ignored over the previous decades. Abusive practices such as prepayment penalties (locking borrowers into expensive mortgages) and yield-spread premiums (providing incentives for steering borrowers into expensive mortgages) could become a thing of the past.

In many other areas, the bill is promising, although its ultimate impact is hard to gauge. The derivatives that Brooksley Born wanted to regulate in 1998—and that were sheltered by the Commodity Futures Modernization Act of 2000—have been brought under the regulatory umbrella. Most derivatives must be centrally cleared and traded either on exchanges or swap execution facilities—steps that should increase both competition and transparency, reducing prices for market participants and risk to the financial system. Derivatives dealers will face new capital requirements and will have new duties to treat their customers fairly, particularly if those customers are municipalities or pension funds. Existing regulatory agencies and the newly formed Financial Stability Oversight Council have new powers to monitor and take action against systemic risks, for example by subjecting important nonbank financial institutions to regulatory oversight. Resolution authority—a new system for taking over and liquidating failing financial institutions (briefly discussed in chapter 7)—should make it impossible to repeat some of the more egregious bailouts of the recent financial crisis. These are all important steps, and there are many others as well.

However, whether these new laws live up to their potential depends heavily on the same regulatory agencies that performed so poorly over the past decades. The Dodd-Frank Act, like most complex legislation, leaves a dizzying number of details to regulatory discretion. Simply putting these new laws into effect requires regulators to write hundreds of new rules, many of which offer opportunities for the financial sector to weaken or pervert the intent of Congress. (The law firm Davis Polk counted 243 new rules and 67 new studies required by the bill.)[16] For example, the new requirements for trading and clearing derivatives include an exemption for "commercial end users" (nonfinancial entities) that use derivatives for hedging purposes. How big that loophole turns out to be depends largely on the wording of the rule defining exempt transactions, an issue on which Wall Street is sure to have its say; ultimately, it could depend on how the courts rule on the eventual appeals by the banks or their clients. Another rule is necessary to define what qualifies as an evasive tactic to avoid regulation. Each of these rules will be the subject of a fight that will be repeated dozens of times as the details of financial reform are hammered out.

Wall Street is gearing up for battle; or, rather, Wall Street never stopped fighting. Lobbying organizations and law firms representing the financial sector have been recruiting former regulators to press their case with their former colleagues.[17] And in this phase, the banks have two advantages. For a brief few months, financial reform was front-page news, with Goldman Sachs providing the color; rule writing, by contrast, is unlikely to command popular attention and will be relegated to the back pages of the newspaper, if it is covered at all. In addition, rule writing is inherently complicated and full of legal technicalities—the natural home turf for the battalions of lawyers employed by Wall Street. And some of the most important rules—including those determining how much capital banks are required to hold, what qualifies as capital, and how capital requirements are measured—will be set in international negotiations where the rule of the least common denominator is likely to prevail. On the other hand, many of the regulators currently in place do genuinely want to do the right thing for the country, fulfilling the potential of the Dodd-Frank Act and constraining the excesses of the financial sector. But they will be under enormous pressure from an extremely well-funded campaign to undermine regulation at every turn. As Raghuram Rajan said, "There is a great amount of ambiguity about how the bill will evolve in practice. It has tremendous promise, but also tremendous scope for disappointment."[18]

The financial reform bill itself is also far from perfect. Unfortunately, Dodd-Frank does little to address a few of the more obvious problems that helped produce the financial crisis. The main executive compensation provisions include a requirement that board compensation committees be composed entirely of independent directors and a "say on pay" rule requiring shareholder votes on executive compensation packages—but those votes are nonbinding. Despite the central role of credit rating agencies in making the credit bubble and financial crisis possible, the conference committee that crafted the final version

of the legislation stripped out the most significant provision aimed at the rating agencies: Senator Al Franken's amendment, originally included in the Senate version, eliminating the ability of banks issuing new securities to decide who would rate those securities. (Instead, the final bill requires the SEC to study the issue of conflicts of interest.)[19] Finally, the bill makes virtually no mention of Fannie Mae, Freddie Mac, or the decades-old bipartisan policy of promoting homeownership and propping up housing prices.

The missed opportunity is that the financial reform bill does too little to weaken the dominant economic and political power of the largest banks. The SAFE Banking Amendment, proposed by Senators Sherrod Brown and Ted Kaufman, would have imposed strict size limits on banks similar to those we argued for in chapter 7. Despite having no support from the congressional leadership or the Obama administration, it improbably made it to a vote on the Senate floor, losing 61–33. "If enacted, Brown-Kaufman would have broken up the six biggest banks in America," a senior Treasury official said to journalist John Heilemann. "If we'd been for it, it probably would have happened. But we weren't, so it didn't."[20]

Instead of breaking up the largest banks, the administration and its congressional allies settled for a version of the "Volcker Rule," named after former Federal Reserve chair and Obama administration adviser Paul Volcker, which aimed at preventing banks from engaging in proprietary trading or sponsoring hedge funds or private equity funds. However, the version that was finally written into the bill contains enough exceptions that even Volcker himself was reportedly disappointed with it.[21] A stronger version proposed by Senators Jeff Merkley and Carl Levin (and supported by Volcker)[22] was kept off the floor in a last-minute procedural maneuver.[23]

Instead of preventing banks from being too big to fail, Dodd-Frank gave regulators new resolution authority to protect the financial system from a collapsing financial institution in a crisis, hoping that fear of being "resolved" would be enough to deter financial institutions from taking excessive risks in the first place. While this is better than nothing, it is highly improbable that authority granted to U.S. regulators over U.S. institutions will be sufficient if a major global bank with subsidiaries in many countries is about to fail. The bill also gives regulators new weapons they can use against big banks, if they so choose. These include the ability to set higher capital requirements for the largest, most important financial institutions, as well as the Kanjorski Amendment (discussed in chapter 7), allowing regulators to force banks to shrink if they pose a risk to the financial system. But whether those weapons will ever be used remains a big question mark.

Just as it had a year earlier when it summoned thirteen bankers to Washington, the Obama administration decided to stick with the banks and the bankers it knew. This decision was not born of corruption, influence peddling, or even any love for the banks. By the middle of 2010, both Barack Obama and Tim Geithner were fed up with an industry that repaid all their efforts to save the major banks—and the bankers' jobs—with all-out attacks in the back rooms of Capitol Hill.[24]

But that decision was born of a belief that America needed the financial system it had, with an oligarchy of megabanks at its pinnacle. Ultimately, the administration agreed with Jamie Dimon that big banks were crucial to the health of the economy and decided it could not live without them. Instead of changing the financial system, the Dodd-Frank Act places its faith in the idea that regulators, armed with additional, sorely needed powers, could constrain its excesses and prevent it from once again torpedoing the global economy.

As we said above, the financial reform bill was a step forward. Doing nothing would have left us with the same financial system that gave us the recent crisis, now even more concentrated and even more emboldened by its ability to call on government support to survive. But Dodd-Frank is not enough. At its core it is a bet on smarter, better regulation—yet it does too little to change the balance of power between Wall Street bankers and Washington officials that was the dominant factor in recent U.S. financial history. The financial sector still has the power to unleash torrential floods of money into the political process. The debate over financial issues is still dominated by people who come from or are going to Wall Street. And the ideology of finance—the idea that behemoth banks peddling increasingly incomprehensible products are somehow good for ordinary people—though shaken, remains dominant in Washington.

On the one hand, it is hard to escape the feeling that we will return to business as usual. In July 2010, only a few days before President Obama signed the Dodd-Frank Act into law, the SEC dropped its charges against Goldman Sachs as part of a settlement agreement. Goldman acknowledged that its marketing materials "contained incomplete information" and that not disclosing Paulson's role in designing the synthetic CDO was a "mistake,"[25] yet insisted that it was not admitting the SEC's allegations.[26] Goldman also agreed to pay a fine of $550 million—the largest penalty ever paid by a Wall Street firm, yet only a fraction of the $3.5 billion in profits the bank had earned in just the first three months of 2010.

And while the job of financial reform remains unfinished, it is not clear who will finish it. Not only do bankers have the incentive to seek short-term profits and ignore long-term risks; politicians also have the incentive to pretend that all is well in the short term and hope the next financial crisis will happen on someone else's watch. The Republican line is that Dodd-Frank is excessive government intrusion into the private sector; the mainstream Democratic line is that Dodd-Frank is the best possible solution. There is no powerful constituency for far-reaching structural reform of the financial system.

But on the other hand, the fight is far from over. The Dodd-Frank Act, though imperfect, marked the end of over three decades of deregulation and nonregulation of the financial sector. As with the Sherman Antitrust Act of 1890, legislation can

play a significant role in changing the mainstream consensus. Wall Street's apologists still sing the praises of free market fundamentalism and unfettered financial innovation, but their accustomed air of inevitability and triumphalism is gone. The American public has become deeply skeptical of financial machinations they cannot understand, and many of them have invested untold hours in learning how the financial system works and whom it benefits.

We are perhaps at a pivotal moment in the battle between Jefferson and Hamilton. Hamilton remains ascendant, but his perch appears shaky and his view of finance has been discredited. What happens next will depend, improbably enough, on people like you. We can sigh with relief that the financial crisis is over and go back to our uncomprehending admiration for the fabulously rich men and women of Wall Street. Or we can continue to demand a financial sector that serves the interests of ordinary people and the real economy. In our democratic system, the political establishment, though slowly and very imperfectly, reflects the will of the people. It is there that the rest of this story will play out.

—Simon Johnson and James Kwak, September 2010

* The manuscript of the first edition of *13 Bankers* was submitted in December 2009 and finalized in January 2010, after a version of the financial reform bill passed the House of Representatives but before formal debate began in the Senate. The first edition was published in the United States in March 2010, in the midst of the Senate debate.

Notes

EPIGRAPH

1. F. Scott Fitzgerald, *The Great Gatsby* (New York: Scribner, 2004), 179. This quotation was used by Bill Moyers to introduce his program on September 19, 2008, the week that Lehman Brothers filed for bankruptcy and AIG was bailed out by the Federal Reserve. *Bill Moyers Journal,* September 19, 2008, transcript available at http://www.pbs.org/moyers/journal/09192008/transcript4.html. It was recommended to us by Graham Smith.

1. Quoted in Eamon Javers, "Inside Obama's Bank CEOs Meeting," *Politico,* April 3, 2009, available at http://www.politico.com/news/stories/0409/20871.html. Also confirmed by ABC News. Rick Klein, "Obama to Bankers: I'm Standing 'Between You and the Pitchforks,' " The Note Blog, available at http://blogs.abcnews.com/thenote/2009/04/obama-to-banker.html.
2. Stock market data are based on the S&P 500 index. Job losses are from Bureau of Labor Statistics, *Current Employment Statistics,* available at http://www.bls.gov/ces/.
3. World output was 2.7 percent lower in Q1 2009 than in Q1 2008; this was the lowest year-over-year figure during the recent global recession. International Monetary Fund, *World Economic Outlook, October 2009: Sustaining the Recovery* (Washington: International Monetary Fund, 2009), 2, available at http://www.imf.org/external/pubs/ft/weo/2009/02/.
4. "List of Bank CEOs Meeting with Obama at the White House," Real Time Economics Blog, *The Wall Street Journal,* March 27, 2009, available at http://blogs.wsj.com/economics/2009/03/27/list-of-bank-ceos-meeting-with-obama-at-the-white-house/.
5. Obama, Gibbs, and Pandit were quoted in Eric Dash, "Bankers Pledge Cooperation with Obama," *The New York Times,* March 27, 2009, available at http://www.nytimes.com/2009/03/28/business/economy/28bank.html. Stumpf was quoted in Jonathan Weisman, Damian Paletta, and Dan Fitzpatrick, "Bankers, Obama in Uneasy Truce," *The Wall Street Journal,* March 28, 2009, available at http://online.wsj.com/article/SB123816459546857301.html.
6. Javers, "Inside Obama's Bank CEOs Meeting," *supra* note 1.
7. Elizabeth Williamson and Damian Paletta, "Obama Urges Bankers to Back Financial Overhaul," *The Wall Street Journal,* September 15, 2009, available at http://online.wsj.com/article/SB125292937349508441.html.
8. Alan Greenspan, "Current Monetary Policy" (lecture, Haskins Partners Dinner of the Stern School of Business, New York University, New York, May 8, 1997), available at http://www.federalreserve.gov/BoardDocs/Speeches/1997/19970508.htm.
9. On Brooksley Born, see Rick Schmitt, "Prophet and Loss," *Stanford Magazine,* March–April 2009, available at http://www.stanfordalumni.org/news/magazine/2009/marapr/features/born.html; Manuel Roig-Franzia, "Credit Crisis Cassandra: Brooksley Born's Unheeded Warning Is a Rueful Echo 10 Years On," *The Washington Post,* May 26, 2009, available at http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502108.html; and "The Warning," *Frontline* (PBS television broadcast October 20, 2009), available at http://www.pbs.org/wgbh/pages/frontline/warning/.
10. Frank Partnoy, *F.I.A.S.C.O.: Blood in the Water on Wall Street* (New York: W. W. Norton, 2009), 59. For another account of the derivatives industry, see Satyajit Das, *Traders, Guns and Money: Knowns and Unknowns in the Dazzling World of Derivatives* (Harlow, England: Prentice Hall, 2006).
11. Bank for International Settlements, *Semi-Annual OTC Derivatives Statistics,* available at http://www.bis.org/statistics/derstats.htm.
12. Quoted in Frank Partnoy, *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets* (New York: Henry Holt, 2004), 163.
13. Alan Greenspan, "Government Regulation and Derivative Contracts" (lecture, Financial Markets Conference of the Federal Reserve Bank of Atlanta, Coral Gables, FL, February 21, 1997), available at http://www.federalreserve.gov/BoardDocs/Speeches/1997/19970221.htm.
14. Quoted in Roig-Franzia, "Credit Crisis Cassandra," *supra* note 9. Summers declined to comment for the Roig-Franzia article. See also interview with Michael Greenberger, *Frontline,* July 14, 2009, transcript available at http://www.pbs.org/wgbh/pages/frontline/warning/interviews/greenberger.html. Born declined to provide details of her conversations with other government officials. Interview with Brooksley Born, *Frontline,* August 28, 2009, transcript available at http://www.pbs.org/wgbh/pages/frontline/warning/interviews/born.html.
15. *Commodity Futures Modernization Act of 2000,* 106th Cong., 2nd sess., Senate Rep. 106-390, available at http://thomas.loc.gov/cgi-bin/cpquery/?&sid=cp106s5nKF&refer=&r_n=sr390.106&db_id=106&item=&sel=TOC_42836&.
16. Derivatives statistics are from Bank for International Settlements, *Semi-Annual OTC Derivatives Statistics, supra* note 11. On the growth and importance of credit default swaps, see Gillian Tett, *Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe* (New York: Free Press, 2009).
17. U.S. real GDP declined by 4 percent from Q2 2008 to Q2 2009; Bureau of Economic Analysis, *National Income and Product Accounts,* Table 1.1.6, available at http://bea.gov/national/nipaweb/SelectTable.asp. Actual and projected

write-downs are from International Monetary Fund, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks, April 2009* (Washington: International Monetary Fund, 2009), 32–34, available at http://www.imf.org/External/Pubs/FT/GFSR/2009/01/index.htm.

18. David Cho, "Banks 'Too Big to Fail' Have Grown Even Bigger: Behemoths Born of the Bailout Reduce Consumer Choice, Tempt Corporate Moral Hazard," *The Washington Post,* August 28, 2009, available at http://www.washingtonpost.com/wp-dyn/content/article/2009/08/27/AR2009082704193.html; Elizabeth Hester and Elisa Martinuzzi, "JPMorgan Tightens Grip on Equity Sales by Selling Own Shares," Bloomberg, June 28, 2009, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=aYlWNEyLQzPk.
19. Press Release, Goldman Sachs, "Goldman Sachs Reports Third Quarter Earnings per Common Share of $5.25," October 15, 2009, available at http://www2.goldmansachs.com/our-firm/press/press-releases/current/pdfs/2009-q3-earnings.pdf.
20. John Gapper, "Master of Risk Who Did God's Work for Goldman Sachs but Won It Little Love," *Financial Times,* December 23, 2009, available at http://www.ft.com/cms/s/0/479ac4ba-eb32–11de-bc99–00144feab49a.html.
21. In 2007, 3.2 percent of U.S. GDP was $450 billion. Bureau of Economic Analysis, *supra* note 17, at Table 1.1.5. Data for 1983 are from Gary H. Stern and Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* (Washington: Brookings Institution Press, 2009), 65. Data for 2007 are from *Federal Reserve Statistical Release, Large Commercial Banks,* December 31, 2007, available at http://www.federalreserve.gov/releases/lbr/20071231/default.htm, and from the annual reports of Goldman Sachs, Morgan Stanley, Merrill Lynch, and Lehman Brothers.
22. Annualized GDP in Q1 2009 was $14.178 trillion. Bureau of Economic Analysis, *supra* note 17, at Table 1.1.5. Asset data are from company quarterly reports.

CHAPTER 1: THOMAS JEFFERSON AND THE FINANCIAL ARISTOCRACY

1. Theodore Roosevelt, "State of the Union Message," December 3, 1901, in John T. Woolley and Gerhard Peters, *The American Presidency Project,* available at http://www.presidency.ucsb.edu/ws/index.php?pid=29542.
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3. From a letter to John Taylor, in Albert Ellery Bergh, ed., *The Writings of Thomas Jefferson,* Volume XV (Washington: Thomas Jefferson Memorial Association, 1907), 23.
4. Ron Chernow, *Alexander Hamilton* (New York: Penguin, 2004), 352.
5. Jerry W. Markham, *A Financial History of the United States, Volume I: From Christopher Columbus to the Robber Barons (1492–1900)* (Armonk, NY: M. E. Sharpe, 2002), 89–90.
6. Thomas Jefferson, "Jefferson's Opinion on the Constitutionality of a National Bank," in Paul Leicester Ford, ed., *The Federalist: A Commentary on the Constitution of the United States by Alexander Hamilton, James Madison and John Jay* (New York: Henry Holt, 1898), available at http://avalon.law.yale.edu/18th_century/bank-tj.asp; Alexander Hamilton, "Hamilton's Opinion as to the Constitutionality of the Bank of the United States," in Ford, *supra,* available at http://avalon.law.yale.edu/18th_century/bank-ah.asp.
7. Chernow, *Alexander Hamilton, supra* note 4, at 353–54.
8. Richard Scott Carnell, Jonathan R. Macey, and Geoffrey P. Miller, *The Law of Banking and Financial Institutions,* fourth edition (Austin: Wolters Kluwer Law & Business, 2009), 2–5.
9. Richard Sylla, "Financial Systems and Economic Modernization," *Journal of Economic History* 62 (2002): 277–92; Peter L. Rousseau, "Historical Perspectives on Financial Development and Economic Growth," *Federal Reserve Bank of St. Louis Review* (July–August 2003): 81–106; and Peter L. Rousseau and Richard Sylla, "Emerging Financial Markets and Early U.S. Growth," *Explorations in Economic History* 42 (2005): 1–26. As the need for large amounts of capital increased (e.g., for canals and railroads), new corporate forms evolved. Jonathan Barron Baskin and Paul J. Miranti, Jr., *A History of Corporate Finance* (Cambridge: Cambridge University Press, 1997). This does not imply that all necessary institutions were in place and functioning smoothly in the United States by 1800; see Bruce Mann, *Republic of Debtors: Bankruptcy in the Age of American Independence* (Cambridge: Harvard University Press, 2002).
10. Rousseau and Sylla, "Emerging Financial Markets," *supra* note 9, at 3. Rousseau and Sylla stress that the United States developed the first truly competitive banking system. Stephen Haber explores how this system emerged from the political logic of competition between states. Stephen Haber, "Political Institutions and Financial Development: Evidence from the Political Economy of Bank Regulation in the United States and Mexico," in Stephen Haber, Douglass C. North, and Barry R. Weingast, eds., *Political Institutions and Financial Development* (Palo Alto: Stanford University Press, 2008): 10–59. For more on the political origins of the American corporate legal environment, see Lawrence E. Mitchell, *The Speculation Economy: How Finance Triumphed over Industry* (San Francisco: Berrett-Koehler, 2007).
11. Markham, *Financial History,* Volume I, *supra* note 5, at 83, 90. His reports to Congress included one on the subject of manufactures and two on public credit. See Chernow, *Alexander Hamilton, supra* note 4.
12. The national debt argument and its outcome are covered in Robert E. Wright, *One Nation Under Debt: Hamilton, Jefferson, and the History of What We Owe* (New York: McGraw-Hill, 2008). See also Albert Jay Nock, *Mr. Jefferson* (New York: Harcourt, Brace, 1926), chapter 5; and Willard Sterne Randall, *Thomas Jefferson: A Life* (New York: Harper Perennial, 1994), chapter 19.
13. Chernow, *Alexander Hamilton, supra* note 4, at 345. More generally, Chernow argues that Hamilton interpreted and applied the Constitution in ways that were intended to help commerce develop.
14. Rousseau and Sylla, "Emerging Financial Markets," *supra* note 9, at 5.
15. "The state-chartered banks, like the federally chartered [Bank of the United States], were corporations with limited liability, which is a major reason why they were able to attract so much capital." Ibid.
16. Richard Sylla, "U.S. Securities Markets and the Banking System, 1790–1840," *Federal Reserve Bank of St. Louis Review* (May–June 1998): 83–98, at 93. His comparison is based on converting U.K. bank capital into dollars at the then prevailing market exchange rate.
17. Richard Sylla, Jack W. Wilson, and Robert E. Wright, "America's First Securities Markets: Emergence, Development, and Integration" (working paper presented at the Cliometric Society Meetings, Toronto, and the NBER Summer Institute, 1997).

18. Rousseau and Sylla, "Emerging Financial Markets," *supra* note 9, at 8–9.
19. On the importance of personal relationships in early U.S. banking, see Naomi Lamoreaux, *Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England* (Cambridge: Cambridge University Press, 1996).
20. Richard Hofstadter, *The American Political Tradition and the Men Who Made It* (New York: Alfred A. Knopf, 1948).
21. Calvin Coolidge, "The Press Under a Free Government" (lecture, American Society of Newspaper Editors, Washington, D.C., January 17, 1925), in Calvin Coolidge, *Foundations of the Republic: Speeches and Addresses* (Freeport, NY: Books for Libraries Press, 1968), 183–90, at 187.
22. Bray Hammond argues that some of Jackson's strongest supporters were actually New York bankers who opposed the Second Bank because it was based in Philadelphia; they wanted some of its more lucrative functions for themselves. Bray Hammond, *Banks and Politics in America from the Revolution to the Civil War* (Princeton: Princeton University Press, 1957).
23. Carnell et al., *Law of Banking, supra* note 8, at 5.
24. The Second Bank was not a central bank in the modern sense. Peter Temin, *The Jacksonian Economy* (New York: W. W. Norton, 1969), 53.
25. Richard H. Timberlake, *Monetary Policy in the United States: An Intellectual and Institutional History* (Chicago: University of Chicago Press, 1993), chapter 3. See also Temin, *Jacksonian Economy, supra* note 24.
26. Arthur Schlesinger, *The Age of Jackson* (New York: Book Find Club, 1945), chapter 7.
27. Quoted in ibid. at 102. Emphasis in original.
28. On the Bank War in general, see Markham, *Financial History,* Volume I, *supra* note 5, at 141–46.
29. Ibid. at 145.
30. Andrew Jackson, "Veto Message," July 10, 1832, in James D. Richardson, ed., *Messages and Papers of the Presidents (Volume II, Part 3: Andrew Jackson, March 4, 1829, to March 4, 1833),* available at http://onlinebooks.library.upenn.edu/webbin/gutbook/lookup?num=10858.
31. Quoted in Jon Meacham, *American Lion: Andrew Jackson in the White House* (New York: Random House, 2008), 201. Emphasis in original.
32. Markham, *Financial History,* Volume I, *supra* note 5, at 145. The actual economic power of Biddle should not be exaggerated; the ensuing recession was small despite the strong rhetoric on all sides. Temin, *Jacksonian Economy, supra* note 24.
33. The Bank of England began as a powerful commercial bank and, during the nineteenth century, became in part a central bank. *Report of the Committee on Finance and Industry, British Parliamentary Reports on International Finance, The Cunliffe Committee and the Macmillan Committee Reports* (New York: Arno, 1978), chapter 4. On the origins of the Bank of England, see Steve Pincus, *1688: The First Modern Revolution* (New Haven: Yale University Press, 2009).
34. Robert V. Remini, *The Life of Andrew Jackson* (New York: Harper Perennial, 2001); Meacham, *American Lion, supra* note 31.
35. Quoted in Schlesinger, *Age of Jackson, supra* note 26, at 84 (emphasis in original). Webster received a retainer as one of the Bank's lawyers. Still, in Schlesinger's assessment, "Webster fought for [the Bank] in great part because it was a dependable source of private revenue." Schlesinger also points out that both opponents and supporters of the Bank were in its debt. Ibid. at 86, n. 22.
36. Meacham, *American Lion, supra* note 31; Robert V. Remini, *Andrew Jackson and the Bank War* (New York: W. W. Norton, 1967).
37. Carnell et al., *Law of Banking, supra* note 8, at 4–5.
38. Nelson W. Aldrich, "The Work of the National Monetary Commission" (lecture, Economic Club of New York, November 29, 1909), available at http://books.google.com/books?id=vDcuAAAAYAAJ. For Aldrich's assessment, see Nathaniel Wright Stephenson, *Nelson W. Aldrich: A Leader in American Politics* (New York: Charles Scribner's Sons, 1930).
39. Stephen Haber, "Financial Markets and Industrial Development: A Comparative Study of Governmental Regulation, Financial Innovation, and Industrial Structure in Brazil and Mexico, 1840–1930," in Stephen Haber, ed., *How Latin America Fell Behind: Essays on the Economic Histories of Brazil and Mexico, 1800–1914* (Palo Alto: Stanford University Press, 1997); Stephen Haber, "Politics, Banking, and Economic Development: Evidence from New World Economies," in Jared Diamond and James Robinson, eds., *Natural Experiments of History* (Cambridge: Harvard University Press, 2009): 88–119. On emerging markets, see chapter 2 of this book. On the general problem of elites blocking economic development, see Daron Acemoglu, James Robinson, and Simon Johnson, "Institutions as the Fundamental Cause of Long-Run Growth," in Philippe Aghion and Steve Durlauf, eds., *Handbook of*

Economic Growth (Amsterdam: North-Holland, 2005).

40. The United States had strong institutions—tending to control the power of elites—due to its colonial experience, in contrast to those of Latin America. Acemoglu et al., "Institutions as the Fundamental Cause of Long-Run Growth," *supra* note 39. Jefferson's ideas and Jackson's success at opposing concentrated power in part reflected those strong institutions.
41. The latest historical work suggests that the United States moved away from agriculture and adopted industrial technologies and new forms of commercial organization earlier than previously believed. See Charles Sellers, *The Market Revolution: Jacksonian America, 1815–1846* (Oxford: Oxford University Press, 1991); David Reynolds, *America, Empire of Liberty* (New York: Basic Books, 2009); and Daniel Walker Howe, *What Hath God Wrought: The Transformation of America, 1815–1848* (Oxford: Oxford University Press, 2007).
42. Lamoreaux, *Insider Lending, supra* note 19; Robert E. Wright, *The Wealth of Nations Rediscovered: Integration and Expansion in American Financial Markets, 1780–1850* (Cambridge: Cambridge University Press, 2002). This point has been emphasized by IMF first deputy managing director John Lipsky. John Lipsky, "Finance and Economic Growth" (lecture, Bank of Mexico Conference, "Challenges and Strategies for Promoting Economic Growth," Mexico City, Mexico, October 19, 2009), available at http://www.imf.org/external/np/speeches/2009/101909.htm.
43. Rousseau and Sylla, "Emerging Financial Markets," *supra* note 9.
44. Hofstadter, *American Political Tradition, supra* note 20, at chapter 7; Matthew Josephson, *The Robber Barons* (San Diego: Harcourt Brace, 1934).
45. Kevin Phillips, *Wealth and Democracy: A Political History of the American Rich* (New York: Broadway Books, 2003), 239–40; Hofstadter, *American Political Tradition, supra* note 20, at chapter 7; Nathaniel Wright Stephenson, *Nelson W. Aldrich, supra* note 38; Edmund Morris, *Theodore Rex* (New York: Random House, 2001).
46. Daron Acemoglu and James A. Robinson, "Economic Backwardness in Political Perspective," *American Political Science Review* 100 (2006): 115–31.
47. On income levels, see Daron Acemoglu, Simon Johnson, and James A. Robinson, "The Colonial Origins of Comparative Development: An Empirical Investigation," *American Economic Review* 91 (2001): 1369–1401; and Daron Acemoglu, Simon Johnson, and James A. Robinson, "Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution," *Quarterly Journal of Economics* 118 (2002): 1231–94. On Mexican finance, see Haber, "Political Institutions and Financial Development," *supra* note 10; Stephen Haber and Noel Maurer, "Related Lending and Economic Performance: Evidence from Mexico," *The Journal of Economic History* 67 (2007): 551–81; and Noel Maurer, *The Power and the Profits: The Mexican Financial System, 1876–1932* (Palo Alto: Stanford University Press, 2002). The Haber and Maurer paper argues that, in the Mexican case, concentration in the banking sector was compatible with effective corporate governance, but did lead to concentration in nonfinancial industries. On financial development and growth in other countries, see Peter L. Rousseau and Richard Sylla, "Financial Revolutions and Economic Growth: Introducing This EEH Symposium," *Explorations in Economic History* 43 (2006): 1–12; and Michael D. Bordo and Peter L. Rousseau, "Legal-Political Factors and the Historical Evolution of the Finance-Growth Link," *European Review of Economic History* 10 (2006): 421–44.
48. Hofstadter, *American Political Tradition, supra* note 20, at chapter 7.
49. Alfred Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, MA: Belknap Press, 1976).
50. Thomas K. McCraw, *Prophets of Regulation* (Cambridge, MA: Belknap Press, 1984), 98.
51. Charles R. Morris, *The Tycoons: How Andrew Carnegie, John D. Rockefeller, Jay Gould, and J. P. Morgan Invented the American Supereconomy* (New York: Henry Holt, 2005), chapter 8.
52. Ibid. at 235; this estimate is for the "liquid industrial, commercial, and financial capital of the United States" that was guided by Morgan directly or indirectly. Brad DeLong finds that "in 1911–12 the presence on one's board of directors of a partner in J.P. Morgan and Co. added about 30 percent to common stock equity value, and about 15 percent to the total market value of the firm." J. Bradford DeLong, "Did J. P. Morgan's Men Add Value? An Economist's Perspective on Financial Capitalism," in Peter Temin, ed., *Inside the Business Enterprise: Historical Perspectives on the Use of Information* (Chicago: University of Chicago Press, 1991): 205–36. See also Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Grove, 2001); Jean Strouse, *Morgan: American Financier* (New York: Random House, 1999); and David M. Kotz, *Bank Control of Large Corporations in the United States* (Berkeley and Los Angeles: University of California Press, 1978).
53. Roosevelt, "State of the Union Message," *supra* note 1.
54. The origins of the Sherman Antitrust Act remain somewhat shrouded in mystery. It appears to have been part of a broader political deal that allowed the Republicans to increase the tariff. There is no indication that it was intended

to be used against big business; nor was it used in that manner for the first decade after it passed. See Thomas W. Hazlett, "The Legislative History of the Sherman Act Re-examined," *Economic Inquiry* 30 (1992): 263–76.

55. *Northern Securities Co. v. United States,* 193 U.S. 197 (1904). For the development of Roosevelt's antitrust approach, see Morris, *Theodore Rex, supra* note 45.

56. Morris, *Theodore Rex, supra* note 45, at 91. The conversation took place on the morning of February 22, 1902.

57. On Roosevelt's intellectual antecedents, how he saw his place in the American tradition, and his political objections to concentrated commercial power, see Hofstadter, *American Political Tradition, supra* note 20, at chapter 9. Roosevelt's earlier thinking and interaction with the Republican Party machine and industrial interests are covered in Edmund Morris, *The Rise of Theodore Roosevelt* (New York: Modern Library, 2001).

58. George J. Stigler, "The Economists and the Problem of Monopoly," *American Economic Review* 72 (1982): 1–12.

59. The mergers were a way to remove "excess capacity" in some industries, but did not create more efficient operations. There was no systematic antitrust policy in the face of this merger wave; see Naomi R. Lamoreaux, *The Great Merger Movement in American Business, 1895–1904* (Cambridge: Cambridge University Press, 2008).

60. On the crisis of 1907, see Morris, *Theodore Rex, supra* note 45; Chernow, *House of Morgan, supra* note 52; Robert F. Bruner and Sean D. Carr, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm* (Hoboken, NJ: John Wiley & Sons, 2007).

61. On financial crises in general, see Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises,* fourth edition (Hoboken, NJ: Wiley, 2000). On the role of credit in booms and busts, see also Wesley C. Mitchell, *Business Cycles* (Berkeley: University of California Press, 1913). On the banking panics between the National Bank Act of 1863 and the creation of the Fed, see Elmus Wicker, *Banking Panics of the Gilded Age* (Cambridge: Cambridge University Press, 2000).

62. On the "financial accelerator," see Ben S. Bernanke, "The Financial Accelerator and the Credit Channel" (lecture, The Credit Channel of Monetary Policy in the Twenty-first Century Conference, Federal Reserve Bank of Atlanta, Atlanta, Georgia, June 15, 2007), available at http://www.federalreserve.gov/newsevents/speech/Bernanke20070615a.htm; Ben S. Bernanke, "Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review* 73 (1983): 257–76; and Ben S. Bernanke and Mark Gertler, "Agency Costs, Net Worth, and Business Fluctuations," *American Economic Review* 79 (1989): 14–31.

63. Chernow, *House of Morgan, supra* note 52, at 123–24.

64. For a detailed history of the formation of the Fed and a discussion of the roles of Aldrich and others, see Elmus Wicker, *The Great Debate on Banking Reform: Nelson Aldrich and the Origins of the Fed* (Columbus: Ohio State University Press, 2005). Wicker traces the origins of the Fed back to the banking panic of 1893–1894.

65. Aldrich, "The Work of the National Monetary Commission," *supra* note 38.

66. Chernow, *House of Morgan, supra* note 52; Stephenson, *Nelson W. Aldrich, supra* note 38; and Melvin Urofsky, *Louis Brandeis: A Life* (New York: Pantheon, 2009).

67. Quoted in "The 'Money Trust,' " *The New York Times,* July 24, 1911, available at http://query.nytimes.com/gst/abstract.html?res=9F05E4DD1131 E233A25757C2A9619C946096D6CF.

68. For the reports of the Pujo Committee, see Federal Reserve Archival System for Economic Research, *Money Trust Investigation. Investigation of Financial and Monetary Conditions in the United States Under House Resolutions Nos. 429 and 504,* available at http://fraser.stlouisfed.org/publications/montru/.

69. Louis Brandeis, "Our Financial Oligarchy," *Harper's Weekly,* November 1913.

70. Louis Brandeis, *Other People's Money, and How the Bankers Use It* (New York: F. A. Stokes, 1914), 4. *Other People's Money* republished a series of articles that originally appeared in *Harper's Weekly.* See also Alexander D. Noyes, "The Money Trust," *The Atlantic Monthly,* May 1913, 653–67.

71. For the history of the Fed, see Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton: Princeton University Press, 1963); and Alan H. Meltzer, *A History of the Federal Reserve, Volume 1, 1913–1951* (Chicago: University of Chicago Press, 2003). For the political compromise that created the Federal Reserve, see David Wessel, *In Fed We Trust: Ben Bernanke's War on the Great Panic* (New York: Crown Business, 2009), 36–38.

72. A version of this idea is central to the historical account in Kindleberger, *Manias, Panics, and Crashes, supra* note 61.

73. Quoted in Urofsky, *Louis Brandeis, supra* note 66, at 346.

74. This was not a new view, but it had previously been held only by "populists" or "progressives" who were not generally part of the mainstream consensus. See, e.g., Michael McGerr, *A Fierce Discontent: The Rise and Fall of the Progressive Movement in America, 1870–1920* (Oxford: Oxford University Press, 2005).

75. David M. Kennedy, *Over Here: The First World War and American Society* (Oxford: Oxford University Press,

2004), chapter 2.

76. Ironically, the origins of the "laissez-faire" philosophy lay in opposition to big business and monopoly power based on state charters and other restrictions on free entry. From the late nineteenth century there was an active debate in the United States about the extent to which this doctrine was still relevant; see Lawrence E. Mitchell, *The Speculation Economy: How Finance Triumphed over Industry* (San Francisco: Berrett-Koehler, 2008). By 1920 "laissez faire" rhetoric was a mainstay of big business, for example as represented by Andrew Mellon and Herbert Hoover, as part of its resistance to regulation (as represented by Brandeis). See David Cannadine, *Mellon: An American Life* (New York: Vintage, 2008); McCraw, *Prophets of Regulation, supra* note 50; and Urofsky, *Louis Brandeis, supra* note 66.

77. Calvin Coolidge, "The Press Under a Free Government," *supra* note 21.

78. Cannadine, *Mellon, supra* note 76; Hofstadter, *American Political Tradition, supra* note 20, at chapter 11. Harding is quoted in Cannadine, *Mellon,* at 277.

79. McCraw, *Prophets of Regulation, supra* note 50, at chapters 4 and 5.

80. Jerry W. Markham, *A Financial History of the United States, Volume II: From J. P. Morgan to the Institutional Investor (1900–1970)* (Armonk, NY: M. E. Sharpe, 2002), chapter 4. Deposit-taking commercial banks were allowed to promote securities; Charles E. Mitchell rose to prominence at National City Bank doing just that—on a salary of $25,000 a year, Mitchell's bonuses pushed his total compensation to $3.5 million between 1927 and 1929. Ibid. at 117. The McFadden Act of 1926 "codified the existing practice of buying and selling 'investment' securities by national banks." Ibid. at 113.

81. J. K. Galbraith, *The Great Crash, 1929* (New York: Mariner, 2009); Charles R. Geisst, *Wall Street: A History from Its Beginnings to the Fall of Enron* (Oxford: Oxford University Press, 2004).

82. The operation of the gold standard meant that the Fed adjusted interest rates to reflect flows of gold in and out of the country; monetary policy was affected more by developments in major European trading nations than by concerns about speculative bubbles. The broader economic philosophy was: stay on gold, let the private sector sort out its own problems, and all will be well. For more details, see Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York: Oxford University Press, 1992); Lester V. Chandler, *Benjamin Strong: Central Banker* (Washington: Brookings Institution Press, 1958); and Liaquat Ahamed, *Lords of Finance: The Bankers Who Broke the World* (New York: Penguin, 2009).

83. Galbraith, *The Great Crash, supra* note 81; Kindleberger, *Manias, Panics, and Crashes, supra* note 61.

84. Quoted in William Greider, *Secrets of the Temple: How the Federal Reserve Runs the Country* (New York: Simon & Schuster, 1987), 65.

85. The definitive source for interest rates is Sidney Homer and Richard Sylla, *A History of Interest Rates,* fourth edition (Hoboken, NJ: Wiley, 2005). Friedman and Schwartz argue that even the tightening in 1928 was a mistake. Friedman and Schwartz, *Monetary History, supra* note 71. See also Ben S. Bernanke, "Money, Gold, and the Great Depression" (H. Parker Willis Lecture in Economic Policy, Washington and Lee University, Lexington, VA, March 2, 2004), available at http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm.

86. Ahamed, *Lords of Finance, supra* note 82; Chandler, *Benjamin Strong, supra* note 82.

87. The Fed was weak by modern standards, but it was not without some power—see William L. Silber, *When Washington Shut Down Wall Street: The Great Financial Crisis of 1914 and the Origins of America's Monetary Supremacy* (Princeton: Princeton University Press, 2007).

88. There was an active debate within the Federal Reserve system, with the New York Fed (which had more autonomy than today) favoring tighter conditions for credit, while the board in Washington preferred to keep the boom going. Meltzer, *History of the Federal Reserve, supra* note 71; Friedman and Schwartz, *Monetary History, supra* note 71; Ahamed, *Lords of Finance, supra* note 82; Cannadine, *Mellon, supra* note 76.

89. Quoted in Ahamed, *Lords of Finance, supra* note 82, at 360; Harrison was at odds with the Federal Reserve Board, but still lent over $100 million into the market. Ibid. at 358–59. He also persuaded the board to cut interest rates from November, but other members of the Fed Board were reluctant to go further. Ibid. at 365, 369.

90. Ibid. at chapter 20.

91. Friedman and Schwartz stressed the importance of a decline in the money supply. Friedman and Schwartz, *Monetary History, supra* note 71. Bernanke argued that the real problem was the failure of banks, as these had local information about borrowers that disappeared when they collapsed. Bernanke, "Non-Monetary Effects," *supra* note 62. See also Alan H. Meltzer, *History of the Federal Reserve, supra* note 71, at chapter 5. The major bank failures began in late 1930 with the Bank of the United States (no relation to the U.S. government). For the full dynamics of the bank failures, see Elmus Wicker, *The Banking Panics of the Great Depression* (Cambridge: Cambridge University Press, 1996).

92. Within New York, the largest banks (e.g., J.P. Morgan, Chase, National City) rescued other large banks (e.g., Kidder Peabody) but declined to save the less prominent Bank of the United States at the end of 1930; this helped trigger wider runs on banks. Ahamed, *Lords of Finance, supra* note 82, at 387–88.

93. Eichengreen, *Golden Fetters, supra* note 82; Peter Temin, *Lessons from the Great Depression* (Cambridge: MIT Press, 1989). Chang-Tai Hsieh and Christina D. Romer are skeptical, at least with regard to the monetary expansion in 1932. Chang-Tai Hsieh and Christina Romer, "Was the Federal Reserve Constrained by the Gold Standard During the Great Depression? Evidence from the 1932 Open Market Purchase Program," *Journal of Economic History* 66 (2006): 140–76, at 172. On the debate over the cause of the Great Depression, see also Peter Temin, *Did Monetary Forces Cause the Great Depression?* (New York: W. W. Norton, 1976); Charles H. Feinstein, Peter Temin, and Gianni Toniolo, *The World Economy Between the World Wars* (Oxford: Oxford University Press, 2008); and Christina D. Romer, "Great Depression," in *Encyclopedia Britannica* (2003), available at http://elsa.berkeley.edu/~cromer/great_depression.pdf. Besides the theories that the Depression resulted from mistakes by the Federal Reserve and that it was caused by the international gold standard, another explanation is that the international community was unable to deal with shocks in Europe. Ahamed, *Lords of Finance, supra* note 82. Alternatively, the federal government may have simply lacked the capacity to counteract the contraction in the private sector, since federal government spending was only 2.5 percent of GDP before the 1929 crash.

94. National City Bank, for example, paid high bonuses tied to selling risky stock. More generally, the prudential standards in banking were lax; Markham, *Financial History,* Volume II, *supra* note 80.

95. Geisst, *Wall Street, supra* note 81, at 214–15, 224–25.

96. On the relationship between private sector banks and the Federal Reserve and regulation more generally, see John T. Woolley, *Monetary Politics: The Federal Reserve and the Politics of Monetary Policy* (Cambridge: Cambridge University Press, 1984), chapter 4. On the history of Federal Reserve politics, see Greider, *Secrets of the Temple, supra* note 84.

97. H. W. Brands, *Traitor to His Class: The Privileged Life and Radical Presidency of Franklin Delano Roosevelt* (New York: Anchor, 2008), 431.

98. Quotations in this paragraph are from ibid. at 450; a slightly later but similar statement is quoted in David M. Kennedy, *Freedom from Fear: The American People in Depression and War, 1929–1945* (Oxford: Oxford University Press, 1999), 282. Roosevelt did not mention Jackson's mistreatment of American Indians. See, e.g., H. W. Brands, *Andrew Jackson: His Life and Times* (New York: Anchor, 2005); Remini, *Life of Andrew Jackson, supra* note 34.

99. Arthur M. Schlesinger, Jr., *The Coming of the New Deal: 1933–1935* (Boston: Mariner, 2003), 444.

100. Carnell et al., *Law of Banking, supra* note 8, at 17.

101. Ibid. at 20.

102. Allen N. Berger, Richard J. Herring, and Giorgio P. Szego, "The Role of Capital in Financial Institutions," *Journal of Banking and Finance* 19 (1995): 393–430. Double liability existed in some states, and for nationally chartered banks from the National Banking Act of 1863, and only ended with the Banking Acts of 1933 and 1935. Anthony Saunders and Berry Wilson, "Contingent Liability in Banking: Useful Policy for Developing Countries?" (Policy Research Working Paper 1538, World Bank, November 1995). Comparable data are not available prior to 1850.

103. The figure is from David Moss, "An Ounce of Prevention: Financial Regulation, Moral Hazard, and the End of 'Too Big to Fail,' " *Harvard Magazine,* September–October 2009, available at http://harvardmagazine.com/2009/09/financial-risk-management-plan. Data are from Bureau of the Census, *Historical Statistics of the United States: Colonial Times to 1970, Part 2* (Washington: U.S. Government Printing Office, 1975), Series X-741; Federal Deposit Insurance Corporation, "Failures and Assistance Transactions," *Historical Statistics on Banking,* available at http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30.

104. Leading independent students of central banking argue that thin equity layers make sense only when there is tight regulation. See, e.g., Charles Goodhart, "Financial Crisis and the Future of the Financial System" (paper presented at the 100th BRE Bank–CASE Seminar, Warsaw, Poland, January 22, 2009).

105. See G. J. Bentson, *The Separation of Commercial and Investment Banking* (London: Macmillan, 1990); and Alexander Tabarrok, "The Separation of Commercial and Investment Banking: The Morgans vs. the Rockefellers," *The Quarterly Journal of Austrian Economics* 1 (1998): 1–18.

106. Thomas Philippon, "The Evolution of the U.S. Financial Industry from 1860 to 2007: Theory and Evidence" (working paper, New York University, NBER, CEPR, November 2008), available at http://pages.stern.nyu.edu/~tphilipp/papers/finsize.pdf.

CHAPTER 2: OTHER PEOPLE'S OLIGARCHS

1. Republic of Korea, "Korea Letter of Intent to the IMF," December 3, 1997, available at http://www.imf.org/external/np/loi/120397.htm.
2. *Time,* February 15, 1999, available at http://www.time.com/time/covers/0,16641,19990215,00.html.
3. Korea was a leading example of what the World Bank famously and perhaps prematurely termed "The East Asian Miracle." *The East Asian Miracle: Economic Growth and Public Policy,* World Bank Policy Research Report (Oxford: Oxford University Press, 1993).
4. Sung Wook Joh, "Corporate Governance and Firm Profitability: Evidence from Korea Before the Economic Crisis," *Journal of Financial Economics* 68 (2003): 287–322, available at http://ideas.repec.org/a/eee/jfinec/v68y2003i2p287-322.html.
5. These ratios are calculated by aggregating total debt and equity up to the chaebol level. Calculated from National Information Credit Evaluation data, as used in Todd Gormley, Simon Johnson, and Changyong Rhee, " 'Too Big to Fail': Government Policy vs. Investor Perceptions" (working paper, November 2009). Figures are for the end of calendar year 1997, and may be affected by currency depreciation if the companies borrowed in foreign currency. But the debt-equity ratios at the end of 1996 were also high: Daewoo's ratio was 3.3, Samsung's was 2.6, and Hyundai's was 4.1.
6. In 1997, the average debt-equity ratio of Korean firms far exceeded that of other countries (Korea, 396 percent; United States, 154 percent; Japan, 193 percent; and Taiwan, 86 percent). Joh, "Corporate Governance and Firm Profitability," *supra* note 4. Se-Jik Kim has slightly different data and puts the debt-equity ratio of Korean firms at 350 percent in 1996, with most of the debt being bank loans. Se-Jik Kim, "Bailout and Conglomeration," *Journal of Financial Economics* 71 (2004): 315–47, at 317. There is no disagreement that the Korean corporate sector was one of the most highly indebted in the world.
7. Anne O. Krueger and Jungho Yoo, "Falling Profitability, Higher Borrowing Costs, and Chaebol Finances During the Korean Crisis," in David T. Coe and Se-Jik Kim, eds., *Korean Crisis and Recovery* (Washington: International Monetary Fund and Korea Institute for International Economic Policy, 2002). For more background on chaebol development, see Eun Mee Kim, *Big Business, Strong State: Collusion and Conflict in South Korean Development, 1960–1990* (Albany: State University of New York Press, 1997).
8. For example, the founder of Hyundai, Chung Ju Yong, formed a political party and ran in the presidential election of 1992.
9. Joh reports chaebol rankings for each year from 1993 through 1997 from the Korea Fair Trade Commission. Joh, "Corporate Governance and Firm Profitability," *supra* note 4, at Table 10. Based on total assets belonging to firms in the same chaebol, Hanbo was number 14 in 1995, up from number 28 in 1994.
10. See Donald Kirk, *Korean Crisis: Unraveling of the Miracle in the IMF Era* (New York: Palgrave, 2001), chapter 8.
11. See Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (Washington: Peterson Institute for International Economics, 2000), 56–57.
12. Sung Wook Joh, "Korean Corporate Governance and Firm Performance" (working paper, 12th NBER seminar on East Asian Economics, 2001).
13. Joh, "Corporate Governance and Firm Profitability," *supra* note 4. See also Jae-Seung Baek, Jun-Koo Kang, and Kyung Suh Park, "Corporate Governance and Firm Value: Evidence from the Korean Financial Crisis," *Journal of Financial Economics* 71 (2004): 265–313.
14. Details of Korea's economic performance immediately prior to the crisis are in "Korea Letter of Intent to the IMF," *supra* note 1.
15. For a timeline of events, see Congressional Research Service Report for Congress, *The 1997–98 Asian Financial Crisis,* February 6, 1998, available at http://www.fas.org/man/crs/crs-asia2.htm. For more detail on the banking dynamics, see Philippe F. Delhaise, *Asia in Crisis: The Implosion of the Banking and Finance Systems* (Singapore: John Wiley & Sons [Asia], 1998).
16. "By the end of 1997, 6.7% of all loans were nonperforming loans, totaling 64.7 trillion won (over $45.6 billion) …. By June 1998, over 10% of all loans were nonperforming loans. These nonperforming loans severely weakened many banks and eventually provoked the liquidity crisis." Joh, "Corporate Governance and Firm Profitability," *supra* note 4, at 292.
17. "Korea Letter of Intent to the IMF," *supra* note 1. Further reforms affecting the financial sector were included in a second Letter of Intent on December 24, 1997, which allowed Korea to access further IMF funding. Republic of Korea, "[Second] Korea Letter of Intent to the IMF," December 24, 1997, available at http://www.imf.org/external/np/loi/122497.htm. See James M. Boughton, *Tearing Down the Walls: The*

International Monetary Fund, 1990–1999 (Washington: International Monetary Fund, 2010) (forthcoming), chapter 11. Paul Blustein explains the U.S. role in arranging this additional support (which included official loans and an agreement that foreign banks would not demand immediate repayment of their loans to Korea). Paul Blustein, *The Chastening: Inside the Crisis That Rocked the Global Financial System and Humbled the IMF,* revised edition (New York: PublicAffairs, 2001), chapter 7.

18. The IMF agreement was negotiated in the run-up to the presidential election, but the incoming president clearly expressed his support at critical moments and his team implemented the reforms. Blustein, *The Chastening, supra* note 17, at chapter 7.

19. In such situations it is hard to determine where U.S. suggestions leave off and IMF advice begins. The first deputy managing director of the IMF at the time, Stanley Fischer, was appointed at the behest of the Clinton administration. Fischer, a leading academic authority on macroeconomics, was in charge of economic strategy at the IMF and in that capacity consulted on a frequent basis with Larry Summers of the U.S. Treasury Department. On this relationship and other connections between Treasury and the IMF, see ibid.

20. The IMF program was insufficiently expansionary at first because the depth of the collapse was not initially understood; fiscal conditions set by the IMF were relaxed later as the crisis deepened.

21. Blustein, *The Chastening, supra* note 17, at chapter 7.

22. See, e.g., Louis Uchitelle, "Crisis in South Korea: The Lenders; A Bad Side of Bailouts: Some Go Unpenalized," *The New York Times,* December 4, 1997, available at http://www.nytimes.com/1997/12/04/business/crisis-in-south-korea-the-lenders-a-bad-side-of-bailouts-some-go-unpenalized.html.

23. "Korea Letter of Intent to the IMF," *supra* note 1.

24. Jagdish Bhagwati argues that a Wall Street–Treasury complex pushed countries into liberalizing their capital inflows in a way that created excessive risks. Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs,* May–June 1998. Rawi E. Abdelal argues that leading European politicians and bureaucrats also pushed this line—including Michel Camdessus, managing director of the IMF at the time of the Korean crisis. Rawi E. Abdelal, *Capital Rules: The Construction of Global Finance* (Cambridge: Harvard University Press, 2006). Paul Blustein, based on extensive interviews with the protagonists, concludes that the United States pushed Korea directly and through the IMF to open up to direct investment by foreign investors in financial services. Blustein, *The Chastening, supra* note 17.

25. Specific ways in which chaebol faced fewer financing constraints are explored in Hyun-Han Shin and Young S. Park, "Financing Constraints and Internal Capital Markets: Evidence from Korean Chaebols," *Journal of Corporate Finance* 5 (1999): 169–91.

26. The extent to which families run businesses around the world is documented by Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Corporate Ownership Around the World," *Journal of Finance* 54 (1999): 471–517. For Asia, see Stijn Claessens, Simeon Djankov, and Larry H. P. Lang, "The Separation of Ownership and Control in East Asian Corporations," *Journal of Financial Economics* 58 (2000): 81–112. For the prevalence of political connections between powerful businesspeople and government, see Mara Faccio, "Politically Connected Firms," *American Economic Review* 96 (2006): 369–86. Specific countries for which we have detailed data on the role of powerful business interests and their political clout include Thailand (Marianne Bertrand, Simon Johnson, Antoinette Schoar, and Krislert Samphantharak, "Mixing Family with Business: A Study of Thai Business Groups," *Journal of Financial Economics* 88 [2008]: 466–98); Malaysia (Simon Johnson and Todd Mitton, "Cronyism and Capital Controls: Evidence from Malaysia," *Journal of Financial Economics* 67 [2003]: 351–82; Edmund Terence Gomez and Jomo K. S., *Malaysia's Political Economy: Politics, Patronage, and Profits* [Cambridge: Cambridge University Press, 1997]); and Pakistan (Asim I. Khwaja and Atif Mian, "Do Lenders Favor Politically Connected Firms? Rent Provision in an Emerging Financial Market," *Quarterly Journal of Economics* 120 [2005]: 1371–1411).

27. Liem headed the Salim Group. Bob Hasan, head of the Numsamba group, was another longtime Suharto friend and business ally. George J. Aditjondro, "Suharto and Sons (And Daughters, In-Laws, and Cronies)," *The Washington Post,* January 25, 1998, C1, available at http://www.washingtonpost.com/wp-srv/business/longterm/asiaecon/stories/sons012598.htm.

28. Marilyn Berger, "Suharto Dies at 86; Indonesian Dictator Brought Order and Bloodshed," *The New York Times,* January 28, 2008, available at: http://www.nytimes.com/2008/01/28/world/asia/28suharto.html.

29. On the nature and value of political connections in Indonesia, see Ray Fisman, "Estimating the Value of Political Connections," *American Economic Review* 91 (2001): 1095–1102. See also Michael Backman, *Asian Eclipse: Exposing the Dark Side of Business in Asia* (Singapore: John Wiley & Sons [Asia], 2001); chapter 14 has details on how the Suharto regime interacted with the private sector. On how subsidies were provided, see Andrew McIntyre, "Funny Money: Fiscal Policy, Rent-Seeking and Economic Performance in Indonesia," in Mustaq H. Khan and Jomo Kwame Sundaram, eds., *Rents, Rent-Seeking and Economic Development* (Cambridge: Cambridge University

Press, 2000). See also Adam Schwarz, *A Nation in Waiting: Indonesia in the 1990s* (Boulder, CO: Westview, 1994), chapter 6.

30. Real GDP per capita (constant prices: chain series), from Alan Heston, Robert Summers, and Bettina Aten, *Penn World Table Version 6.3,* Center for International Comparisons of Production, Income and Prices at the University o f Pennsylvania, August 2009. This measure adjusts incomes for their purchasing power, a method that has limitations but is reasonably accurate for assessments over long periods of time; see Simon Johnson, William Larson, Chris Papageorgiou, and Arvind Subramanian, "Is Newer Better? Penn World Table Revisions and Their Impact on Growth Estimates" (working paper, NBER, October 2009).

31. On Russian reform and the oligarchs, see Anders Aslund, *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed* (Washington: Peterson Institute for International Economics, 2007); Chrystia Freeland, *Sale of the Century: Russia's Wild Ride from Communism to Capitalism* (New York: Crown Business, 2000); and David Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: PublicAffairs, 2002). For early accounts of privatization and other reforms before the rise of the oligarchs, see Joseph R. Blasi, Maya Kroumova, and Douglas Kruse, *Kremlin Capitalism: Privatizing the Russian Economy* (Ithaca, NY: Cornell University Press, 1997); and Thane Gustafson, *Capitalism Russian-Style* (Cambridge: Cambridge University Press, 1999). For a broader assessment of Russian reform, emphasizing that there were no good alternatives, see Andrei Shleifer and Daniel Treisman, *Without a Map: Political Tactics and Economic Reform in Russia* (Cambridge: MIT Press, 2000). On powerful groups controlling the state in the former Soviet Union, see Joel S. Hellman, Geraint Jones, and Daniel Kaufmann, "Seize the State, Seize the Day: State Capture and Influence in Transition Economies," *Journal of Comparative Economics* 31 (2003): 751–73.

32. It is difficult to separate the influence of the IMF and the U.S. Treasury Department. The senior IMF staff member responsible for Russia makes it clear that the G7 (the group of seven large industrial nations, within which the United States has a leading voice) agreed with the IMF's overall direction; if anything, the G7 preferred a bigger budget deficit and, by implication, more capital inflows to the short-term government debt market. See John Odling-Smee, "The IMF and Russia in the 1990s" (IMF working paper WP/04/155, August 2004), available at http://www.imf.org/external/pubs/ft/wp/2004/wp04155.pdf. The general U.S. preference for capital account liberalization is clear in its subsequent free trade agreements with Singapore and with Chile, as well as in its negotiations over China's accession to the World Trade Organization.

33. Aslund, *Russia's Capitalist Revolution, supra* note 31, at chapter 5.

34. George A. Akerlof, Paul M. Romer, Robert E. Hall, and N. Gregory Mankiw, "Looting: The Economic Underworld of Bankruptcy for Profit," *Brookings Papers on Economic Activity* 24 (1993): 1–73.

35. The classic techniques involve managers transferring assets (below market price) to, or buying inputs (above market price) from, companies they control. See, for example, the discussion of Gazprom in Vladimir A. Atansov, Bernard S. Black, and Conrad S. Conticello, "Unbundling and Measuring Tunneling" (working paper, January 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1030529. These phenomena are also seen in high-income countries. Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Tunneling," *American Economic Review Papers and Proceedings* 90 (2000): 22–27.

36. Peter Boone and Boris Fyodorov, "The Ups and Downs of Russian Economic Reforms," in Wing Thye Woo, Stephen Parker, and Jeffrey Sachs, eds., *Economies in Transition: Comparing Asia and Europe* (Cambridge: MIT Press, 1996). There is more evidence of tunneling during the 1997–1998 emerging markets crises in Simon Johnson, Peter Boone, Alasdair Breach, and Eric Friedman, "Corporate Governance in the Asian Financial Crisis," *Journal of Financial Economics* 58 (2000): 141–86.

37. On the appropriation of state property at the fall of the Soviet Union, see Simon Johnson and Heidi Kroll, "Managerial Strategies for Spontaneous Privatization," *Soviet Economy* 7 (1991): 281–316. There was a great deal more theft under the smoke screen created by very high inflation. Anders Aslund, Peter Boone, Simon Johnson, Stanley Fischer, and Barry W. Ickes, "How to Stabilize: Lessons from Post-Communist Countries," *Brookings Papers on Economic Activity* 1996: 217–313.

38. Carlos Diaz-Alejandro, "Good-Bye Financial Repression, Hello Financial Crash," *Journal of Development Economics* 19 (1985): 1–24.

39. The IMF's voting structure is determined by countries' quotas (their potential financial commitments to the IMF), which imperfectly reflect their economic and financial power. The G7 and its close allies control a majority of the votes at the IMF and the United States has an effective veto over any major policy decision.

40. The Indonesia Letter of Intent, dated October 31, 1997, promised to clean up the banking system. Republic of Indonesia, "Indonesia Letter of Intent," October 31, 1997, available at http://www.imf.org/external/np/loi/103197.htm. In its retrospective study, the IMF's Independent Evaluation Office stressed that closing sixteen banks in November 1997 was supposed to "imply a new way of doing business.

However, several factors undermined the credibility of this policy. Most important, the President's family challenged the closures. His son arranged for the business operations of Bank Andromeda to be shifted to another bank in which he had acquired an interest. The President's half-brother initiated a legal challenge to the closure of his bank. The public also saw some inconsistency in the closure of the 16 banks when it was widely—and correctly—believed that many other banks were in similar condition.… Under pressure from the President, the Minister of Finance soon reversed his previously announced tough position, saying there would be no more bank closures." IMF Independent Evaluation Office, *The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil* (Washington: International Monetary Fund, 2003), 75. See also Haggard, *Asian Financial Crisis, supra* note 11, at 66–67. In January 1998, the Indonesian government was supposed to pass a budget that had a surplus equal to 1 percent of GDP. Instead they proposed a budget that appeared to be balanced (with no surplus), which was interpreted as a further sign that Suharto was not willing to take resources away from his family and associated patronage networks. The initial critical reaction from the IMF and the United States helped trigger a further depreciation of the Indonesian rupiah. Eva Reisenhuber, *The International Monetary Fund Under Constraint: Legitimacy of Its Crisis Management* (New York: Springer, 2001), 207. More companies struggled to pay their debts and had to cut costs, contributing to social unrest.

41. See International Monetary Fund, *Ukraine: 2005 Article IV Consultation and Ex Post Assessment of Longer-Term Program Engagement,* November 2005, available at http://imf.org/external/pubs/ft/scr/2005/cr05415.pdf.

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47. See Ajai Chopra, Kenneth Kang, Meral Karasulu, Hong Liang, Henry Ma, and Anthony Richards, "From Crisis to Recovery in Korea: Strategy, Achievements, and Lessons," in Coe and Kim, eds., *Korean Crisis and Recovery, supra* note 7; Haggard, *Asian Financial Crisis, supra* note 11, at chapter 4; Isao Yana-gimachi, "Chaebol Reform and Corporate Governance in Korea" (Policy and Governance Working Paper Series No. 18, Graduate School of Media and Governance, Keio University, Japan), available at http://coe21-policy.sfc.keio.ac.jp/ja/wp/WP18.pdf; and Frederic Mishkin, *The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich* (Princeton: Princeton University Press, 2006), 99–103. Mishkin, a governor of the Federal Reserve from 2006 to 2008, argues that further capital market liberalization is the key to growth in emerging markets.

48. In the 1990s, Argentina tried a version of the Russian strategy—capital inflows that supported a budget deficit and allowed a boom in private sector investment. This was the brainchild of Domingo Cavallo, a distinguished economist with a Ph.D. from Harvard, and received strong support from the IMF (and the United States) even as the approach ran into trouble. Failing to deal with underlying political issues, including the inability to effectively tax powerful business elites, ended in a collapse of the currency, a banking crisis, and defaults on Argentina's public and private debt in 2001–2002. See Paul Blustein, *And the Money Kept Rolling In (and Out)* (New York: PublicAffairs, 2005); and Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (Washington: Peterson Institute for International Economics, 2002).

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are about unstable capital inflows. The United States borrows only in U.S. dollars, thus removing the foreign exchange rate risk that contributed to downfall in Korea, Indonesia, and Russia. And the United States remains the ultimate safe haven, at least for now. When the world becomes more unstable, the ensuing "flight to quality" means that investors buy U.S. government debt; no emerging market country has this advantage.

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CHAPTER 3: WALL STREET RISING

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CHAPTER 4: "GREED IS GOOD"

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Further Reading

Tens of millions of words have been written about the recent global financial crisis, its causes, and the lessons one might draw from it. We are probably responsible for a few hundred thousand of them on our blog, *The Baseline Scenario* (http://baselinescenario.com). The specific sources we drew on are detailed in the Notes to this book. This section is intended only to provide a starting point for readers who would like to learn more about the financial crisis and the issues discussed in this book; we have chosen to include only books and blogs (not academic papers), as they are most likely to be useful for a general audience. The lists below are necessarily incomplete and arbitrary, but we hope that at least some readers will find them useful.

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BLOGS

The financial crisis significantly increased the popularity and importance of many blogs focusing on economics, finance, and public policy. Blogs enabled commentators to offer almost immediate reactions to breaking news stories or policy announcements, and policymakers began paying attention to bloggers as an important audience. There are hundreds of worthwhile blogs that cover economics and economic policy. These are some of the ones that we read, with apologies to those that we are sure to have overlooked.

The Balance Sheet (James Surowiecki): http://www.newyorker.com/online/blogs/jamessurowiecki/
Beat the Press (Dean Baker): http://www.prospect.org/csnc/blogs/beat_the_press
Calculated Risk: http://calculatedriskblog.com
The Conscience of a Liberal (Paul Krugman): http://krugman.blogs.nytimes.com/
J. Bradford DeLong's Grasping Reality with Opposable Thumbs: http://delong.typepad.com/
Econbrowser (Menzie Chinn and James Hamilton): http://www.econbrowser.com/
Econlog (Arnold Kling, Bryan Caplan, and David Henderson): http://econlog.econlib.org/
Economists' Forum (Martin Wolf and guests): http://blogs.ft.com/economistsforum/
Economist's View (Mark Thoma): http://economistsview.typepad.com/
Economix (*New York Times* reporters and guest economists): http://economix.blogs.nytimes.com/
Executive Suite (Joe Nocera): http://executivesuite.blogs.nytimes.com/
Free Exchange (*The Economist*): http://www.economist.com/blogs/freeexchange/
Interfluidity (Steve Randy Waldman): http://www.interfluidity.com/
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Making Sense (Paul Solman): http://www.pbs.org/newshour/economy/makingsense/
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Marginal Revolution (Tyler Cowen and Alex Tabarrok): http://www.marginalrevolution.com/
Naked Capitalism (Yves Smith and others): http://www.nakedcapitalism.com/
Planet Money: http://www.npr.org/blogs/money/
Real Time Economics (*Wall Street Journal*): http://blogs.wsj.com/economics/
Rortybomb (Mike Konczal): http://rortybomb.wordpress.com/
Felix Salmon: http://blogs.reuters.com/felix-salmon/

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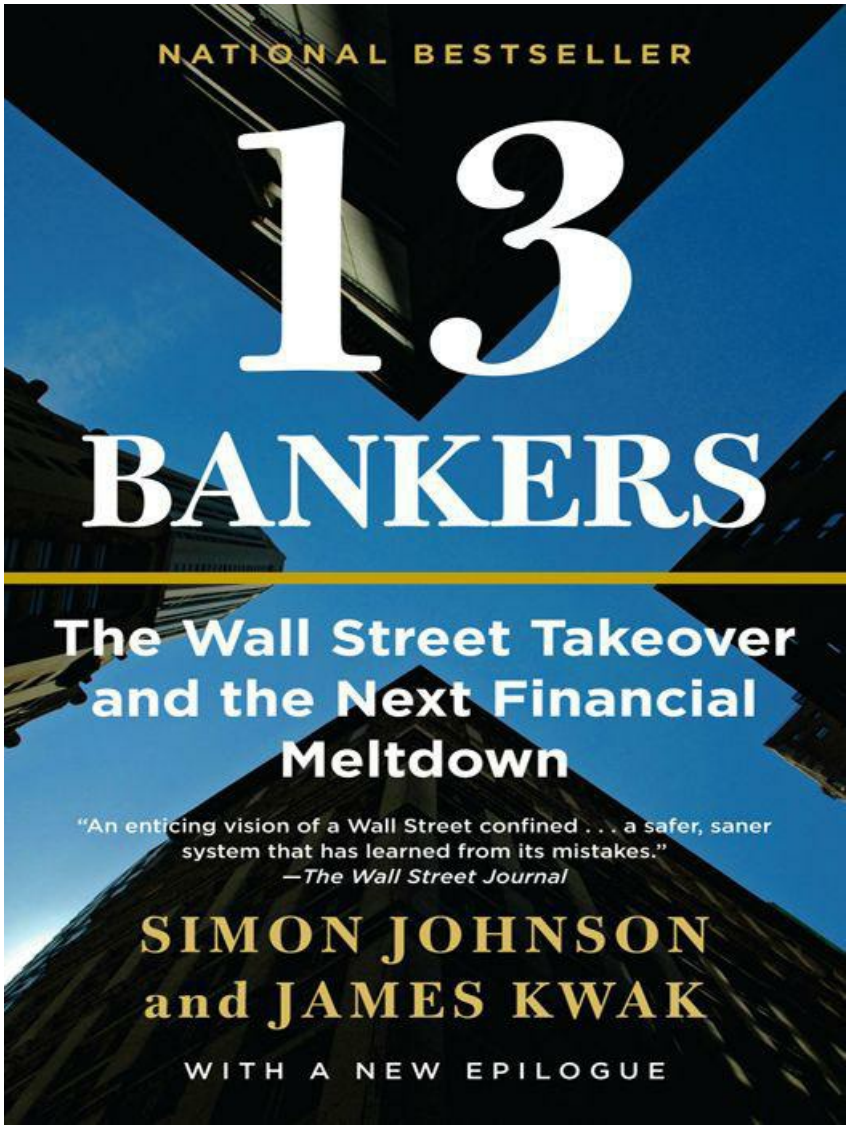
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APPOINTING CENTRAL BANKERS

KELLY H. CHANG

Political Economy
of Institutions and Decisions

APPOINTING CENTRAL BANKERS

THE POLITICS OF MONETARY POLICY IN THE UNITED STATES AND THE EUROPEAN MONETARY UNION

This book examines how the president and the Senate influence monetary policy by appointing Federal Reserve members. The book answers three questions about the appointment process and its effects. First, do politicians influence monetary policy through Federal Reserve appointments? Second, who influences the process – the president alone or both the president and the Senate? Third, what explains the structure of the Federal Reserve appointment process?

The analysis shows the conditions under which the president alone, both the president and the Senate, or neither may influence monetary policy with Federal Reserve appointments. The structure of the process reflects historical political battles between the Democrats and Republicans regarding the centralization of authority to set monetary policy within the Federal Reserve System.

The study extends the analysis to the European Central Bank and shows that the Federal Reserve process is more representative of society than the European Central Bank process.

Kelly H. Chang is currently the Chief Currency and Political Strategist at UBS Private Banking. Prior to her current position, she was an Assistant Professor of Political Science and Public Affairs at the University of Wisconsin-Madison and a Robert Wood Johnson Scholar in Health Policy at the University of Michigan. While holding a National Science Foundation Graduate Research Fellowship, she received a Ph.D. and M.A. in political science and M.A. in economics from Stanford University. She has written and published a number of articles on political economy centering around central banks and political appointments.

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The Politics of Monetary Policy in the United States and the European Monetary Union

KELLY H. CHANG

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1

Introduction

Central banks are often independent, but the degree of independence varies among the banks and over time. Until recently, the British government dictated the Bank of England's monetary policy (Schaling 1995: 91–2). In contrast, the Deutsche Bundesbank controlled policy without government interference (Schaling 1995: 95–6).[1] De Nederlandsche Bank straddled the two extremes; in the event of disagreement, the Dutch finance minister and the central bank had to compromise (Schaling 1995: 93–4). Both the Bundesbank and De Nederlandsche Bank are now parts of the European System of Central Banks, and both should be more similar in their independence; the statute for the new system explicitly prohibits any central bank from taking government instructions (Grilli, Masciandro, and Tabellini 1991; see Cukierman 1992 and Schaling 1995 for excellent reviews of the existing indices of central bank independence).

Although central banks vary in independence, most share a common characteristic: political appointments. Despite the safeguards of central bank independence – for example, no government instructions or closed policy meetings – politicians appoint monetary policy makers. Thus, appointments remain a potential avenue of political influence on monetary policy. The idea behind appointments is simple: if a politician appoints someone like herself, then the appointee should act like the politician when setting monetary policy.

However, influence rarely works so directly or easily. The extent to which politicians influence monetary policy through appointments depends on the appointment process itself, particularly two features of the process. First, different branches of government often share the power to

[1] Prior to the start of EMU. In January of 1999, the ECB took over the monetary policy setting authority of the Deutsche Bundesbank and De Nederlandsche Bank.

appoint. For some central banks, the cabinet appoints candidates subject to legislative approval (e.g., Japan; Bank of Japan Law, Art 23, ¶1–2). For others, the process is reversed: the legislature or cabinet nominates, and the president appoints (e.g., Germany; European Commission 1998: 40, fn. 3). In either set of cases, those who nominate have first-mover advantage and can have relatively more power in the process.

Second, central banks usually have decision-making boards with multiple members. As a result, politicians can rarely influence policy dramatically with one appointment; they usually have the existing members to contend with. In Sweden, until 1999, this problem did not exist as virtually all terms expired every four years right after each parliamentary election (Schaling 1995: 90–1). In Germany, however, each term lasted eight years, and the terms were staggered over several years.[2] Thus in Sweden, one round of appointments was sufficient to significantly influence policy, while in Germany it was probably not enough.

In short, politicians have to work within the constraints of the process in order to influence monetary policy through appointments. Furthermore, in every country, the appointment process reflects the degree to which the powers are separated or shared in the governmental system. In Sweden, the legislature dominates the process, but legislative dominance does not mean much in the context of unified government; in such a system, both legislative and cabinet approval of nominees would be redundant. In Germany, the legislature nominates, and the executive appoints, and the separation of these powers does make sense because the government is not necessarily unified; the majority party of both the lower house, the Bundestag, and the upper house, the Bundesrat, can differ from that of the president.

In the United States, as in Germany, the appointment power is also shared between the executive and legislative branches. In accordance with Article II, Section 2 of the U.S. Constitution,[3] the president appoints Federal Reserve (Fed) members with the advice and consent of the Senate. The president has first-mover advantage in his powers to nominate, but his choice must be conditioned by the Senate's preferences, because of the

[2] These features still exist although the Bundesbank no longer sets monetary policy.

[3] "[The President] shall nominate and by and with the advice and consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the Supreme Court, and all other officers of the United States, whose appointments are not herein otherwise provided for, and which shall be established by law: but the Congress may by law vest the appointment of such inferior officers, as they think proper, in the President alone, in the courts of law, or in the heads of departments."

Senate's power to veto the president's choice. This simple bargaining process, the same process for thousands of federal appointments, produces the policy makers to one of the most powerful institutions in the world – the Federal Reserve. But this particular process, the process for the Fed, has seldom been studied.

This book examines the Fed appointment process and its impact on monetary policy. Because the appointment process repeats in a stable context, it provides an excellent opportunity to examine interbranch bargaining in an area rarely studied by economists – appointment politics – and in a policy subject rarely studied by political scientists – monetary policy. What is the appointment process? How does it really work? Which politicians influence appointments? Who designed the process and for what purpose? This book attempts to tackle these questions with a detailed theoretical and empirical study of Fed appointments that is extended to the new European Central Bank (ECB) – often called the world's most independent central bank.

1.1 THE BOOK'S MAIN QUESTIONS

In mid-January of 1996, Alan Blinder, the Vice Chairman of the Federal Reserve, announced his imminent resignation. Two days later, the Clinton administration expressed interest in the possible nomination of Felix Rohatyn (Wessel 1996: A2), a well-known easy monetary policy advocate. In a vociferous and public attack, Senate Republicans subsequently opposed Rohatyn's candidacy and specifically his potential easy influence on monetary policy (Wilke and Frisby 1996: A3, A16). Rohatyn withdrew within days from consideration although the administration had yet to announce a formal nomination (Wilke 1996b).

About ten days later, the Clinton administration nominated Alice Rivlin, the White House Budget Director, and an academic economist, Laurence Meyer, for an additional vacancy. Both Rivlin and Meyer were widely seen as much more conservative candidates compared to Rohatyn. This time the Senate Republicans were far more receptive. Senator Mack of the Banking Committee remarked that the new members "... are likely to give us a board committed to price stability, and that's what we want to see" (quoted in Wilke 1996a).

This story highlights several important insights into the political appointment process of the American system. First, politicians care about appointments because they believe appointments affect policy. Senator Mack objected to Rohatyn's possible easy influence on monetary policy

and supported Rivlin and Meyer's likely contributions to price stability. Second, the Senate as well as the president may influence the appointment process. Rohatyn's withdrawal from candidacy followed heavy Senate criticism. Third, prior to the formal nomination, the president and Senate engage in bargaining regarding the possible nominees. The back and forth between the president and Senate and Rohatyn's withdrawal preceded a formal administration nomination.

But these insights follow from one anecdote. Do they generalize to other appointments – in other American agencies, in other central banks, or in the Fed? This study addresses the question theoretically and empirically with respect to the Fed with an extension to the ECB. More precisely, the study addresses three specific questions. First, do politicians influence monetary policy through appointments? Second, who influences appointments – the president and Senate jointly or just the president? Third, what explains the structure of Fed appointments?

1.2 Question 1: Do Politicians Influence Monetary Policy through Appointments?

It seems reasonable to assume politicians want their monetary policy preferences to be reflected in monetary policy. Monetary policy profoundly influences the economy, and the economy is often the key to electoral success. A strong empirical relationship exists between the economy's performance and voting for the incumbent party (Kramer 1971; Stigler 1973; Tufte 1975; Fair 1978, 1980; Alesina and Rosenthal 1989, 1995; Erikson 1990; Alesina, Londregan, and Rosenthal 1993). For example, Reagan took advantage of this relationship in 1980 with the campaign slogan, "Are you better off than you were four years ago?"

Because politicians know the appointment process and the Fed's structure, they should be able to strategically appoint Fed members in order to obtain their preferred policy. I use this logic to construct a model of how politicians' monetary policy preferences translate to policy, and then empirically test the model's predictions to see if political influence occurs in the manner specified by the model.

In answer to this first question, this book's results indicate that politicians do influence monetary policy with Fed appointments. Despite the Fed's highly regarded independence, appointments remain an important avenue of political influence on monetary policy. In other words, independence does not imply total freedom from political authority. The Fed may have more autonomy compared to other American agencies, and the Fed

is more autonomous compared to most central banks, but it hardly runs amok. By appointing the appropriate members, the president and Senate basically keep the Fed in line with their preferences while still allowing for the Fed's freedom on a day-to-day basis.

The question of political influence and monetary policy has received much attention in economics, but the perspective is different from the one adopted in this book. From the economic perspective (see particularly Kydland and Prescott 1977), political influence is a *problem* that needs to be solved. The problem starts with the policy makers' incentive to deviate from the socially optimal inflation rate of zero. If policy makers unexpectedly inflate, unemployment decreases, but because economic agents know that policy makers have these incentives, they expect the policy makers to deviate. Because expectations determine inflation, the outcome is positive inflation, which is suboptimal. In their landmark study, Kydland and Prescott (1977) called this the problem of "time inconsistency."

Subsequent economic studies concentrated on two sets of solutions to the problem of time inconsistency. The first was reputation. Barro and Gordon (1983) found that through repeated interactions, policy makers can convince economic agents of their dedication to zero inflation. The second set focused on institutions. Rogoff (1985) and others examined how delegation of monetary authority to a conservative central banker renders society better off by lowering inflation and increasing output. Subsequent works in central bank independence found that appointment features such as longer terms, timing around elections, and conservative biases of the central bankers are pareto efficient (Frey and Schneider 1981; Grilli, Masciandro, and Tabellini 1991; Lohmann 1992; Waller 1992; Alesina and Summers 1993; Waller and Walsh 1996; see Cukierman 1992; Persson and Tabellini 1994, 1999 for excellent summaries).

The problem of political influence is further complicated by the existence of political parties. The "political business cycles" literature showed how policy can fluctuate suboptimally according to partisan interests (Nordhaus 1975; Hibbs 1977; Rogoff and Sibert 1988; Persson and Tabellini 1990; and Rogoff 1990). In a vein similar to Barro and Gordon, Alesina (1987) demonstrated that if the parties cooperate on setting a credible policy in a repeated, two-party game, the cycles attenuated. Building on Rogoff's institutional solution, Waller (1992) and Waller and Walsh (1996) found that the partisanship of central bankers can be reduced by working with the timing of central bank appointments around elections.

The modeling choices in this literature reflect the interest in solving the problem of political influence. The models are dynamic, general equilibrium representations of the entire economy with few institutional details. The actors are represented by homogenous types or representative agents. For example, one central banker represents all central bankers. In the political business cycle models, the policy makers are divided into two parties, but for each party, one party member represents the entire party. Furthermore, the work is more theoretically than empirically developed.[4] But these choices are understandable because the purpose of these models is to show whether a variation in the setup, the proposed solution, leads to optimal outcomes in economic aggregates such as inflation or output. In such models, details may add unnecessary complications.

A group of economists and political scientists have taken an approach different from the preceding general equilibrium models. The quantitative work is empirical and focuses on the Fed's reaction function: regression models with monetary policy as a dependent variable and political influence measures as independent variables (e.g., Beck 1982a; Chappell, Havrilesky and McGregor 1993, 1995; Havrilesky 1993, 1995; Morris 1994, 2000). In particular, Havrilesky (1993, 1995) used reaction functions extensively to find the influence of the president, Congress, and interest groups. On appointment specifically, the results of Morris (1991, 1994, 2000) and Keech and Morris (1996) support presidential and congressional influence through appointments. Morris' thesis (1994) provided the first efforts to formalize a theory of Fed appointments. There are also some very careful qualitative studies by Woolley (1984), who delved into the political meaning of independence, and Kettl (1986), who focused on the evolution of the Chair's role.

In contrast to the studies in time inconsistency, central bank independence, and political business cycles, the Fed literature is characterized by an almost opposite set of features. First, few models of strategic interaction exist (exceptions are Morris 1994; Morris and Munger 1997), and

[4] The empirical work has lagged behind the theoretical breakthroughs. Some evidence suggests a negative relationship between inflation and central bank independence (higher central bank independence implies lower inflation; Grilli, Masciandro, and Tabellini 1991; see Cukierman 1992 for an extensive review). Considerably more empirical work has been done with respect to political business cycles. Starting with Hibbs (1977), the evidence tends to support post-election cycles based on certain conditions predicted by the models (Alesina and Roubini 1990; Persson and Tabellini 1994, 1999). The evidence is not so clear on preelection cycles (Nordhaus 1975; Alesina and Roubini 1990; Persson and Tabellini 1994, 1999).

if they do, the models are static, one-shot games rather than dynamic, repeated games. Second, Fed studies often do make distinctions between different individual actors rather than typologizing them. For example, Chappell, Havrilesky, and McGregor (1993, 1995) examine the differing influences of Reagan and Carter. Third, Fed scholars talk more about the institutions and processes of monetary policy, but there is little formalization of these characteristics. Fourth, in direct contrast to the time inconsistency and central bank independence literature, studies of the Fed are characterized by more empirical than theoretical work.

While both sets of studies provide important findings about central banks, the Fed, and monetary policy, none are quite right for answering the first main question. As this book will show, the appointment process determines how and when influence occurs. The central bank independence literature abstracts from process, as it rightly should, since its concerns are not how the process *actually* works, but rather how central bank relations with politicians *should* work – an essentially normative enterprise, albeit with positive tools. As for the reaction function approach, it is also unsuited to answering the first main question because it seeks to show whether influence exists after any appointment. But not all appointments are alike; influence occurs in certain circumstances but not in others. In this book, those circumstances are clarified through a model of the appointment process that shows that whether influence occurs depends on the direction of policy change desired by the politicians and if the current makeup of the central decision-making board is favorable for moving policy in that direction. Rather than as a *problem* to solve, I treat political influence as a phenomenon about which we want to find out the mechanisms and effects.

1.3 Question 2: Who Influences Appointments?

Both the president and Senate have distinct powers in the appointment process: the president chooses nominees, but the Senate can veto those nominees. Can the president afford to ignore the Senate, or does the Senate's veto power really mean something?

In fact, the Senate's veto power has substantial bite in the process, as this book will show. The Senate does not have to actually exercise its veto power, and it rarely does; in the case of Fed appointments, the Senate has never rejected a nominee (Morris 2000: 78). The mere threat of the veto is enough to make the president pay attention to the Senate's preferences. If the president does not anticipate the Senate, he faces the consequences – a

long, drawn-out confirmation battle that means tolerating whatever policy the current Fed dishes out compared to a possibly better policy if the president compromises with the Senate. For example, rather than fight a war for Rohatyn, the president compromised with his choices of Rivlin and Meyer.

This second question underscores a debate in the political science appointments literature between those who believe the president always anticipates the Senate versus others who believe the president dominates all the time. Proponents of presidential anticipation claim that Senate acquiescence is not Senate powerlessness because the president takes into account the Senate's preferences before formally nominating the candidates (Calvert, McCubbins, and Weingast 1989; Lemieux and Stewart 1990; Hammond and Hill 1993; Morris 1994; Nokken and Sala 2000; Snyder and Weingast 2000). In contrast, presidential dominance scholars claim that the president chooses whomever he pleases, and the Senate will agree because of a norm of deference to the president (Moe 1985, 1987b). Both have used the rarity of Senate rejections as support for their respective theories, but Senate acceptance cannot be used to refute or support either theory: both predict acceptance.[5]

As with many debates, the truth lies somewhere in the middle, as other parts of the bureaucratic delegation literature have concluded. Over the last twenty years, political scientists have gradually modified the principal-agent theory to the realities of the American political setting. Older studies tended to focus on one principal or another, but more recent studies incorporate multiple principals. In the early 80s, the congressional dominance literature examined how Congress influences the bureaucracy through oversight (Weingast and Moran 1983; McCubbins and Schwartz 1984; Weingast 1984). Presidential scholars responded by pointing out the importance of the president through mechanisms such as appointments (Mackenzie 1981; Moe 1985, 1987b). Recent studies take a more holistic approach by considering the president, Congress, the courts, and the bureaucracy together. They show how these institutional actors bargain with one another given their different constitutional powers (Moe 1985, 1987b; McCubbins, Noll, and Weingast 1987; Calvert, McCubbins,

[5] The two theories are also observationally equivalent with respect to Senate roll-call votes when: (1) the president's ideal point lies outside the range of the Senate ideal points, and (2) if dominance scholars define Senate deference as median deference rather than unanimous deference. In (1), all senators vote in the same manner regardless of dominance or anticipation. In (2), a majority of the senators vote in the same manner regardless of dominance or anticipation.

and Weingast 1989; Ferejohn and Shipan 1989, 1990; Matthews 1989; Eskridge and Ferejohn 1992; Hammond and Knott 1996; McCarty 1997; Epstein and O'Halloran 1999; Cameron 2000). These studies have identified the conditions under which Congress, the president, or the courts dominate policy and when they truly share powers (see particularly McCarty and Poole 1995; Hammond and Knott 1996).

Those conditions are also apparent in the Fed appointment process. If we start with a model in which the president always anticipates the Senate, there are still cases in which the president clearly dominates, and others in which neither the president nor the Senate dominates. It depends on whether the president and Senate agree on the direction of policy change and on their preferences relative to current monetary policy.

First, if the president and Senate disagree on the direction of policy change, there is deadlock, and they agree to maintain current policy. Any policy change makes one or the other worse off. Clinton faced this situation with his first few appointments to the Fed. Clinton wanted to move policy in an easier direction, but the Republican Senate Banking Committee did not. When he tried to move policy with Rohatyn, the committee objected, and Clinton had to pull Rohatyn's nomination as well as an earlier nomination of Alicia Munnell.

Second, if they agree on the direction of change, but the president likes the current policy more than the Senate, then the president dominates. From the beginning of his first administration, Reagan wanted to move monetary policy in an easier direction. Martha Seger was Reagan's second Fed appointee in 1984. She faced Democratic opposition in the Senate Banking Committee, but the Republican majority in the committee sided with Reagan and wanted policy to ease up even more than Reagan did. With his choice of Seger, Reagan moved policy as far as he could with this one appointment, and the Democratic senators could not stop him.[6]

Third, if they agree on the direction, and the Senate likes the president's preferred policy more than the current policy, then the president again dominates. When Carter appointed Nancy Teeters in 1978, both he and the Senate clearly favored easier policy; the Senate favored less easier policy, but only slightly less. Under these circumstances, Carter was able to choose Teeters who, even today, is pointed out as the quintessential monetary policy liberal.

[6] Reagan appointed Seger during a congressional recess and angered the Democrats in the process. The Democrats tried to pass an amendment to withdraw the nomination, but the amendment failed to pass on party lines (Morris 2000: 78).

Finally, if they agree on the direction, but the Senate likes the current policy more than the president does, then the president has to accommodate the Senate. For example, when Reagan appointed Alan Greenspan in 1987, he sought a candidate less hawkish than Paul Volcker. The Senate also wanted someone less hawkish but somewhat more hawkish than Greenspan (Greider 1987: 713–14; Martin 2000: 155–7). But because they agreed that policy should move toward somewhat less vigilance on inflation, and because the President had first-mover advantage in choosing the nominee, Reagan could choose a less hawkish candidate, Greenspan, than the Senate would have preferred. However, he could not have gone further to choose a candidate who was still more liberal without incurring Senate threats of rejection.

These second and third cases therefore show presidential dominance within an anticipation framework. But is there dominance all the time? This book's empirical results indicate that it is unlikely. In a direct comparison of the anticipation and dominance models, anticipation does better most of the time for the Federal Open Market Committee (FOMC) – the Fed's main decision-making body.

In identifying dominance within an anticipation framework, this book fits in with more recent studies of appointments. In their study of Supreme Court appointments, Moraski and Shipan (1999) demonstrate that depending on the policy preferences of the president and Senate relative to the current policy, the president or the Senate or both may influence appointments. Bailey and Chang (1999, 2003) show that in addition to the policy preferences, the costs to each side of further nominations determine whether one, the other, or both the president and Senate influence appointments. McCarty and Razaghian (1999) bring similar concerns to an examination of Senate confirmation times for executive branch appointments.

1.4 Question 3: What explains the structure of Federal Reserve appointments?

The Federal Reserve Act of 1913 created the Federal Reserve System, which consists of twelve district reserve banks,[7] and two main decision-making institutions in Washington, DC: the Board of Governors (BOG)

[7] The twelve district reserve banks are located in New York, Boston, Philadelphia, Richmond, Cleveland, Chicago, Atlanta, Dallas, St. Louis, Minneapolis, Kansas City, and San Francisco.

Table 1.1: *The Structure of the Federal Reserve System*

Institution	Number of Members	Appointment Procedure	Functions
District Reserve Banks	12 banks	Bank presidents – by board of directors with the advice and consent of the BOG	Facilitates payments, supervises and regulates banks, participates on the FOMC
Board of Governors	7	By president with the advice and consent of the Senate	Sets the discount rate, determines reserve requirements, participates on the FOMC
Federal Open Market Committee	12	Composed of 7 BOG members and 5 reserve bank presidents	Primary monetary policy-making body; sets the federal funds rate using open-market operations

and the FOMC (Table 1.1). The FOMC is the principal decision-making body of the Federal Reserve System with primary responsibility for setting monetary policy. In its meetings, which occur approximately every six weeks, the FOMC decides by majority rule whether to change the federal funds rate using *open market operations* – sales and purchases of government securities. The federal funds rate is the rate at which banks lend funds overnight to one another, and it is a crucial determinant of other interest rates such as the prime rate.

The twelve-member FOMC consists of two sets of members. The first is the BOG – seven members in total. By itself, the BOG sets the discount rate, the rate at which the Fed lends funds to banks. The president has the formal power to nominate the BOG members to fourteen-year terms[8] with the advice and consent of the Senate. The Federal Reserve Act provides for two appointments per presidential term, two years apart from one another, but in reality, each of the last five presidents, with the exception of George H.W. Bush (Bush appointed three), has appointed at least four governors per presidential term due to early governors' retirements.

[8] The BOG terms are the longest in federal service with the exception of the life terms for federal court judges.

The president also has the power to appoint both the chairman and vice chairman of the BOG, each of whom has a four-year term and a regular fourteen-year governor's term.

The second set of FOMC members consists of the presidents of the district reserve banks. The twelve reserve banks represent the twelve Federal Reserve districts located throughout the country with disproportionate representation of the eastern seaboard and the midwest. The board of directors of each reserve bank appoints the bank's president with the consent of the BOG. Although there are twelve reserve bank presidents, only five seats on the FOMC are reserved for them. The president of the New York Reserve Bank always occupies one of those seats, and a system of annual rotation among the other eleven reserve banks determines the occupants of the other four seats.[9] By tradition, the chairman of the BOG is also the FOMC chairman, and the FOMC vice chairman is the New York Fed president.

The decision-making board has a mixture of presidential appointees and regional representatives, both sets of whom are appointed in different ways. Why did politicians construct such a complicated appointment structure? Previous studies of the Fed's history have not directly addressed this question.

The earlier works on the Fed's origins have varying themes. Kolko (1967) subscribes to the capture theory and argues that the Fed reflected the interests of New York bankers. Livingston (1986) makes a similar argument but couched in class terms: the decline of "competitive-entrepreneurial capitalism" and the rise of the labor class forced capitalists as a class to push for the creation of the Fed as part of a larger new corporate investment system. Timberlake (1993) argues that the creation of the Fed was part of a grand development of the central banking concept in the United States. As for more political analyses, Wiebe (1962), West (1977), and White (1983) provide excellent and balanced studies of the various constellation of interests behind banking reform, but each has his own particular focus. White's study focuses on the evolution of the dual (state and national) banking system and its effects on banking reform. Wiebe studies the role of businessmen in progressive reform. His study is particularly valuable in specifying the interests of nonbanking business

[9] The first of the four reserve bank president seats rotates among the Federal Reserve Banks of Boston, Philadelphia, and Richmond. The second seat alternates between Cleveland and Chicago. The third seat rotates among Atlanta, Dallas, and St. Louis. The final seat rotates among Minneapolis, Kansas City, and San Francisco (Federal Reserve Act: §12A[a]).

interests. But none of these studies tackles the question of why the Fed looks as strange as it does – why the FOMC has twelve members, only seven of whom are presidential appointees; why the appointees have such long terms; why the terms are staggered; and why there is a somewhat decentralized central banking system.

An interest-based, positive explanation lurks behind the Fed's particular institutional features, including those of the structure of appointments. Broz (1999) applies such an explanation to the Fed's creation as it relates to the international currency system. He argues that the Fed was developed to create a sound payments system in the United States and to provide a basis for the establishment of the dollar as an international currency. But while Broz's perspective is the same as the one adopted in this book, the focus is different. Broz has a distinctly international focus in mind, while the focus here is more domestic – how domestic political groups helped to shape the Fed. Furthermore, while Broz seeks mostly to explain why the Fed exists at all, I focus more on why certain of the Fed's details exist in their current forms.

In answer to this third question, the study shows that the structure of Fed appointments reflects battles between Republicans and Democrats about centralization – the centralization of monetary policy-making powers in the central decision-making board versus in the branches of the central bank – and appointment power – the power of the president and Senate to appoint members of the central decision-making board.

Given the strong regional interests in the United States during the early part of the twentieth century, a traditionally centralized central bank on the model of European central banks was politically infeasible. The only attempt to create such a bank died in 1912 together with the Aldrich Bill. The subsequent plan, the Federal Reserve Act, called for a federal system of central banking, with the regional components having substantial powers to set monetary policy. Unfortunately, this system, in combination with the preferences of the appointees at the time, resulted in a Fed unwilling to actively intervene in the economy when the economy needed intervention the most – the Great Depression. The first Roosevelt administration spearheaded a movement to restructure the Fed with more power at the center. Since this restructuring in 1935, the Fed's basic structure and powers have hardly changed.

But each time the central banking system centralized or decentralized, it was accompanied by bargaining about appointment power. Prior to the Fed's creation in 1913, the Republicans repeatedly pushed for a centralized system with appointment power in the hands of New York bankers. The

Democrats pushed for a decentralized system with appointment power in the hands of the government; they got less centralization for more appointment power. In 1935, the Democrats managed to get more centralization for less appointment power. In analyzing these developments, the chapter on the Fed's history details the institutional evolution of the Fed between 1907 and 1935.

1.5 IMPLICATIONS

These three questions and their answers bring out the essential political struggles that determine monetary policy. Interbranch bargaining between the president and Senate determines the desired policy, but both must work through an appointment process that insulates the Fed from immediate influence. The Fed's insulation, however, does not mean that it is free from influence, nor does it mean that the politicians only appoint inflation hawks to the Fed – a popular misconception. As this study shows, inflation doves as well as hawks are appointed, resulting in some highly charged political conflicts within the Fed itself.

Although this book is concerned with appointment politics, there are, of course, other potential avenues of political influence on monetary policy. In addition to his formal powers, the president has some famous informal channels of influence on the Fed. Depending on the president, the Fed Chairman has weekly meetings with the president and the Treasury Secretary. At times, regular meetings of the Quadriad have occurred among the Fed, the Treasury, the Council of Economic Advisors, and the Office of Management and Budget.

Through these regular channels and more spontaneous forms of communication such as by telephone or memo, the president can potentially influence the Fed, as both anecdotal and systematic evidence seems to indicate. In one very famous example, Nixon apparently pressured Burns to inflate the economy just before the 1972 Presidential election (Borins 1972; Maisel 1973). Although some, including Burns, have denied this charge, other examples (see Greider 1987; Havrilesky 1995: 35–6) and systematic evidence in the Political Business Cycle literature support presidential and/or party influence on monetary policy (Nordhaus 1975; Hibbs 1977; Beck 1982a, 1982b; Alesina 1987; Grier 1987; Rogoff and Sibert 1988; Alesina and Roubini 1990; Alesina and Rosenthal 1995).

In addition to approving presidential nominees to the BOG, the Senate Committee on Banking, Housing, and Urban Affairs conducts semiannual oversight hearings of the Fed's monetary policy and reviews

legislation related to the Fed's structure. The semiannual oversight hearings in the Senate Banking Committee are conducted according to the Full Employment and Balanced Growth Act of 1978.[10] Under this act, the BOG submits a monetary policy report to the Senate Banking Committee every six months. In addition, the Chairman presents the report before the full Senate Committee; this presentation is often called the Humphrey-Hawkins testimony. Similar hearings also occur in the House Committee on Banking and Financial Services under the same act. These hearings usually take place in February and July of each year and are closely watched by members of the financial community.

But appointments are particularly important because they are both a regular and a formal avenue of political influence. The president may lunch with the Fed Chairman, but there is no guarantee that the Fed Chairman adheres to what the president wants. In fact, at no time does the Chairman want to give the impression to either the president or anyone else that the Fed is trying to adhere to the president's wishes; this would soil the sacred image of the Fed's independence. As for the congressional banking committees, legislation is generally not easy to pass, and even more difficult when it concerns an attack on the Fed's independence. Representative Wright Patman, a famous foe of the Fed, attempted throughout his long career to make the Fed more politically dependent in various ways, but he failed each time. As for the Humphrey-Hawkins testimonies, they are in line with Greenspan's desire to make monetary policy more transparent to the financial community and the public, rather than being a check by Congress on the Fed's policy.

In contrast, appointments are potentially powerful because the president and Senate can put in place for a long time a person who shares their views. One might argue that just as weekly lunches with the president may be ineffective, appointees can be as well. There is no commitment device to keep them from straying from the wishes of the president and Senate. But no commitment device is needed if the president and Senate are careful enough to choose someone who is not swayed from their convictions, as this book intends to show. Furthermore, there is guaranteed potential for influence every two years – the frequency of the regular appointments.

This book is inevitably informed by a rich and varied literature from a number of different fields. As a study of central banks and monetary policy, this book relates closely to the macroeconomic literature

[10] Although the act's provisions expired in 2000, both the Senate and House continue to holds these hearings under the same format as previously.

on the relationship between rational expectations and monetary policy and on central bank independence. As a study of policy delegation and bureaucracy, the book fits in with the political science studies of the political control of agencies, separation of powers, and more specifically, appointments. As a study of an institution as an object of political choice, the book connects to the growing literature in organization theory of the political foundations of institutional emergence. The book stands at the intersection of many different fields as a study of the politics of monetary policy.

The different strands of the related literature are quite complementary and have much to offer one another once the relevant connections have been made between them. First, the studies of central bank independence are largely theoretical rather than empirical, while the flip side characterizes studies of the Fed. Second, neither are much concerned with process – the principal concern of the appointments literature. Third, the normative focus of the central bank independence literature is balanced by the positive studies of the Fed and appointments. Fourth, the appointments literature has yet to examine central bank appointments that are central to works in central bank independence and the Fed. Finally, an understanding of the Fed's institutional origins would benefit from a positive analysis of institutions.

As the following chapters demonstrate, this study builds heavily on this previous body of work by attempting to make these complementary connections. First, the study is both theoretical and empirical and attempts to provide a tight connection between the two. Second, the appointment process and its relation to policy are the real foci of this study. The study looks into and illuminates the previously black box of the appointment process. Third, the study is explicitly positive – interested in what is rather than what should be. Fourth, the study examines the appointment processes of two different central banks and shows how the differences in the processes lead to different policy outcomes. Finally, I perform a positive, interest-based analysis of the Fed's origins to uncover why the appointment structure looks as it does.

These political struggles are neither unique to monetary policy nor the United States. This study attempts to shed light on the fundamental dynamics of the bargaining process and provides an approach to the study of these dynamics that can be applied in a number of different settings including the European Monetary Union (EMU).

Similar to the presidential nomination/Senate confirmation sequence in the United States, members of the ECB are nominated by the Council

of Ministers and confirmed by the Heads of States. But unlike the U.S. president, the Council of Ministers' nominations are not binding; the Heads of States can suggest other nominees. Furthermore, the Heads of States must unanimously approve a nominee whereas Senate confirmation requires only a majority vote.

As the study will show, these differences have important implications for how influence occurs on policy through appointments. First, the unanimity rule makes it possible, but unlikely, for extremely inflationary countries to influence policy through appointments; when such countries prefer the current policy, the only way to satisfy them is to find another policy that satisfies them. It is more difficult for extreme politicians to exercise undue influence in the United States, because the president is only required to satisfy the Senate median rather than all the senators. Second, unanimity favors the status quo as it only takes one veto to stop policy from changing; again, because not every senator has to be satisfied in the American system, policy is easier to change. Third, even the existence of an agenda setter with binding powers is not enough on the ECB to substantially change policy. The model shows that the unanimity rule has to be changed as well.

Since the discussion for EMU began, a great deal of discussion has surrounded the entrance of traditionally inflationary countries such as Italy, Spain, Portugal, and, most recently, Greece. Although there has been much concern regarding the negative effects of these countries on monetary policy, the analysis in Chapter 5 shows that the power of one country with extreme inflation preferences is limited to conditions when all countries agree on the direction of policy change. But this is rare, and most of the time, the status quo prevails, and as Chapter 5 shows, that was the case in 1999 when EMU began. At the time, the status quo was of relatively tight policy, and thus the institutions created by the EMU founders guaranteed that Italy, Spain, and Portugal, assuming that they wanted to, could not disproportionately influence policy in order to produce easier policy.

1.6 THE PLAN OF THE BOOK

The book uses a variety of methods to tackle the three main questions. I study the Fed appointment process both theoretically and empirically with a combination of tools.

Chapter 2 develops a bargaining model of the process by which the president and the Senate appoint members to the Fed. The model

lays out the policy preferences of both the president and the Senate and how those preferences become actual policy within the constraints defined by the appointment process. For each appointment opportunity, the model predicts the location of monetary policy following the appointment.

Chapter 3 provides the estimates of monetary policy preferences that are required to test the predictions from Chapter 2. For presidents, senators, and Fed members, an econometric model of voting on monetary policy is estimated using new data from the Fed's voting records and coded signals of presidential and senatorial statements regarding monetary policy. The model controls for the current economic conditions that may inspire even inflation hawks to vote for easy policy during recessions.

Chapter 4 uses the preference estimates from Chapter 3 to test the predictions from Chapter 2. From the Chapter 2 model, I derive the testable hypotheses appropriate for answering the first two questions of this book. In answer to the book's first question of whether political influence on monetary policy occurs through appointments, the results are positive; Fed appointments are a viable source of political influence on U.S. monetary policy. In answer to the second question of who influences, the results support the president always anticipating the Senate in terms of the FOMC. Dominance has less support.

Chapter 5 adapts the Chapter 2 model to the study of appointments in the new ECB. In this process, the Heads of States of the member EMU countries must unanimously approve the nominees. As a result, the model demonstrates that sometimes extremely dovish or hawkish countries could determine European monetary policy, while at other times, it is very difficult to change the current policy. Although the model lends support to recent alarm regarding the entry of high inflation countries such as Italy, preliminary results indicate that the current situation dictates against a change in the current, relatively tight policy.

Chapter 6 answers this book's third question by examining the Fed appointment process as an endogenous object of political choice. Extensive archival research is used to discover the political foundations of the Fed for its creation in 1913 and for its restructuring in 1935. The research indicates that the Fed's unusual appointment structure resulted from the battles between the Democrats and Republicans regarding the extent to which the Fed's powers were centralized. The Democrats and their constituencies of smaller banks feared a central bank controlled by big New York banks. These New York banks supported the Republicans who pushed for a real central bank. The Federal Reserve System, as established, was

a compromise consisting of many smaller central banks with a central board of regional representatives as well as presidential appointees.

Chapter 7 summarizes and concludes by providing suggestions of possible extensions to other agencies and central banks. With suitable modifications, the model is applicable to any number of governmental and policy settings. The comparative possibilities are outlined in this concluding chapter.

2

A Formal Model of the Appointment Process

This chapter presents a formal model of the process by which the president and Senate appoint members to the Fed. The model lays out the president and Senate's strategic considerations when they are faced with an appointment opportunity posed by either the retirement or by the expiring term of a Fed member. The president moves first with his power of nomination and thinks about how to exploit that first-mover advantage, while the Senate tries to maximize its veto power over the president's choice of nominee. Once they agree on a nominee, the president and Senate face constraints on how far they can move Fed policy with a single appointment; the Fed's multimember decision-making structure forces the president and Senate to work around the existing Fed members. In sum, the model details how preferences work within the constraints of the appointment process to produce monetary policy.

The model encompasses several of the theories of appointments discussed in Chapter 1. The first is presidential anticipation: in the model presented here, the president always anticipates the Senate's preferences. Under a certain set of circumstances, this means that the president dominates, and at other times, the president compromises with the Senate. Under still other circumstances, neither dominates, and both in a situation of deadlock simply maintain the current policy. Thus given presidential anticipation, the model demonstrates that presidential dominance, presidential compromise, or deadlock can occur.

2.1 AN INFORMAL DESCRIPTION OF THE APPOINTMENT PROCESS

This book focuses on the BOG appointments as they affect policy made by the FOMC; the study takes as given the appointees for the reserve banks

presidents. The appointment process used to appoint BOG members follows the general presidential nomination-Senate confirmation sequence prescribed in Article II, Section 2 of the U.S. Constitution. The only special feature of the process is a prescription of the Federal Reserve Act: the president must give consideration to representation of the twelve reserve districts and "fair representation of the financial, agricultural, industrial, and commercial interests and geographical divisions of the country" (Federal Reserve Act §10 ¶1, 38 Stat. 251(1913), 12 U.S.C. §241(1935)). Informally, consideration is given to the preferences of individual senators, financial sector opinions, and the candidate's sex and race (Havrilesky 1995: 291, 296–7; Jones 1995: 69).

The president submits his nominee to the Senate which refers the nomination to its Committee on Banking and Urban Affairs.[11] The Banking Committee investigates and holds hearings to question the nominee. Committee members often ask candidates about potential conflicts of financial interest and about their policy views. The Committee usually considers BOG candidates with nominees for other official posts related to the financial industry (e.g., commissioners for the Securities and Exchange Commission). The Banking Committee then votes to recommend the nominee to the full Senate. If the nominee makes it through committee, the full Senate debates and votes to confirm the nominee. To date, neither the Banking Committee nor the full Senate has formally rejected a nominee to the BOG. In fact, the Senate has confirmed most nominees by unanimous consent (Morris 1991: 31).

To summarize, the president chooses a candidate, the Senate Banking Committee votes to recommend the nominee, and the full Senate then decides whether to confirm the appointment. The following model attempts to capture the key features of this process.

2.2 THE APPOINTMENT PROCESS MODEL

2.2.1 *Assumptions and Definitions*

1. *Actors and their preferences.* There are three sets of actors in the following model: presidents, Senate Banking Committee members, and FOMC members (Table 2.1).

[11] The Banking Committee usually consists of eighteen members, a majority of whom are from the majority party.

Table 2.1: *Acronyms, Variables, and Other Notations*

FOMC	Federal Open Market Committee
BOG	Board of Governors
P	President's ideal point
S	Senate Banking Committee median's ideal point
SQ0	FOMC median before a retirement
SQ1	FOMC median after a retirement
SQ2	FOMC median after the new appointee takes office
x1, . . . , x12	FOMC members numbered in order of easiest to tightest policy
y	FOMC retiree
x	New appointee
SQ^-	Senate's indifference point
L	Lower limit of the range of possible outcomes
H	Upper limit of the range of possible outcomes

I assume that all actors have well-behaved, single-peaked preferences over a single dimension of monetary policy measured by the federal funds rate, $r \in [0, 1]$; lower rates indicate easier policy. The utility for an individual i is a monotone, decreasing function, θ, of the distance of her ideal point, r_i, from the current Fed policy, $SQ : U_i(r_i, SQ) = \theta(|r_i - SQ|)$.

As the statistical model of preferences makes clearer in Chapter 3, r_i measures at any time an individual's leaning toward easier or tighter policy as a function of the individual's characteristics and economic conditions. Volcker and Seger's r_is tell us that Seger is *always* easier than Volcker. Because r_i is a function of economic conditions, one can also think of r_i as an implied catch-all for common economic outcomes such as inflation. Thus Volcker is always an inflation hawk relative to Seger.

2. *Actions.* First, the president chooses a nominee, x, on the set of $r \in [0, 1]$; the nominee maps to a specific FOMC median, $SQ2$. Section 2.2.4 describes the exact mapping. Second, the Senate accepts or rejects the nominee. Third, the FOMC members vote on monetary policy according to the rule: Vote = tighter policy if $r_i > SQ$, Vote = easier policy, otherwise.

3. Other assumptions and implications

THE SENATE BANKING COMMITTEE AND THE FOMC. Because both the Senate Banking Committee and the FOMC are majority rule institutions, it follows from the preceding assumptions, plus the assumption of perfect

and complete information, that the median voter theorem applies to both these collective institutions; the Senate Banking Committee median (S) and the FOMC median (SQ) capture the policy positions of the two institutions.

I assume further that the Banking Committee median accurately represents the Senate floor median; hereafter all references to the Senate are to the Senate Banking Committee. Although there is some theoretical and empirical controversy regarding this assumption, Krehbiel (1990) and Krehbiel and Rivers' (1988) results support the assumption. In particular, Krehbiel (1990) shows, using a variety of interest group ratings, that many committees, including the Senate Banking Committee, are not preference outliers compared to the floor. Krehbiel and Rivers (1988) focus on the Senate Committee on Labor and Human Resources since they are concerned with minimum wage law.

The FOMC median, the current Fed policy or SQ, is the median of the members *currently serving* on the FOMC. When a vacancy occurs, in the absence of an appointment, the FOMC continues to function with the reduced membership.[12] With an odd number of members, the median member is the FOMC median. With an even number of members, I designate the midpoint between the two middle members as the median.

Despite the conventional wisdom of the all-powerful Fed chair, the FOMC median is a reasonable proxy for the institution for several reasons. First, the chair has agenda-setting powers, but those powers are limited. In a typical FOMC meeting, the chair begins with his assessment of the current economy and provides options regarding the amount by which the FOMC might want to change interest rates. Each member then reacts and adds to the chair's comments, and in light of their comments, the chair may adjust his proposal. Once the chair is satisfied that his proposal has at least majority support, he calls for a vote.[13] Thus the chair's agenda-setting power is neither exclusive nor absolute; others can help set the agenda, and the chair engages in an intrameeting adjustment process for his own agenda.

Second, even if the chair has agenda-setting power, he must satisfy the median. Suppose the reversion point is the median – the policy starting

[12] Seven FOMC members constitute a quorum.

[13] I thank the research staff at the Minneapolis Fed for information on the FOMC meetings.

point.[14] For an odd number of FOMC members, the chair cannot move the outcome away from the median member because he cannot obtain majority support for any other proposal.

The same is true for an even-numbered FOMC, for example with twelve members. In that case, the reversion point is also the median, but the median is now the *range* between the sixth and seventh members; any given realization of the median is a random draw from that range. If the chair is to the left of the sixth member, he cannot obtain any point to the left of the range's midpoint, because the seventh member would reject that point. The seventh member would be better off with the status quo because it guarantees that at least some draws of the median are right of the midpoint, closer to her ideal point. Thus the best the chair can do is to choose the midpoint itself, which guarantees that the outcome is always at the midpoint rather than to the right of the midpoint some of the time.[15] The seventh member accepts the midpoint because she is indifferent between the midpoint and the status quo; in expectation, they yield the same utility.[16]

Third, the empirical evidence for chair agenda-setting power is mixed at best. If the chair has much agenda-setting power, his voting weight should be higher compared to that of the other members. Krause (1994) finds support for the chair's ability to build consensus, and Chappell, McGregor, and Vermilyea (1998) conclude that the chair's voting weight is higher than that of typical FOMC members. However, Chappell, McGregor, and Vermilyea (1998) also conclude that the median voter theorem, which presupposes equal voting weights, accurately represents FOMC voting behavior. Furthermore, Chappell, Havrilesky, and McGregor (1993: 203; 1995: 123) find that they cannot reject the hypothesis of equal chair voting weight.[17]

[14] Given the median voter theorem, the assumption is reasonable.

[15] Although the policy outcome point – the FOMC median – does not change, the actual Fed policy can still change. Depending on the economic situation, the same median point can mean raising interest rates fifty basis points or lowering them twenty-five basis points. The context will translate the median point to the real policy at a particular point in time.

[16] Essentially, the foregoing is an application of the RR (1978) setter game in which one player is a majority rule body and the starting point is the median. In this setup, the median always prevails, although this is not the case if the median is not the starting point.

[17] The extent to which these studies arrive at different conclusions is disconcerting. The mixed results may have to do with the use of different sources of data and testing methods. The debate might be settled when the Fed finally releases all of the minutes

The remaining evidence regarding chair power is anecdotal, but even anecdotes provide mixed evidence. According to Greider (1987: 639–40), Volcker was informally outvoted in 1987: "The sharp division in the Federal Open Market Committee was not revealed by the final vote or by the FOMC's minutes. The chairman himself did not normally dissent, even when he did not get his way . . . *Volcker yielded to the others*," (p. 640, emphasis added). Rose (1974: 187–8) claims that Burns was formally outvoted on a number of occasions. These anecdotes indicate that the chair does not always have his way with the other FOMC members, but rather, it may be the other way around.

APPOINTMENTS AND POLICY. As the utility function reflects, actors care only about policy – not about specific appointments; they care about appointments only insofar as they affect policy. But policy, the end goal, is produced by the FOMC, while appointments, the means to the ends, are on the BOG. How can the president and Senate ensure policy effects on the FOMC through BOG appointments?

Essentially the president and Senate can manipulate FOMC policy with their BOG appointments because the BOG members make up a majority of the FOMC. I assume that the president and Senate are perfectly informed about the preferences of current and future reserve bank presidents. Because reserve bank presidents often serve multiple five-year terms, and this system of rotation is fixed, the assumption is reasonable. For example, the Philadelphia reserve bank president recently retired after nineteen years of service – nearly four consecutive terms.

2.2.2 *The Sequence*

The *appointment process model* is a spatial bargaining game between the president and the Senate. The game begins when a member of the FOMC leaves. The president moves first with his choice of appointee, after which the Senate can veto the choice. Once they agree on an appointee, the appointment is made, a new policy outcome is realized (the resulting FOMC median), and payoffs are distributed to the president and Senate based on the new outcome. If they fail to agree on an appointee, the

from its meetings. With the voting records from the publicly available "Record of Policy Actions," the data used in this study, a true test of the chair's agenda-setting power is not possible. The record does not provide enough information on the deliberations prior to the vote, and the votes already reflect chair influence. The minutes of the meetings do not suffer from this limitation. Chappell, McGregor, and Vermilyea (1998) use the currently available set of minutes to conduct their test.

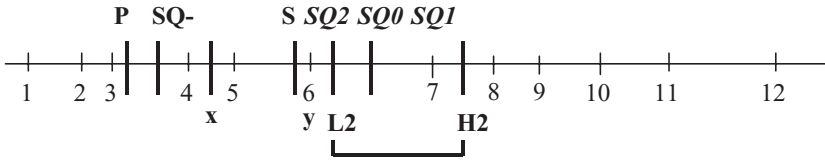

Figure 2.1: Example

president and Senate have to put up with the median of the eleven-member FOMC – the reversion point.

2.2.3 An Example

Before describing the equilibria of the game more generally, consider the example in Figure 2.1. We need the following definitions.

Retirees and nominees. Define y as the retiree, and x as the nominee or if approved – the appointee.

Status quos. $SQ0$ is the median of the FOMC *before* any given retirement, $SQ1$ is the FOMC median *after* the retirement, and $SQ2$ is the FOMC median after an appointee takes her seat on the FOMC.

Policy outcome. $SQ2$ is the policy outcome.

Reversion point. $SQ1$ is the reversion point.

The Senate's indifference point. The Senate's indifference point, SQ^-, is the point at which it is indifferent between SQ^- and $SQ1 : |S - SQ1| = |S - SQ^-|$.

FOMC members. The FOMC members are labeled $\{x1, \ldots, x12\}$ in order of easier to tighter monetary policy. In Figure 2.1, the x's for the FOMC members have been dropped for ease of explication.

Range of possible outcomes. The range of possible outcomes is the range in which the president and Senate can move the FOMC median with a given single appointment. L is the lower limit, and H is the upper limit of the range.

In this example, the president (P) and the Senate Banking Committee median (S) favor easier policy relative to the current status quo, $SQ0$.

The appointment process begins with a retirement, $y = x6$. After the retirement, the FOMC median immediately changes from $SQ0$ to $SQ1 = x7$, which is the reversion point, the outcome that the president and Senate must tolerate in the absence of an agreement.

If we compare P, S, and $SQ1$ and forget momentarily about the other FOMC members, the president and Senate would agree on the Senate's indifference point, SQ^-, as the policy outcome. The president would suggest this point as the agenda setter, and the Senate would agree to it because it is indifferent between SQ^- and $SQ1$. So far, the game is a straightforward application of the Romer and Rosenthal (1978) setter game.

However, SQ^- lies outside the possible range of outcomes for the retirement, $y = x6$. For this retirement, whether the nominee's ideal point is $x5$ or $x1$, the lowest point the president and Senate can achieve with this single appointment is $L2 > SQ^-$. In this manner, $L2$ defines the lower boundary of the range of *possible* outcomes. The upper boundary, $H2 = \frac{x7+x8}{2}$, results from an appointment to the right of $x8$. $[L2, H2]$ is the entire range of possible outcomes for $y = x6$.

The president and Senate still want to get as close as possible to SQ^-. In the range of possible outcomes, that point is $L2$ – the *actual* outcome. Formally, the equilibrium of this particular game is defined on the path by the president's nominee choice, $x \leq x5$ and the Senate's acceptance. The president and Senate receive payoffs based on $SQ2 = \frac{x5+x7}{2}$.

2.2.4 *Possible Outcomes*

I now generalize the example by first examining all the possible outcomes and then adding the president and Senate to the analysis and seeing what it means for the actual outcomes.

The example illustrates that the game is relatively simple except for the mapping of appointees to policy outcomes – the FOMC medians. First, a single appointee's position, x, is never the policy outcome of the game. In the preceding example, even if $x6$ is the retiree, and x is between $x5$ and $x7$, the new policy outcome would be $\frac{x+x7}{2}$ rather than x.

Second, even though x itself can never be the policy outcome, x may define a unique policy outcome, that is the correspondence between x and $SQ2$ can be unique. However, at other times, the correspondence between x and $SQ2$ is not one to one; a range of appointees leads to the same outcome. Going back to the example, when $x6$ leaves, any new x such that $x5 < x < x7$ will determine a unique policy outcome defined by $\frac{x+x7}{2}$. The same is true for any x such that $x7 < x < x8$; the outcome in this case will be $\frac{x+x7}{2}$. However, any appointee greater than $x8$ will not result in a unique policy outcome. In fact, all such appointees will result in the *same* outcome, $\frac{x7+x8}{2}$. Similarly, all appointees less than $x5$ will result in the same outcome, $\frac{x5+x7}{2}$.

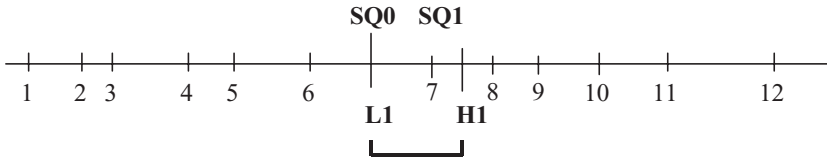

Figure 2.2: Range 1

These complications will affect the extent to which the president and Senate can move policy to exactly their desired location with one appointment. Sometimes, no matter how much they would like to move policy to some location, there will be a limit to which they can do so, and the limit will be determined by the location of the vacancy.

In this subsection, I formally characterize the limits – the range of possible outcomes for any given vacancy. The possible outcomes are grouped into four ranges based on seat numbers: the first five seats, seat 6, seat 7, and the last five. Range 1 is defined as $[L1, H1]$, Range 2 as $[L2, H2]$, and so on.

Range 1 (Figure 2.2): *if* $y \in \{x1, x2, x3, x4, x5\}$

Range 1 is defined by a vacancy in one of the first five FOMC seats. Once one of $\{x1, x2, x3, x4, x5\}$ retires, the FOMC median will immediately move to $SQ1 = x7$.

The first two sets of possible appointees do not uniquely define the outcome, $SQ2$. First, in (1) in the following text, all appointments to the left of $x6$ ($x \leq x6$) will result in $SQ0$, the same median before the retirement of the outgoing member. Thus $SQ0$ defines the lower limit, $L1$, to which the president and Senate may move policy with any one such retirement. Second, in (2), any appointment to the right of $x8$ will result in the median defined by the mean between the 7th and 8th FOMC members. This point defines the upper limit, $H1$, to which the president and Senate may move policy with any one such retirement. To formalize, the nonunique correspondences between x and $SQ2$ are defined by:

$$(1)\ x \leq x6 \quad \Rightarrow \quad SQ2 = SQ0 = L1$$
$$(2)\ x \geq x8 \quad \Rightarrow \quad SQ2 = \frac{x7 + x8}{2} = H1$$

The second set of possible appointees, between seats 6 and 8, do define a unique set of outcomes – the mean of the new appointee and the 7th member. The new outcome will be between the lower and upper

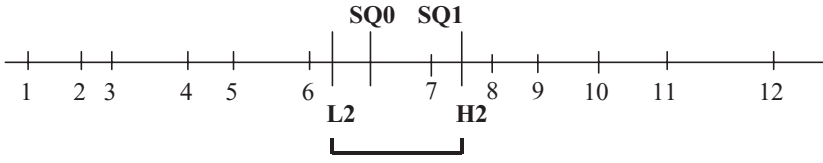

Figure 2.3: Range 2

limits. The unique one-to-one correspondences between x and $SQ2$ are defined by:

$$(3)\ x6 < x < x8 \quad \Rightarrow L1 < \quad SQ2 = \frac{x + x7}{2} < H1$$

Thus the complete range of outcomes for $y \in \{x1, \ldots, x5\}$ is $L1 \leq SQ2 \leq H2$. Whether a one-to-one correspondence exists depends on whether x is between or outside the boundaries defined by seats 6 and 8.

Range 2 (Figure 2.3): *if* $y \in \{x6\}$

Because $x6$ and $x7$ define the FOMC median, a retirement of $x6$ or $x7$ means that the president and Senate can potentially change the outcome to a greater extent compared to when the other members retire. For example, if $x5$ rather than $x6$ retires, the president and Senate will always bump up against the lower limit, L, defined in part by $x6$: $L = SQ0 = \frac{x6+x}{2}$. When $x6$ retires, $x5$ defines the lower limit rather than $x6$, and thus the lower limit is lower, and the range is larger.

If $x6$ retires, $SQ1 = x7$. As in Range 1, there are two sets of possible outcomes based on the placement of the new appointee.
The first set defines the nonunique correspondences between an appointee and outcomes:

$$(1)\ x \leq x5 \quad \Rightarrow \quad SQ2 = \frac{x5 + x7}{2} = L2 \leq L1$$
$$(2)\ x \geq x8 \quad \Rightarrow \quad SQ2 = \frac{x7 + x8}{2} = H2 = H1$$

In (1), since $x5 \leq x6$, this lower limit will be lower than in Range 1: $L2 < L1$. According to (2), the upper limit stays the same: $H1 = H2$. In sum, Range 1 $\leq$ Range 2.

The second set defines the unique outcomes. When x is between $x5$ and $x8$, x together with $x7$ will define the new outcome:

$$(3)\ x5 < x < x8 \quad \Rightarrow \quad L2 < SQ2 = \frac{x + x7}{2} < H2$$

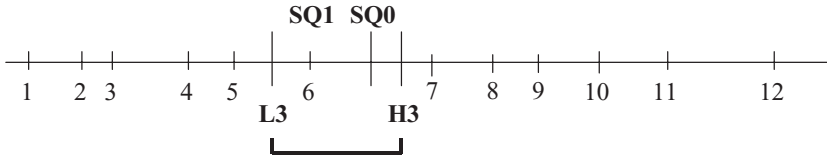

Figure 2.4: Range 3

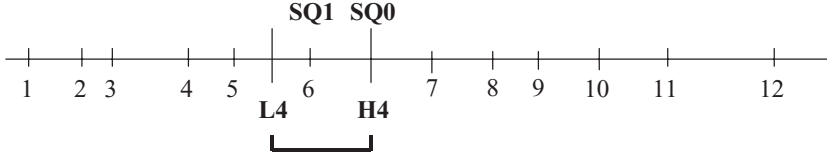

Figure 2.5: Range 4

Thus the complete range of outcomes for $y \in \{x6\}$ is $L2 \leq SQ2 \leq H2$, where $L2 \leq L1$ and $H1 = H2$ such that Range 1 $\leq$ Range 2.

Range 3 (Figure 2.4): *if* $y \in \{x7\}$

Analogous reasoning applies to Ranges 3 and 4 in which $y \in \{x7, \ldots, x12\}$. In order to be complete, I quickly provide the formal details.

For any $y \in \{x7\}$, $SQ1 = x6$. The nonunique correspondences between x and $SQ2$ are defined for any x such that:

$$(1)\ x \leq x5 \quad \Rightarrow \quad SQ2 = \frac{x5 + x6}{2} = L3$$

$$(2)\ x \geq x8 \quad \Rightarrow \quad SQ2 = \frac{x6 + x8}{2} = H3$$

The unique correspondences are:

$$(3)\ x5 \leq x \leq x8 \quad \Rightarrow \quad L3 < SQ2 = \frac{x + x6}{2} < H3$$

Thus the total range of outcomes for $y \in \{x7\}$ is $L4 \leq SQ2 \leq H4$.

Range 4 (Figure 2.5): *if* $y \in \{x8, x9, x10, x11, x12\}$

For any $y \in \{x8, \ldots, x12\}$, $SQ1 = x6$. The nonunique correspondences between x and $SQ2$ are defined for any x such that:

$$(1)\ x \leq x5 \quad \Rightarrow \quad SQ2 = \frac{x5 + x6}{2} = L4 = L3$$

$$(2)\ x \geq x7 \quad \Rightarrow \quad SQ2 = SQ0 = H4 \leq H3$$

The unique correspondences are defined for any x such that:

$$(3)\ x5 < x < x7 \quad \Rightarrow \quad L3 < SQ2 = \frac{x + x6}{2} < H3$$

Thus the total range of outcomes for $y \in \{x8, \ldots, x12\}$ is $L3 \leq SQ2 \leq H3$ where $L3$ is the same as $L4$ but $H3 \geq H4$, and Range $3 \geq$ Range 4. As with the retirement of $x6$, $x7$'s retirement, compared to the other members' retirements, leaves the president and Senate more latitude to move policy.

2.2.5 Actual Outcomes: Adding the President and the Senate

In the previous section, I examined the entire range of *possible* outcomes for a single appointment given the location of the vacancy. In this section, I predict the location of the *actual* outcomes in the range of possible outcomes by adding the president and Senate to the analysis. The actual outcomes are determined by the three possible orderings of the president and Senate relative to $SQ1$.

Case 1: Presidential Dominance

DEFINITION. *Romer-Rosenthal (RR) equilibrium policy.* The RR equilibrium policy is the game's outcome in the absence of the constraints imposed by the range of possible outcomes, for example SQ^- in the example. The RR equilibrium policy is the Romer-Rosenthal setter game (1978) equilibrium.

In Case 1, the president is closer to the status quo, $SQ1$, than the Senate. As the agenda setter, the president can propose his ideal point, P, as the *RR equilibrium policy*, and the Senate will accept the proposal as the outcome will be closer to its ideal point, S, than the status quo, $SQ1$. The problem is that P might be outside the range of possible outcomes. In that case, whichever boundary point, L or H, is closer to the president's ideal point will become the actual policy outcome.

More formally, there are two possible configurations of this case. In each configuration, $|P - SQ1| < |S - SQ1|$.

$$(1)\ S < P < SQ1 \quad \Rightarrow \quad SQ2 = P \textit{ if } P \in [L, H],\ \ SQ2 = L \textit{ otherwise}$$
$$(2)\ SQ1 < P < S \quad \Rightarrow \quad SQ2 = P \textit{ if } P \in [L, H],\ \ SQ2 = H \textit{ otherwise}$$

Case 2: Presidential Compromise. In this case, the Senate is closer than the president to the status quo, $SQ1$. However, the ultimate policy outcome depends on how close the Senate is to the president. In some cases

(Case 2a), the Senate is closer to the president than the Senate's indifference point, SQ^-, and in those cases, the president has every incentive to propose his ideal point as the RR equilibrium policy which the Senate has no reason to reject because the reversion point, the status quo point, $SQ1$, is farther away from S than P. In other cases (Case 2b), the Senate's indifference point is closer than the Senate's ideal point to the president, and the president will propose SQ^- as the RR equilibrium policy; the Senate will accept as it is indifferent, by definition, between SQ^- and the status quo.

As before, the actual outcome will be whichever is possible: a boundary point or P in the first set of cases (Case 2a), and a boundary point or SQ^- in the second set of cases (Case 2b).

There are four possible configurations of Case 2. In each configuration, $|S - SQ1| < |P - SQ1|$.

Case 2a: S is closer to P than to SQ1

$$(1)\ P < S < SQ1 \text{ and } S < \frac{P + SQ1}{2}$$
$$\Rightarrow\ SQ2 = P \text{ if } P \in [L, H], SQ2 = L \text{ otherwise}$$
$$(2)\ SQ1 < S < P \text{ and } S > \frac{P + SQ1}{2}$$
$$\Rightarrow\ SQ2 = P \text{ if } P \in [L, H], SQ2 = H \text{ otherwise}$$

Case 2b: S is closer to SQ1 than to P

$$(3)\ P < S < SQ1 \text{ and } S > \frac{P + SQ1}{2}$$
$$\Rightarrow\ SQ2 = SQ^- \text{ if } SQ^- \in [L, H],\ \ SQ2 = L \text{ otherwise}$$
$$(4)\ SQ1 < S < P \text{ and } S < \frac{P + SQ1}{2}$$
$$\Rightarrow\ SQ2 = SQ^- \text{ if } SQ^- \in [L, H],\ \ SQ2 = H \text{ otherwise}$$

Note that although S is closer to $SQ1$ than to P in Case 2, the president still dominates in configurations (1) and (2). This is due to the president's agenda-setting power which also shows its advantages in the Senate's inability to get its ideal point, S; at best, the Senate can obtain SQ^-.

Case 3: Deadlock. In this case, the status quo lies between the president and Senate's ideal points. Thus, neither the president or Senate is willing to give up ground, because one's gain is the other's loss. They therefore agree to disagree; they maintain the current FOMC median. $SQ1$ is the RR equilibrium policy.

There are two possible configurations in this case:

$$(1)\ P < SQ1 < S \quad \Rightarrow \quad SQ2 = SQ1$$
$$(2)\ S < SQ1 < P \quad \Rightarrow \quad SQ2 = SQ1$$

The President's Influence. All in all, the president maintains much influence over the process even in this model of presidential anticipation. Essentially he gains leverage from his first-mover advantage. In Case 1, if the Senate moved first rather than the president, the outcomes would be either S or the president's indifference point, much as the current Case 2 is favorable toward the president. In Case 2, the outcome would be S rather than P or SQ^{-}; there would be Senate dominance. But in the current constitutional setup, because the president is the agenda setter, he can use this advantage in order to obtain a point closer to or identical to his ideal point in either of the first two cases. In Case 3, who moves first does not matter because $SQ1$ is always the outcome.

2.3 AN EXTENSION OF THE MODEL TO MULTIPLE APPOINTMENTS

In this section, I briefly consider an extension to the model. I consider how the model would change if the president and Senate were to look ahead and bargain over a series of appointments rather than a single appointment. In the Appendix, I consider a second extension of the model to the BOG.

In the previous setup, the president and Senate played a new appointment process game each time a new vacancy occurred on the FOMC. It is interesting to consider what would happen if all of these games were linked sequentially for a given president and Senate.

Assume for simplicity that there is no discounting and that the president and the Senate can foresee the upcoming retirements; as the term lengths are for fixed periods, the assumption is reasonable.[18] Also assume that the utilities of the presidents and senators are now based on an average of payoffs from all the games they play; this assumption takes into account the game's total additive payoffs given that the original utility function is a loss function with negative payoffs. Formally, $U = \frac{1}{T}\sum_T \theta(|r_i - SQ_t|)$, where t denotes an iteration of the game. If this particular president and Senate has three appointment opportunities, for example, we would like

[18] Furthermore, early retirements are also usually known in advance.

to know how the third appointment conditions the choice of the second, and how the second conditions the first.

In this modified setup, there are two possible changes to the original model. First, the exact placement of the appointees may matter more than previously. Referring to the example in Figure 2.1, the president and Senate would previously appoint anyone to the left of $x5$ ($x \leq x5$) in order to achieve $SQ2 = L2$, which is as close as possible to SQ^-, the RR equilibrium policy. With multiple appointments, placements of appointees between SQ^- and $x5$ could impede future progress toward SQ^-. Therefore, the president and Senate appoint members right at SQ^- if no member is at that point, or if there is already a member at SQ^-, they will appoint members at or to the left of SQ^- in order to maximize the future chances of getting exactly to SQ^-. Thus in general, the president and Senate will try to appoint members on or as near as possible to the RR equilibrium policy point: P in Case 1, P or SQ^- in Case 2, and $SQ1$ in Case 3.

Second, the president and Senate may never reach the long-run equilibrium point even with multiple appointment opportunities. Going back to the example, if a second appointment opportunity opened up at $x10$, $SQ1$ will become $x5$. This then creates a deadlock situation with P and S on either side of $SQ1 = x5$. The president and Senate will not be able to agree on policy changes and will maintain the outcome at $x5$ with this and any future appointments. Thus progress toward SQ^- will stop at $x5$.

In the two consecutive appointment opportunities described, note that the appointee was $x \leq x5$ for the first appointment opportunity, and $x5$ for the second. Interestingly, we have come full circle: the original static model also predicts $x \leq x5$ for the first appointment, and if the same president and Senate play a second appointment game after the first, then $x = SQ1 = x5$, as they will be in a deadlock situation. Thus without reference to the second game conditioning the first game, the predictions are the same from the original static model versus those of the more dynamic version considered in this section.

2.4 SUMMARY

This chapter has developed a model of the process to appoint members to the Fed: both the FOMC and the BOG (in the Appendix). The model is similar to the Romer and Rosenthal (1978) setter game except that the multimember structure of the FOMC imposes limits on the extent

to which the politicians can make progress toward the RR equilibrium policy.

The model makes clear, testable predictions about the location of policy after a new appointee takes office based on the preferences of the president, Senate, and the existing Fed members. In order to test these predictions, we need a measure of preferences over monetary policy and a method to estimate the ideal points – the aim of the next chapter.

2.5 APPENDIX: THE BOARD OF GOVERNORS

The appointment process model easily extends to the seven-member BOG with three slight modifications due to the odd rather than even number of members on the BOG. First, $SQ0$ and $SQ2$ are defined by a single member, $x4$, on the seven-member BOG, and $SQ1$ is defined by the two middle members of the after-retirement, six-member BOG.

Second, there are only three rather than four ranges of possible outcomes. The original four ranges for the FOMC are based on four groupings of the twelve FOMC seats: the group of seats to the left of the median ($x \leq x5$), each of the two seats that make up the FOMC median ($x6$ and $x7$), and the final group of seats to the right of the median ($x \geq x8$). Because the BOG contains an odd number of members, the median is defined by a single member, $x4$, rather than two members as previously. Therefore, the middle range is reduced from two ranges to one defined by the vacancy of $x4$. The ranges based on the left and right sides of the median are virtually the same except for a smaller number of seats. Range 1 is $y \in \{x1, x2, x3\}$, Range 2 is $y \in \{x4\}$, and Range 3 is $y \in \{x5, x6, x7\}$.

Third, because a single member defines the median, x can become the outcome of the game.

The definitions of the limits are analogous to those of the FOMC ranges with slight differences.

Range 1: *if* $y \in \{x1, x2, x3\}$

For any $y \in \{x1, x2, x3\}$, $SQ1 = \frac{x4+x5}{2}$. The nonunique correspondences between x and $SQ2$ are defined for any x such that:

$$(1)\, x \leq x4 \quad \Rightarrow \quad SQ2 = x4 = SQ0 = L1$$
$$(2)\, x \geq x5 \quad \Rightarrow \quad SQ2 = x5 = H1$$

The unique correspondences are defined for any x such that:

$$(3)\, x4 \leq x \leq x5 \quad \Rightarrow \quad L1 \leq SQ2 = x \leq H1$$

Range 2: *if* $y \in \{x4\}$

For any $y \in \{x\}$, $SQ1 = \frac{x3+x5}{2}$. The nonunique correspondences are:

$$(1)\, x \leq x3 \quad \Rightarrow \quad SQ2 = x3 = L2 < L1$$
$$(2)\, x \geq x5 \quad \Rightarrow \quad SQ2 = x5 = H2 = H1$$

The unique correspondences are:

$$(3)\, x3 \leq x \leq x5 \quad \Rightarrow \quad L2 \leq SQ2 = x \leq H2$$

Range 3: *if* $y \in \{x5, x6, x7\}$

For any $y \in \{x5, x6, x7\}$, $SQ1 = \frac{x3+x4}{2}$. The nonunique correspondences are:

$$(1)\, x \leq x3 \quad \Rightarrow \quad SQ2 = x3 = L3 = L2 < L1$$
$$(2)\, x \geq x4 \quad \Rightarrow \quad SQ2 = x4 = H3 < H1 = H2$$

The unique correspondences are:

$$(3)\, x3 \leq x4 \quad \Rightarrow \quad L3 \leq SQ2 = x \leq H3$$

In overall comparisons, Range 2 is the largest of the three. Whether Range 1 is greater than Range 3 and vice versa depends on the distance between $x4$ and $x5$ for Range 1 and between $x3$ and $x4$ for Range 3.

Adding the president and Senate is totally analogous to the FOMC game; either the RR equilibrium policy or the boundary points will prevail.

3

Estimating Monetary Policy Preferences

Testing the implications of the appointment process model requires estimates of monetary policy ideal points for presidents, Senate Banking Committee members, and FOMC members. In this chapter I develop a method to estimate those ideal points.

3.1 THE BASIC PROBLEMS

3.1.1 Problem 1: Economic Conditions

The first problem of estimating monetary policy preferences is the confounding of ideal points with economic conditions. In monetary policy, the economic context of voting leads to highly similar voting patterns for very different individuals. Those patterns make it difficult to differentiate among individuals with commonly used measures such as vote proportions.

Take the example of Nancy Teeters and Henry Wallich. President Carter appointed Teeters to the BOG in 1978. As a member of the FOMC, Teeters was a well-known easy-policy advocate in contrast to Henry Wallich, a staunch tight-policy supporter, who was appointed in 1974 (Greider 1987: 72, 81, 465–6). Despite their differences, both Teeters and Wallich consistently voted for tighter monetary policy during 1978–82, a period of very high inflation.[19] As a result, Teeters and Wallich appear over their careers to have very similar monetary policy preferences based on a vote proportion measure:[20] Teeters' vote proportion was 0.51 from

[19] Annual rate of 13.1 percent for the United States in 1980 (OECD 1997: A19): the highest level since World War II.

[20] An individual's tight policy votes divided by the total number of her votes.

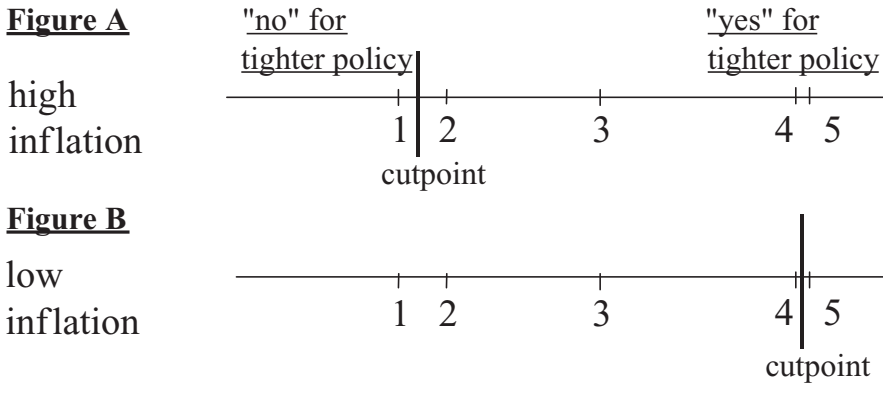

Figure 3.1: Ideal Points and Cutpoints

1978 to 1984, and Wallich's was 0.61 from 1974 to 1986. On the BOG, they are right next to each other in a rank ordering of all seven contemporary members. Basically, because of inflation, Teeters had few opportunities to vote for easy policy even if she wanted to, and the same is true in the other direction for Wallich who faced a severe recession during 1975–6 and in 1980.

The problem is that vote proportions discard useable information regarding the economic context of voting. Vote proportions average across the votes and therefore, across the economic shifts. Thus two individuals with the same voting record will have the same vote proportion regardless of when they served. However, the "when" matters a great deal. If an individual votes for tight policy all the time, our insights should be different if she served during inflationary times as opposed to recessionary times.

In sum we need to know how the conditions during the time of service skews votes in one direction or the other. The method in this chapter uses a statistical model that controls for the economic swings. As in Figure 3.1, the model works on the idea that cutpoints shift across individuals who have fixed ideal points.

3.1.2 Problem 2: Comparisons across Time and Institutions

The second problem of estimating monetary policy preferences is the comparison of individuals across time and across the three institutions of the presidency, Senate, and the Fed.

The appointment process model requires comparisons of Fed members appointed on different dates. For example, in order to assess the impact

of Martha Seger's 1984 appointment to replace Nancy Teeters (appointed August 1978), it is necessary not only to compare both Seger and Teeters to one another, but also to the previous appointees who were serving on the BOG: Rice (April 1979), Volcker (July 1979), Martin (January 1982), Partee (December 1975), Gramley (February 1980), and Wallich (January 1974). The rank orderings of these appointees determines the Fed median – a crucial variable in the formal model. The preceding also applies to the Senate median.

The appointment process model also requires comparisons of individuals from three different institutions. In the model, the locations of the president, the Senate median, and the FOMC median relative to one another determines the predicted locations of the new appointee and the resulting FOMC median. Testing the model therefore requires estimating ideal points for all three sets of actors on one common scale.

3.2 THE PREFERENCE ESTIMATION MODEL

The method in this chapter tackles both problems of estimating monetary policy preferences. First, in dealing with the current economic conditions, the method uses a fixed effects model with two sets of variables that isolate the effects of individual characteristics from the time-specific economic conditions. I use the coefficients on the individual characteristics as ideal points estimates.

Second, with respect to producing estimates comparable across time, the coefficients on the individual characteristics are not time-specific. On comparing across institutions, the method uses one institution, the FOMC, to bridge across the three institutions. Because presidents and senators take positions on FOMC votes, the FOMC provides a common scale for all three sets of ideal points. This feature is analogous to Bailey and Chang's (2001) work on the Supreme Court in which the president takes positions on Supreme Court and Senate votes. The difference is that in their setup, the bridge actor, the president, actively takes positions in the other arenas; whereas in this setting, the other arenas' actors take positions in the bridge actor's arena. Thus the bridge actor's role in one setup is opposite to her role in the other setup.

3.2.1 Assumptions

As in Chapter 2, I assume that the true underlying monetary policy preferences of each actor, i ($i \in \{1, \ldots, N\}$), are defined on a single dimension of

Table 3.1: *Notation*

r = federal funds rate
t = time of meeting (t = 1, . . . , T)
i = index for individual i (i = 1, . . . , N)
α_i = set of coefficients on dummy variables equal to 1 for member i, 0 otherwise
x_t = set of macroeconomic variables
β = set of coefficients on x_t
ε_{it} = error term

easier to tighter monetary policy as measured by a lower or higher federal funds rate, r. Each individual has an ideal federal funds rate, r_i. We are interested in estimating r_i for presidents, senators, and FOMC members. (See Table 3.1 for notation.)

It seems reasonable to assume that each individual has a core set of characteristics that do not vary according to the current economic conditions. Thus when inflation is high, even if individuals all vote for tighter policy, they will still vary in the extent to which they desire tighter policy. Although Teeters and Wallich voted identically to tighten policy in the late 70s, no one would claim that these two individuals shared the same monetary policy philosophy. As the economy came out of recession in the 80s, their different core views on policy revealed themselves in opposing votes.

I therefore further assume that r_i is related to (1) a set of macroeconomic variables (e.g., inflation, Gross Domestic Product [GDP] growth, unemployment) and (2) a set of individual variables (e.g., political affiliation, education, and years in government). The macroeconomic variables are time-specific to each FOMC meeting, t ($t \in \{1, \ldots, T\}$) but not individual-specific. Conversely, the individual variables are individual-specific but not time-specific.

The separation of these variable types is an attempt to capture the following assumed sequence of events: (1) the individual observes the current macroeconomic conditions, (2) she processes these observations with her characteristics, then (3) she arrives at her ideal federal funds rate for time t.

As a function of economic conditions, r_i is a catch-all for common economic outcomes such as inflation, unemployment, and output. In other words, r_i is not just the preferred federal funds rate, but also the preferred inflation rate, unemployment rate, and growth rate.

3.2.2 The Model

If the current economic conditions affect individuals equally, the conditions should scale up or down all ideal points, r_is, by the same amount. As required, in the following model, any change in x_t affects each individual's ideal point, r_i, by the same amount, β:

$$r_{it} = \alpha_i + \beta' x_t + \epsilon_{it} \tag{3.1}$$

where α_i is a coefficient on a dummy variable for individual i, x_t is a $K \times 1$ vector of macroeconomic variables, β is the $K \times 1$ corresponding vector of coefficients, and ϵ_{it} are errors.

Assuming that the error structure is $E(\epsilon_{it}) = 0$, $E(\epsilon_{it}^2) = \sigma^2$, and $E(\epsilon_{it}\epsilon_{jt}) = 0$ for $i \neq j$, Equation 3.1 is a fixed effects model. The β capture the effects of the macroeconomic variables on all individuals, and the α_i capture the effects peculiar to individual i over all time (Hsiao 1986: ch. 3).

If r_{it} were observed, one could use ordinary least squares (OLS) to estimate Equation 3.1, but rather than r_{it}, we observe discrete votes, r_{it}^*, defined by:

$$r_{it}^* = 1 \quad \text{if } r_{it} > r_t \tag{3.2}$$

$$r_{it}^* = 0 \quad \text{if } r_{it} \leq r_t \tag{3.3}$$

where "1" denotes a vote for tighter policy, and r_t is the current federal funds rate.[21]

With the definition of r_{it}^* in Equation 3.2, and the assumption that ϵ_{it} is normally distributed $(0, \sigma^2)$, Equation 3.1 is a binary probit, fixed effects model:[22]

$$\begin{aligned} P(r_{it}^* = 1) &= P(r_{it} > r_t) \\ &= \Phi\left(\frac{\alpha_i}{\sigma} + \frac{\beta' x_t}{\sigma} - \frac{r_t}{\sigma}\right) \end{aligned} \tag{3.4}$$

A nonstandard aspect of this equation is its relationship to contingent valuation models that are often used to estimate the willingness to pay for environmental quality (Cameron and Huppert 1991). In effect r_t is a referendum question. At time t, each FOMC member receives a

[21] The coding of the data is binary due to limitations in the voting data. See data section for more details.

[22] We can also entertain other distributional assumptions. I assume the normal for convenience. The resulting estimation of the probit model is relatively simple, and the estimates are consistent for large T.

take-it-or-leave-it question based on the current interest rate: Do you find a higher interest rate acceptable compared to the current interest rate? If the answer is "yes", $r^*_{it} = 1$, and if the answer is "no", $r^*_{it} = 0$.

The parameters of the model are easy to estimate with any standard package. I used SST version 4.0. According to Hsiao (1986: 159), the maximum likelihood estimates of the parameters are consistent when the number of observations per individual is large – as is the case in my dataset (see Section 3.3).

3.2.3 *The α_is as Ideal Point Estimates*

Note that in Equations 3.1, 3.2, and 3.4, references are to r_{it} – the individual's ideal point at time t. But as explained previously, we need r_i, the ideal point irrespective of time. As a result, we are particularly interested in the α_i coefficients, which are not dependent on time, as proxies for r_i. From Equation 3.4, since:[23]

$$\frac{\partial P(r^*_{it} = 1)}{\partial \alpha_i} = \phi(\alpha_i + \beta' x_t - r_t) > 0 \tag{3.5}$$

the higher the value of α_i, the greater the likelihood that individual i votes for tighter policy. Thus an individual with a high value of α_i tends to favor tighter policy, while those with lower values favor easier policy. In this manner, α_i is a proxy *time independent* estimate of the true ideal federal funds rate for individual actor i.

A legitimate question about this model is: if one is interested in individual characteristic variables, why not *explicitly* include them in the model as variables in their own right? The reasons are twofold. First, it can be difficult to identify and/or measure these variables. Many individual-specific variables potentially affect ideal points including party affiliation, profession, years in government, and level of education, but identifying the complete and relevant set of variables is not necessarily possible. In terms of measurement, education, for example, can be measured by tangibles such as level, type, and number of degrees, but other more intangible features, such as the conservativeness of the education, are more difficult to measure.

[23] Henceforth, for notational simplicity, I drop σ from the equations. Normalizing σ to one just changes the scaling of the estimates.

Table 3.2: *Summary Characteristics of the Data*

	FOMC	Senate Banking Committee	President	Macroeconomic Variables
Period	1970–95	1974–95	1969–94	1969–95
Frequency	every 6 weeks	every 6 months	monthly	monthly
No. of observations	2966	660	305	324
$y_{it} = 1$	47.70%	39.90%	39.70%	
$y_{it} = 0$	52.30%	60.60%	60.30%	

Second, the particular variables themselves are not always of interest per se. Rather, an estimate of general individual characteristics is more important for some applications. In testing the appointment process model, we want to know where individual ideal points lie relative to one another – not necessarily why individuals have a particular ideal point. The α_i estimates are single measures of all the individual-specific characteristics that inform us of the relative location of the actors.

3.3 DATA, ESTIMATED MODEL, AND RESULTS

3.3.1 The Data

The estimation uses two new datasets of FOMC voting and Senate Banking Committee signals, and two existing datasets for the presidents and economic variables.

1. The FOMC Voting Data (Table 3.2). This dataset is a panel of each FOMC member's vote (for tighter or easier policy) at the approximately monthly meetings during the period 1970–95.

I constructed this dataset by analyzing the formal voting records contained in the *Federal Reserve Bulletin*'s "The Record of Policy Actions." The coding involved a two-step process. First, I assigned a direction, tighter or easier, to each meeting's "Current Economic Policy" or "Domestic Policy Directive."[24] When the FOMC decided to maintain prevailing conditions,

[24] A binary rather than a three-level variable is used because individuals rarely truly vote for the status quo. When the FOMC votes for the status quo, they almost always assign a tight or easy bias to their vote. Due to the high percentage of votes in which some bias is mentioned, it was quite difficult to confidently code status quo votes as real status quo votes.

I assigned a direction based on that of the previous meeting. Second, I assigned the directive's direction to each member in the directive's voting majority. For each member in the minority, I assigned a direction based on explicit references to the direction she would have preferred. In contrast to many previous studies,[25] this study includes all votes at meetings, nondissents as well as dissents, and therefore utilizes all the information contained in the formal voting records.

The entire dataset also contains data from 1951–69, but I did not use that data because the FOMC used a different set of criteria for judging economic conditions during that period. Beck (1982a: 420, 422) points out that before 1970, the FOMC under Chairman Martin did not rely on quantitative economic indicators, preferring to rely instead on the "tone" of markets. According to Maisel (1973: 114), a former Fed member, "[Martin] felt that the economy was too complex to explain in detail; intuition would be lost and false leads followed if too much stress were put on measurement," and (1973: 118) "[Martin] pointed out again and again the inability of everyone, including himself, to explain movements in the money supply – a fact which led him to put his faith in the tone and feel of financial markets as opposed to specific measurements." Essentially the Fed's consistent reliance on econometric modeling of the economy came only after Martin left the chairman's office. Thus for consistency in the data, I stuck to the post-Martin period.

In the estimation for 1970–95, there were seventy-two FOMC members and 258 FOMC meetings. I could not estimate the α_i parameter for individuals who voted in one direction 100 percent of the time because the α_i estimates for such individuals tended to infinity. However, in the next chapter's empirical analysis of the model's predictions, I do include these individuals in the rank orderings of the contemporaneous FOMC members by placing them on the extreme ends of the distribution; thus an individual who voted for tight policy 100 percent of the time was placed at the tightest position of the twelve FOMC members in a given period. I used an average of 42 votes per individual with a minimum of 5 (for 2 individuals) and a maximum of 137.

2. *The Senate Banking Committee Signaling Data.* This dataset consists of each Banking Committee member's (forty-two total senators) signal for tighter or easier policy relative to current FOMC policy. The signals come

[25] Yohe (1966); Canterbery (1967); Puckett (1984); Belden (1989); Havrilesky and Schweitzer (1990); Havrilesky and Gildea (1992).

from the semiannual monetary policy hearings (forty-three total hearings), the Humphrey-Hawkins testimonies, mandated by the Full Employment and Balanced Growth Act of 1978.[26] These hearings were meant to give the senators and the public a chance to question the Fed chairman about the Fed's current and future policy.

I analyzed statements from the testimonies during the period 1974–95. For each senator who spoke at the hearings, I coded her statement(s) in the direction appropriate to her voiced concerns. For senators who did not speak,[27] I assigned a direction based on that of the current FOMC policy. For each senator, there was an average of fifteen signals with a minimum of five and a maximum of thirty-eight.

Because the senators' remarks during the hearings are in relation to current FOMC policy, the information from these hearings is ideally suited for the estimation of the senators' and FOMC members' preferences on one common scale.

3. *The Presidential Signaling Data.* This dataset consists of each president's (six total presidents) monthly signal for tighter or easier policy from Thomas Havrilesky's SAFER dataset.[28] Havrilesky and his research assistants coded *The Wall Street Journal*'s articles that commented on the administration's stance on current FOMC policy. Thus, like the Senate data, these data consist of the president's position on FOMC policy and are ideally suited for estimating preferences for the president and FOMC members on one common scale.

For my dataset, I aggregated Havrilesky's measure on a monthly basis for the period 1969–94 (305 months) (Havrilesky 1988, 1991, 1993,

[26] The Full Employment and Balanced Growth Act of 1978 requires the Fed chairman to testify before the Senate Committee on Banking and Urban Affairs on a semiannual basis. During the period 1974–8, the act was considered in a number of different forms, and the hearings, which were to become law according to the act, began during this period. The exact titles and dates of the hearings are: 2-6-74 Oversight on Economic Stabilization, Subcommittee On Production and Stabilization; 2-25-75 Monetary Policy Oversight; 1975–1976 First thru Fourth Meetings on the Conduct of Monetary Policy, House Concurrent Resolution 133; 1977–1978 First thru Third Meetings on the Conduct of Monetary Policy, House Concurrent Resolution 133 and Public Law 95-188; 1979–1995 Federal Reserve's [First or Second] Monetary Policy Report for [Year]; and Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins), Semiannual hearings [Feb., July].

[27] Over the entire period, 1974–94, roughly half of the Senate Banking Committee members spoke during the Humphrey-Hawkins testimonies. Fewer tended to speak during the earlier hearings, and greater numbers tended to speak in the more recent hearings.

[28] For more on this dataset, see Havrilesky 1991, 1993, and 1995.

1995). The original coding was three-tiered: easier (+1), tighter (−1), or no change (0). I summed the signals for each month. For sums greater than zero, I assigned an easy policy signal for the month. For sums less than zero, I assumed that the administration was satisfied with current FOMC policy and assigned a direction according to that of current FOMC policy. For each president, there was an average of fifty-one signals with a minimum of seventeen and a maximum of ninety-six.

4. *Macroeconomic Data.* The macroeconomic data are monthly observations of seven variables during 1970–95. The data originate from the Business Cycle Indicators (BCI) and Business Statistics (BS) historical data series produced by the U.S. Department of Commerce Bureau of Economic Analysis.

The seven variables constitute the main economic conditions to which FOMC members may be thought to respond.[29] First, the real federal funds rate, $RFFR_t$, provides the status quo policy. I define the $RFFR_t$ as the federal funds rate less the annual rate of inflation. Second, the inflation rate is the most commonly cited reason for Fed actions. I used two measures of inflation: the rate of change of the consumer price index (CPI) for inflation of consumer goods prices, and the rate of change of the prices of industrial commodities (PIC) for inflation of nonconsumer goods prices. Third, the Full Employment and Balanced Growth Act of 1978 mandates Fed attention to the unemployment rate. Fourth, the nominal effective exchange rate of the dollar captures international considerations. Fifth, the index of industrial production (IIP) is a measure of output. Finally, M1 captures direct fluctuations in the money supply.

3.3.2 The Estimated Model

I combined the three sets of data into a single matrix with 120 individuals and 312 months. With an average of forty-two votes per FOMC member,

[29] A more commonly used model of Fed behavior is the Taylor Rule, developed by economist John Taylor (Taylor 1993). The Taylor Rule is an optimal model of aggregate Fed behavior and states that the federal funds rate should increase in response to a rise in: (1) the difference between potential and real GDP and (2) the difference between the inflation rate and the target inflation rate of 2 percent. Taylor purposely chose a simple rule that explicitly took into account output growth and inflation. Although the Taylor Rule is based on the actual behavior of the Fed, it is largely a normative instrument that prescribes how the Fed should act (a disadvantage for my project because I am more interested in a positive analysis of the Fed's actions).

fifteen signals per senator, and fifty-one signals per president, I faced the rare panel situation of many cross-sectional *and* time series observations; therefore the parameter estimates are consistent in a probit, fixed effects model (Hsiao 1986: 159).[30]

I estimated this final model from the data:

$$P(r^*_{it} = 1) = \Phi[\alpha_i - \beta_1 RFFR_t + \beta_2 INFL_{t-1} + \beta_3 UNEMP_{t-1} + \beta_4 DOLLAR_{t-1} + \beta_5 IIP_{t-1} + \beta_6 M1_{t-1} + \beta_7 PIC_{t-1}] \quad (3.6)$$

in which the α_i are coefficients on dummy variables for each individual member, and all of the other variables are summarized in Table 3.3.[31]

[30] Maddala (1987) recommends logit for consistency when the dependent variable is categorical, but he only considers situations in which the number of cross sections is high, and the number of observations per person is low; here, the number of observations per person is also high. I also estimated the model with logit, and the coefficient estimates correlated at 0.999.

[31] The data are quite imperfect for two reasons. First, the data frequency differs in each dataset, precluding ideal comparisons of votes or signals. We would really like to observe immediate reactions of the president and Banking Committee to any FOMC decision. Unfortunately the ideal is elusive because the FOMC meets eight times a year, the Banking Committee holds monetary policy hearings twice a year, and the president signals many times a month. Consequently, some FOMC decisions receive more attention than others by the Banking Committee and the president. Second, both the Banking Committee hearings and *The Wall Street Journal* produce noisy signals. Although monetary policy is the subject of the Banking Committee hearings, the hearings often focus on fiscal policy as well. In addition, the hearings can be poorly attended. As for *The Wall Street Journal*, it faces other news constraints and may fail to report all the president's monetary policy signals. Either source may contain statements that focus on tightening moves because they are more controversial than easing moves.

Because the data exhibit variation in both frequency and reliability, one estimation model for all three sets of actors might be problematic because it would imply that the errors are drawn from the same distribution. I therefore estimated two empirical models in addition to Equation 3.6, one each for the president and Senate Banking Committee.

1. Senate Banking Committee

$$P[r^*_{it} = 1] = \Phi[\alpha_i - \beta_1 RFFR_t + \beta_2 INFL_t + \beta_3 UNEMP_{t-1} + \beta_4 IIP_{t-1}] \quad (7.1)$$

2. President

$$P[r^*_{it} = 1] = \Phi[\alpha_i - \beta_1 RFFR_t + \beta_2 INFL_t + \beta_3 UNEMP_t + \beta_4 IIP_t] \quad (7.2)$$

I calculated the correlation of the ideal point estimates from these models with those from the larger model. The ideal points of the two sets of presidents correlate at 0.985, and the ideal points of the senators correlate at 0.968. Thus there is

Table 3.3: *Definitions of the Variables*

r_{it}	Direction of vote for member i at time t. 1 indicates a higher desired federal funds rate than the prevailing rate or tighter policy, and 0 indicates lower desired federal funds rate or easier policy.
$RFFR_t$	The real federal funds rate at time t. $RFFR_t = FFR_t$ - inflation rate. The inflation rate in this instance is the annual inflation rate calculated from the percent change of the Consumer Price Index for all urban consumers (CPI-U) from the previous 12 months.
$INFL_t$	The inflation rate as indicated by the change in the proportion of the (CPI-U) from the previous month.
$UNEMP_t$	The unemployment rate as indicated by the change in the proportion of the unemployment level from the previous month.
$DOLLAR_t$	The value of the dollar relative to a basket of foreign currencies as indicated by the change in the proportion of the value from the previous month.
IIP_t	The value of the index of industrial production as indicated by a change in the proportion of the index from the previous month.
$M1_t$	The value of M1 as indicated by a change in the proportion of M1 from the previous month. M1 consists of currency and checkable deposits.
PIC_t	The value of the producer price index for the industrial commodities grouping as indicated by a change in the proportion of the index from the previous month.

1. *The β Estimates: The Macroeconomic Variables.* Table 3.4 presents the coefficient estimates for the macroeconomic variables. The overall fit is good with approximately 71 percent of the votes predicted correctly ex post. The estimates are in the predicted directions and significant at all conventional levels.

DIRECTION OF THE COEFFICIENTS. The directions of the coefficient estimates are as expected. First, inflation (INFL, PIC), growth (IIP), and money supply (M1) positively affect the probability of voting for tighter policy; essentially, the results show that the Fed tries to put a cap on an overheating economy by tightening. Second, RFFR, unemployment (UNEMP), and the dollar exchange rate (DOLLAR) negatively affect the probability of voting for tighter policy; the Fed tries to stimulate

very little difference between using the separately specified models versus the larger model.

Table 3.4: *Estimated Coefficients on the Macroeconomic Variables*

	Dependent Variable: DIR $VOTE_t$					
	(1)	(2)	(3)	(4)	(5)	(6)
$RFFR_t$	−0.0860	−0.0831	−0.0903	−0.0827	−0.0855	−0.1048
	(0.0009)	(0.0095)	(0.0097)	(0.0100)	(0.0102)	(0.0165)
$INFL_t$	0.4266	0.1410	0.1813	0.2887	0.7106	0.2559
	(0.0794)	(0.0751)	(0.0759)	(0.0784)	(0.0941)	(0.1058)
$UNEMP_{t-1}$		−0.2680	−0.2550	−0.2739	−0.3098	−0.2979
		(0.0203)	(0.0205)	(0.0212)	(0.0220)	(0.0224)
$DOLLAR_{t-1}$			−0.0464	−0.0636	−0.0621	−0.0641
			(0.0106)	(0.0109)	(0.0110)	(0.0111)
IIP_{t-1}				0.3938	0.41846	0.47044
				(0.0280)	(0.0289)	(0.0304)
$M1_{t-1}$					0.3768	0.4398
					(0.0455)	(0.0468)
PIC_{t-1}						0.4771
						(0.0467)
log L	−2558.2	−2467.5	−2458.0	−2350.9	−2315.8	−2261.1
Percent correctly predicted	64.91	67.11	67.28	69.67	70.40	70.86

Values in parentheses are standard errors

the economy through easing when the economy descends into a recession, as higher rates of unemployment would indicate. As for the exchange rate, the Fed may try to keep the dollar from running too high against other currencies, as the Fed did in the mid-80s. Regarding the RFFR, the negative sign could indicate that the FOMC moderates the RFFR by reducing its value when it increases and increasing it when it decreases.

MAGNITUDE. As in all probit models, the magnitude of the βs is not directly interpretable; for true magnitude, we need to examine the marginal effects of x_t with respect to $P(r_{it}^* = 1)$:

$$\frac{\partial P(r_{it}^* = 1)}{\partial x_{kt}} = \phi[\alpha_i + \beta_k' x_{kt}]\beta_k \tag{3.7}$$

where $k = \{1, \ldots, 7\}$ and indexes each of the macroeconomic variables including the RFFR. Table 3.5 presents the value of (3.7) for each variable in x_t when all other variables are evaluated at their mean values. If inflation doubles (a change of 100 percent) in a month, for example, an individual is approximately 10 percent more likely to vote for tighter policy.

Table 3.5: *Marginal Effects of the Macroeconomic Variables*

x_{kt}	Marginal Effects of x_{kt}
$RFFR_t$	−0.0415
$INFL_t$	0.1014
$UNEMP_{t-1}$	−0.1180
$DOLLAR_{t-1}$	−0.0254
IIP_{t-1}	0.1864
$M1_{t-1}$	0.1743
PIC_{t-1}	0.1891

The results bolster and break down some strongly held beliefs about the Fed's reactions to the economy. The Fed is often attacked for reacting too strongly to inflation and not strongly enough to unemployment, the latter being one of the impetuses for the Full Employment and Balanced Growth Act of 1978. However, the congressional draftees of the act would be pleased by these results; according to Table 3.5, the Fed reacts with nearly equal weight to both consumer inflation and unemployment, although it is also clear that the Fed reacts more strongly to inflation in terms of the PIC. The Fed is also often attacked for squelching growth; in fact, the results do indicate that the Fed tightens in response to growth and that it reacts more strongly to growth (IIP) than any other variable except for the PIC.

The Fed also responds to international considerations in the form of the nominal effective exchange rate although at a lower level compared to the domestic variables. Previous studies of FOMC behavior concluded that the FOMC does not consider international factors, which seems counter-intuitive given the Fed's active role in notable international events.[32] In contrast, this study finds significant effects of the dollar on voting probabilities during 1970–95. A number of important international events probably contributed to this effect, including the 1971 switch from the gold standard, the oil shocks of 1973 and 1979, and the overvaluation of the dollar in 1986. International effects could be missing from the previous

[32] Chappell, Havrilesky, and McGregor (1993): 197, fn. 21: "Following other reaction function studies, we also considered exchange rates and balance of payments measures as possible explanatory variables. Like most of those studies, we find little evidence that international variables have consistently influenced monetary policy." See also Beck (1982a) who uses the Deutsche Mark as an independent variable but finds that it is not significant (p. 426).

studies because they covered longer or shorter time periods that exclude these events.[33]

The α_i Estimates: Ideal Points. Tables 3.6, 3.7, 3.8 present the α_i estimates for the FOMC members, senators, and presidents in order of easiest to tightest policy.

The extent to which the α_i estimates are reasonable can be measured by the extent to which they tend to confirm anecdotal evidence of the monetary policy reputations. From those standards, the estimates in Tables 3.6, 3.7, and 3.8 appear quite reasonable.

In line with the scarce sources on this subject, FOMC members with reputations for easier policy, such as Maisel or Seger, tend to top the list while those with reputations for tighter policy, such as Volcker, tend toward the bottom. Burns was known as somewhat liberal but more conservative than Maisel, and Burns follows Maisel on the estimate list. Coldwell, Partee, and Wallich were known as staunch tight-policy advocates and are located near the bottom of the list. The sources consist of a few books (Maisel 1973; Greider 1987) and conversations with current and former Fed staff members.

Despite the success in locating most of the members relative to one another, some of the estimates seem off especially in the more recent FOMC sessions. Greenspan seems too liberal, and Yellen and Blinder seem much too tight. For Yellen and Blinder, the problem is that they had relatively small numbers of observations (ten for Blinder, nine for Yellen) during a period dominated by indications of overheating and therefore tightening moves by the FOMC. For others like Greenspan, the period between 1987 and the early 90s was characterized by a long period of easing by the Fed because of the 1987 stock market crash and the ensuing recession. As more data points are added to the dataset, the individuals will have greater numbers of observations that expose them to a greater variety of conditions, which in turn will allow us to pinpoint their preferences more precisely.

As for Senate members, Alfonse D'Amato, a strong critic of tight monetary policy, is near the top while Proxmire, a supporter of tight monetary policy, is near the bottom. In the Humphrey-Hawkins testimonies, D'Amato repeatedly riled against the Fed for policy that he deemed too tight. Proxmire often extolled the virtues of a tight policy FOMC and criticized the Fed for easing too much.

[33] Chappell, Havrilesky, and McGregor (1993, 1995) describe the period 1960–87 (p. 198). Beck (1982a) covers the period March 1970–August 1979 (p. 423).

Table 3.6: *FOMC Members – Ideal Point Estimates*

Member	Estimate of α	Standard Error	Member	Estimate of α	Standard Error	Member	Estimate of α	Standard Error
Swan	−0.44573	0.56759	Robertson	0.96026	0.22252	Minehan	1.41854	0.59756
Hickman	−0.10306	0.50784	Treiber	0.97277	0.44357	Jackson	1.43039	0.26516
Seger	0.01634	0.26130	LaWare	0.99017	0.23199	Eastburn	1.48211	0.28091
Johnson	0.16581	0.28284	Boykin	1.00094	0.28667	Volcker	1.50463	0.21681
Holland	0.16785	0.34706	Brimmer	1.01859	0.20796	Phillips	1.53465	0.28166
Corrigan	0.41728	0.22622	Sherrill	1.06946	0.25674	Solomon	1.57756	0.28954
Heller	0.42739	0.30968	Morris	1.07991	0.22251	Martin	1.58188	0.31276
Angell	0.46858	0.23166	Lilly	1.17698	0.32771	Gardner	1.58530	0.28774
Maisel	0.50188	0.23890	Keehn	1.18372	0.24373	Lindsey	1.62146	0.28245
Mullins	0.61680	0.30886	Winn	1.24786	0.23789	Baughman	1.62867	0.32899
Bucher	0.66585	0.28271	Kimbrel	1.24971	0.24483	Partee	1.65010	0.22469
Horn	0.67352	0.36558	Parry	1.25718	0.30125	Coldwell	1.65366	0.21881
Mitchell	0.69600	0.20878	Hoskins	1.27353	0.36238	Gramley	1.66531	0.28953
Debs	0.73775	0.75914	Clay	1.27699	0.26800	Wallich	1.75048	0.21834
Sheehan	0.74245	0.27004	Hayes	1.28455	0.21865	Roos	1.76330	0.31540
Hoenig	0.75658	0.40557	Rice	1.29466	0.25055	Yellen	1.91701	0.49707
Greenspan	0.77746	0.22052	Teeters	1.31102	0.25987	Blinder	1.97705	0.48522
MacLaury	0.82441	0.35561	Forrestal	1.34058	0.27701	Scanlon	1.97883	0.56589
Stern	0.85236	0.30648	Jordan	1.34621	0.36746	Bopp	2.07879	0.54823
Kelley	0.85711	0.21764	Guffey	1.34950	0.24591	McTeer	2.31671	0.51583
Melzer	0.87210	0.28802	Balles	1.37432	0.25764	Ford	2.40089	0.50317
Daane	0.89784	0.21293	Black	1.37598	0.23599	McDonough	2.51151	0.42555
Burns	0.89930	0.20478	Mayo	1.37898	0.22859	Timlen	2.62590	0.63862
Boehne	0.92204	0.26374	Schultz	1.40884	0.32499	Willes	2.63177	0.54602
Francis	0.95390	0.29349	Moskow	1.41854	0.59756	Roberts	2.70825	0.60184
						Miller	2.79723	0.51513

Table 3.7: *Senate Banking Committee Members – Ideal Point Estimates*

Member	Estimate of α	Standard Error	Member	Estimate of α	Standard Error	Member	Estimate of α	Standard Error
Sasser	−0.17323	0.40818	McIntyre	0.93180	0.50178	Sparkman	1.27723	0.48172
Wirth	0.33217	0.48294	Mattingly	0.93478	0.48015	Morgan	1.33903	0.44274
Roth	0.36939	0.51219	Chafee	1.01436	0.48864	Proxmire	1.36791	0.30751
Graham	0.50990	0.44288	Bond	1.03484	0.35648	Schmitt	1.37644	0.49800
Sanford	0.50990	0.44288	Shelby	1.03484	0.35648	Domenici	1.41183	0.52561
Riegle	0.53805	0.29353	Boxer	1.04153	0.57371	Armstrong	1.41209	0.34597
Dixon	0.62503	0.33621	Bryan	1.07047	0.40989	Tower	1.56822	0.34242
Sarbanes	0.71877	0.28122	Cranston	1.08312	0.28203	Gorton	1.58323	0.49676
Mack	0.81863	0.42410	Gramm	1.10088	0.32593	Helms	1.62073	0.60185
Kerry	0.82032	0.42350	Dodd	1.10660	0.29928	Bennett	1.83670	0.57963
Kassebaum	0.83164	0.45345	Hecht	1.14117	0.40510	Lugar	1.86913	0.43415
Heinz	0.86290	0.29940	Garn	1.14880	0.27973	Faircloth	2.25117	0.70224
D'Amato	0.87573	0.29902	Williams	1.22253	0.38565	Moseley-Braun	2.25117	0.70224
Brooke	0.93180	0.50178	Stevenson	1.24178	0.42616	Murray	2.25117	0.70224

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Table 3.8: *Presidents – Ideal Point Estimates*

President	Estimate of α	Standard Error
Bush	−0.66979	0.37614
Nixon	0.76827	0.20731
Ford	0.95333	0.35003
Carter	1.21460	0.25732
Reagan	1.21926	0.22658
Clinton	1.93938	0.35871

The estimates for the presidents are somewhat surprising. In contrast to the preferences for fiscal policy, there is no easy conclusion regarding whether Republicans prefer one type of policy versus the Democrats. George H. W. Bush tops the list as the easiest policy advocate, while Clinton bottoms out the list as the tightest policy advocate. A mixture of Republicans and Democrats populate the middle region between these two ends. Reagan is where he should be according to Chappell, Havrilesky, and McGregor (1993) and Greider (1987); as a supply-sider, he was well known for wanting easy members on the Fed.

As far as the relationship between the dimensions of fiscal and monetary policy, it is tough to conclude that there is a clear relationship. Bush was known for his fiscal conservatism, and Reagan is known for tripling the national debt. The two are at opposite ends of the monetary policy spectrum, which implies that fiscal conservatives are easy monetary policy advocates and vice versa. However, this sort of reasoning breaks down for the Democrats. Carter was fiscally more liberal than Clinton, and yet, Carter is also more liberal in terms of monetary policy rather than more conservative. On the congressional side, Boxer and Gramm are in the middle, and Moseley-Braun is at the tight money end. Further research is definitely needed in this regard.

3.4 SUMMARY

Empirical tests of spatial models require ideal point estimates. Normally, the best data we have for estimating ideal points consist of a panel of individual votes or signals. The same individuals in these data make different choices in different contexts. In terms of monetary policy, changing economic conditions affect whether policymakers vote for tighter monetary policy. They are more likely to do so when inflation is high than during

a recession. Methods of ideal point estimation that do not control for these economic conditions yield similar or identical estimates for all individuals. Vote proportions and Americans for Democratic Action (ADA) scores are two commonly used ideal point measures that suffer from this problem.

This chapter developed a method based on the fixed effects model that controls for economic conditions and produces unique ideal point estimates that are comparable across both time and institutions. As the appendix in Section 3.5 points out, the method is similar to NOMINATE but uses macroeconomic control variables as vote covariates, which provides efficiencies in the number of estimated parameters, saves estimation time, provides intuitive coefficient interpretations, and provides instant standard errors.

The method yields reasonable estimates of monetary policy preferences for all the major actors involved in monetary policy making: presidents, Senate Banking Committee members, and FOMC members. These estimates are used in the next chapter to test the implications of the appointment process model.

Although this chapter focuses on monetary policy preferences, the problems described are hardly unique to this area. The method can be used to estimate preferences over any dimension affected by economic conditions, time, and issues of comparability across institutions. Fiscal policy, stock market regulation, welfare policy, and unemployment policy are just a few of the areas in which changing economic conditions are likely to affect policy votes at a given point in time. The method can also be used to estimate preferences across time and institutions; testing any separation of powers model requires such estimates. Thus the method is applicable to a variety of ideal point estimation problems in which the contexts for voting are different across sets of individuals and are dynamically changing.

3.5 APPENDIX: A COMPARISON WITH NOMINATE

The past two decades have witnessed the increased use of spatial models in political science. A consequence of this occurrence has been the development of methods to test spatial models, particularly methods to estimate the ideal points of individuals in such models. The most prominent and widely used of these methods is NOMINATE, a set of FORTRAN codes initially developed by Keith Poole and Howard Rosenthal to estimate ideal points for members of Congress from congressional roll-call votes

(Poole and Rosenthal 1985, 1997). With Poole, McCarty later extended the code to estimate presidential ideal points (McCarty and Poole 1995).

NOMINATE is an excellent method when information about the individuals and/or the votes is unavailable or costly to obtain. In the congressional setting, for example, we may know little about what affects members' ideal points such as district characteristics. Likewise for bills, we may have little information about a bill or a series of bills; a number of appropriations bills may really be about defense spending rather than the larger fiscal picture. Despite the lack of this information, NOMINATE extracts estimates for the cutpoints between "yes" and "no" votes, individual ideal points, and the dimensionality of the bills.

Using the fixed effects setup, we can estimate a one-dimensional model comparable to NOMINATE:

$$r_{it} = \alpha_i + \beta_t' X_t + \epsilon_{it} \tag{3.8}$$

where t now indexes votes, and X_t is a vector of dummy variables for the T votes rather than the macroeconomic variables. This model therefore contains dummy variables for each individual *and* each vote. It produces N, α estimates, one for each individual, and T, β estimates, one for each vote.

The β estimates from this model and the cutpoint estimates for NOMINATE are similar although not exactly identical. First, both are vote parameters that affect the individual equally and are estimated holding individual ideal points constant. Second, the estimates of β from Equation 3.8 are effectively cutpoints. In the NOMINATE setup, individual ideal points are fixed, and cutpoints for bills move among them to determine who votes "yes" and "no" on the bill. In Equation 3.8, the cutpoint and the ordering of individual ideal points are fixed, and the coefficients move the entire individual orderings around the cutpoint. Both models use the estimates to determine the probability of an individual voting "yes" for tighter policy.

Under the right conditions, there are four advantages to using the fixed effects setup presented in the previous sections of this chapter. First, there are efficiency gains in the number of estimated parameters. In the context of FOMC votes, suppose there were fifty votes in the 1970s. With this data, NOMINATE would estimate fifty vote parameters, one cutpoint parameter for each vote. The setup in this chapter uses available information about high inflation in the 70s as a proxy for the cutpoints. As a result, only one parameter, the coefficient on the inflation rate, rather than fifty parameters, one for each vote, needs to be estimated – a savings

of forty-nine estimated parameters. Suppositions aside, seven macroeconomic variables, rather than the inflation rate alone, tie down the cutpoints for the 268 FOMC votes in the period 1970–95. Compared to the NOMINATE setup, there is a savings of 261 vote parameter estimates.

Second, because the number of estimated parameters is far fewer in the fixed effects setup, the model is much faster to estimate. While it takes about one minute to estimate the probit, fixed effects model, NOMINATE can take as long as one-and-a-half hours depending on computing power. The main reason for the difference in estimation time is that the sheer number of estimated parameters is far smaller for the fixed effects model estimation – for example, for the FOMC: 268 vote parameters +72 individual parameters = 340 total for NOMINATE, and 7 macroeconomic coefficients +72 individual parameters = 79 total for the fixed effects model.

Third, the probit model structure allows for easily interpretable coefficients. With correct manipulations, each coefficient adds to or subtracts from the probability of voting for higher interest rates, and this probability is bounded between zero and one. As discussed previously in Equation 3.7 and Table 3.5, a one-unit change in the macroeconomic variables leads to a $\phi(\alpha_i + \beta' x_t - r_t)$ change in the probability of any individual voting for tighter policy. For instance, if unemployment rises by 100 percent, the probability of any FOMC member voting for tighter policy drops by approximately 10 percent. The interpretations are couched in nicely understood percentage terms.

Fourth, standard errors are easily estimated. They are simply the standard errors of the coefficients from a probit model. The standard errors of the point estimates using NOMINATE are difficult to calculate, although NOMINATE coefficients are not alone in this regard; neither the Heckman/Snyder estimates (Heckman and Snyder 1997) nor the Groseclose/Snyder estimates (Groseclose, Levitt, and Snyder 1999) have easily computed standard errors. Although standard errors may not be needed in some applications, they are certainly needed for testing spatial models like the appointment process model. As will be seen in the next chapter, to test the point prediction of a model, one needs to perform hypothesis tests of whether the point prediction and the actual point are statistically different from one another.

Thus there are real gains to be made from utilizing available information. There may be fewer parameters to estimate, faster estimation of the remaining parameters, intuitive interpretations of coefficients, and easily calculable standard errors.

But it is important to point out that the method presented here only works optimally under certain conditions. Most importantly, the dimensionality of the issue must be well known, and the direction of votes must be clearly identifiable. It is also important to identify properly useable vote covariates although the model can be estimated without the covariates. All three conditions are met in monetary policy, and it is not difficult to imagine that being the case for many other areas of economic policy such as fiscal policy. If the conditions are not met, NOMINATE is the better option because NOMINATE teases out information from the data such as the dimensionality of the issue space.

4

Empirically Testing the Model's Predictions

With the ideal point estimates from Chapter 3, this chapter tests the model's predictions from Chapter 2. For each Fed appointment opportunity, I use the ideal point estimates to order the appointing president and the Senate median among the Fed members who remain after the retiree leaves. This ordering produces a point prediction for the Fed median, which we can compare to the actual Fed median in the data.

The model is used to test two sets of hypotheses for the FOMC and the BOG. The first set of hypotheses answers the question of whether political influence on monetary policy occurs through Fed appointments. The second set concerns the question of influence by whom: the president alone or both the president and Senate. The chapter first considers these hypotheses for the FOMC and then for the BOG.

The results for both the FOMC and the BOG show that political influence occurs. On the FOMC, influence is by both the president and Senate, while on the BOG, it is unclear who influences. But because the FOMC is the more important monetary policy-making body, the results show generally that appointments are an important avenue of political influence on monetary policy by both the president and Senate rather than the president alone.

The chapter proceeds by describing the appointments data. I then restate the model's predictions and enumerate the exact procedures by which I test the predictions. Finally, I present the results in turn for the FOMC and for the BOG.

4.1 THE DATA ON APPOINTMENTS

I examine twenty-three appointments made in the period 1975–94. Table 4.1 contains complete details regarding each appointment: the

Table 4.1: *The Data on Appointments*

Appointee	Appointment Date	Start Date	President		Senate Median		FOMC Median		BOG Median	
Jackson	5/22/75	7/14/75	Ford	0.95333	Williams	1.22253	Hayes, Mayo	1.00729	Burns	0.89930
Gardner	11/15/75	2/13/76			Williams	1.22253	Eastburn, Volcker	1.19981	Gardner	1.58530
Lilly	11/15/75	6/1/76			Williams	1.22253	Black, Jackson	1.10070	Gardner	1.58530
Partee	12/5/75	1/5/76			Williams	1.22253	Jackson, Eastburn	1.14603	Gardner	1.58530
Miller	12/8/77	3/8/78	Carter	1.21460	Williams	1.22253	Gardner, Coldwell	1.26623	Partee	1.65010
Teeters	8/28/78	9/18/78			Williams	1.22253	Gardner, Coldwell	1.26623	Partee	1.65010
Rice	4/12/79	6/20/79			Stevenson	1.24178	Black	1.09879	Partee	1.65010
Schultz	4/12/79	7/27/79			Stevenson	1.24178	Black	1.09879	Partee	1.65010
Volcker	7/25/79	8/6/79			Stevenson	1.24178	Black	1.09879	Volcker	1.50463
Gramley	2/29/80	5/28/80			Williams	1.22253	Schultz, Volcker	1.15803	Volcker	1.50463
Martin	1/11/82	3/31/82	Reagan	1.21926	Dodd	1.10660	Volcker, Martin	1.26595	Martin	1.58188
Seger	5/31/84	7/2/84			Dodd	1.10660	Rice, Volcker	1.10863	Martin	1.58188
Angell	10/10/85	2/7/86			Cranston	1.08312	Melzer, Morris	0.72266	Rice	1.29466
Johnson	10/10/85	2/7/86			Cranston	1.08312	Melzer, Morris	0.72266	Rice	1.29466
Heller	5/12/86	8/19/86			Cranston	1.08312	Melzer, Horn	0.52190	Angell	0.46858
Kelley	1/21/87	5/20/87			Chaffee, Bond	1.02460	Stern	0.60990	Heller, Angell	0.44799
Greenspan	6/2/87	8/11/87			Chaffee, Bond	1.02460	Greenspan	0.56458	Heller, Angell	0.44799
LaWare	5/23/88	8/15/88			Chaffee, Bond	1.02460	Greenspan, Kelley	0.60702	Angell	0.46858
Mullins	12/8/89	5/21/90	Bush	−0.66979	Kerry	0.82032	Greenspan, Stern	0.58724	Mullins	0.61680
Lindsey	1/14/91	11/26/91			Kerry	0.82032	Hoenig, Greenspan	0.54047	Greenspan	0.77746
Phillips	8/27/91	12/2/91			Kerry	0.82032	Hoenig, Greenspan	0.54047	Kelley	0.85711
Blinder	4/22/94	7/1/94	Clinton	1.93938	Boxer	1.04153	Forrestal	1.11935	Phillips	1.53465
Yellen	4/22/94	8/1/94			Shelby	0.52551	Forrestal, Phillips	1.20727	Phillips	1.53465

appointee's name, the appointment date, the date on which the appointee took office, the appointing president, the appointing Senate Banking Committee median, the FOMC median, and the BOG median. The numbers in the columns next to the presidents, the Senate medians, FOMC medians, and the BOG medians indicate their respective ideal point estimates.

The period covered exhibited considerable political and economic variation. On the political side, the twenty-three appointments encompassed five presidential administrations, of which three were Republican (Ford, Reagan, and Bush), and two were Democratic (Carter and Clinton). Reagan had the highest number of appointment opportunities at eight, and Clinton had the fewest number at two, although he went on to appoint four more during his two administrations. The appointments also encompassed at least ten different Senate Banking Committees with four different chairs – Proxmire, Garn, Riegle, and D'Amato.

The economic conditions also varied considerably. The period started in the 70s with hyperinflation and stagflation. There were recessions in the late 70s, early 80s, and early 90s as well as booms in the mid- to late 80s and mid-90s. The stock market exhibited similar trends during this period culminating in the 1987 crash.

The changing political and economic landscape meant that the Fed faced considerable challenges during this period. The 70s were characterized by a phenomenon unknown until then – stagflation, a period of high inflation and low growth. Some blame Arthur Burns, the Fed chair until 1977, for insufficient vigilance toward inflation during the early to mid-70s. The Fed certainly lost some credibility just before the 1972 election when Burns was accused of backing down to political pressures from the president. Miller, the next chair, was widely criticized for his inability to solve the economy's problems and particularly for the Fed's continual unexpected behavior. By the time Miller left in 1979, the economy was in deep trouble, and the Fed's reputation had taken a beating. In fact, for the first time in forty-two years, Congress took serious legislative actions with regard to the Fed in the Full Employment and Balanced Growth Act of 1978 that mandated Fed attention to unemployment and hearings before congressional committees.

Carter brought in Volcker to remedy both the problem of stagflation and the Fed's reputation. Volcker immediately and consistently raised rates to very high levels, which proved to be an unpopular set of moves. For example, near the beginning of his term, home building

contractors protested the sharp rate hikes (Greider 1987: 189). Despite the protests, Volcker stuck to his guns, and he is widely credited for ending hyperinflation and stagflation during the 80s as well as resurrecting the Fed's reputation.

However, Volcker stayed a hawk too long against a president and Congress who were decidedly more dovish. When Volcker continued to insist on maintaining high rates in the mid 80s, he was at one point outnumbered on a vote by recent Reagan appointees. This event was unprecedented; no chair had ever lost a Fed vote. When it was clear that Volcker no longer had support either within the Fed or from the president or Congress, he resigned in mid-1987 (Greider 1987: 711–13).

Almost immediately after Greenspan took office in August of 1987, the stock market crashed in October. Unlike the Fed during the 1929 crash, this Fed immediately eased policy, and the market recovered slowly. Greenspan is often credited with leading the economy out of the ensuing crisis and recession. Like Volcker's Fed, Greenspan's Fed has often made unpopular rate hikes such as in 1991 and 1994, but probably not to the same extent as Volcker's Fed.

Thus much happened during the period under study both for the Fed and the context in which it functioned. The model from Chapter 2 looks at how some of this context influenced the Fed – namely political changes in the presidency and Congress and their policy repurcussions through appointments. We now turn to how well the model's predictions are empirically supported.

4.2 THE PROCEDURES FOR TESTING THE MODEL

In the discussion of the appointment process model in Chapter 2, *SQ*2 is the theoretical model's prediction of the FOMC median for a given appointment opportunity. We now have to distinguish between this predicted FOMC median and the actual FOMC median.

Predicted versus actual. Define *PRED* as the model's predicted FOMC median, and *ACTUAL* as the actual, empirical FOMC median after an appointee takes office.

The goal of the testing procedures is to compare predicted versus actual FOMC medians, that is to test *PRED* = *ACTUAL*, for the set of twenty-three Fed appointments. In order to do so, it is necessary to identify values of the quantities, *PRED* and *ACTUAL*, for every appointment opportunity.

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4.2.1 Identifying PRED

For each of the twenty-three appointment opportunities, I use the following procedures to determine *PRED*:

Step 1: Range of possible outcomes and *SQ* points. First, I identify the retiree, *y*, and the date of retirement. Second, using the retirement date, I identify and use the FOMC estimates to order the Fed members before and after the retirement.[34] This identifies the Fed median before retirement ($SQ0$), the Fed median after retirement ($SQ1$), the retiree's seat number, and the corresponding range of possible outcomes (Range 1, 2, 3, or 4 for the FOMC and Range 1, 2, or 3 for the BOG).

Step 2: Case and RR equilibrium policy. I find the president and Senate median[35] for the appointment opportunity and compare them to $SQ1$. The comparison pins down the case (1, 2, or 3) and its corresponding prediction of the RR equilibrium policy.

Step 3: *PRED.* I combine the range of possible outcomes with the case and RR equilibrium policy which subsequently nails down the exact prediction for the FOMC median, *PRED*, after the new appointee takes office. *PRED* is the RR equilibrium policy if it is in $[L, H]$, or otherwise, either of L or H.

Essentially the president and Senate strive to get as close as possible to the RR equilibrium policy given that the range of outcomes places constraints on the proximity with which they can reach the RR equilibrium policy. If the RR equilibrium policy is within the range of possible outcomes for a given appointment, it is the predicted policy outcome for that appointment. Otherwise, one of the upper or lower bounds of the range will be the predicted policy outcome.

The following table (Table 4.2) provides a guide for the predictions, *PRED*. The rows contain the three cases: Case 1 – presidential dominance, Case 2 – presidential compromise, and Case 3 – deadlock. As in Chapter 2, I have split Case 2 into two subcases. In the first, S is closer to P, and the RR equilibrium policy is P. In the second, S is closer to $SQ1$, and the RR equilibrium policy is SQ^{-}. The columns of Table 4.2 indicate whether P

[34] The ordering is for *all* current Fed members, including those for whom an α_i estimate is not available due to their voting 100 percent in one direction. I place those members at the extremes of the ordering.

[35] Just as I did for the Fed, I order all current senators including those who voted 100 percent in one direction.

Table 4.2: *Table of Predictions*

	P and S < SQ1	P and S > SQ1
Case 1	P if in [L, H]	P if in [L, H]
	L otherwise	H otherwise
Case 2a	P if in [L, H]	P if in [L, H]
	L otherwise	H otherwise
Case 2b	SQ^- if in [L, H]	SQ^- if in [L, H]
	L otherwise	H otherwise
Case 3	SQ1	

Entries are the values of *PRED*.

and *S* are to the left or right of *SQ*1. The first line of each entry indicates the *PRED* outcome if the RR equilibrium policy is in the range of possible outcomes ($\in [L, H]$), and the second line indicates the *PRED* outcome otherwise. For Case 3, the predicted outcome is always *SQ*1.

4.2.2 *Identifying ACTUAL*

I use two measures of *ACTUAL*. The first is the median of the twelve FOMC members' ideal points after the appointee took office. I designate this median as $ACTUAL_1$.

The second is the mean of a set of 1,000 simulated medians. For each FOMC, there are twelve members, each of whom has a normal ideal point distribution with mean, α_i, and a standard deviation, σ_{α_i}. For each FOMC after an appointee took office, I draw once from each of the twelve member distributions and find the median value, *m*, of the realized ideal points. I then conduct 1,000 sets of such draws which produces 1,000 medians. I define $ACTUAL_2$ as the mean of the 1,000 medians: $ACTUAL_2 = \mu_m = \frac{\sum_{n=1}^{1,000} m}{1,000}$.

$ACTUAL_2$ is a better measure for testing the model's predictions because it more closely reflects the true distribution of the FOMC median which is a function of twelve distributions – one for each FOMC member. In contrast, $ACTUAL_1$ only reflects the ideal point distribution of one member – the median member. Nevertheless $ACTUAL_1$ turns out to be a good approximation of the true median; the median of the twelve drawn points for any given draw is often close in value to $ACTUAL_1$. In fact, the values of $ACTUAL_2$ are not very different from those of $ACTUAL_1$; for the FOMC, the correlation between the two is 0.980, and for the BOG, it is 0.984. The real difference is in the standard deviation which is smaller for $ACTUAL_2$ than for $ACTUAL_1$, because individuals are more likely to

vary than the median of those individuals; this is because the distribution of a median is generally very stable.

4.2.3 Comparing PRED to ACTUAL

In the following sections, I directly compare *PRED* to both $ACTUAL_1$ and $ACTUAL_2$. More precisely, I test the following hypotheses for each of the twenty-three appointments:

$$H_0 : PRED = ACTUAL \tag{4.1}$$

$$H_a : PRED > ACTUAL \text{ or } PRED < ACTUAL \tag{4.2}$$

Thus if the model is correct and politicians do influence policy through a particular appointment, then $PRED = ACTUAL$, and we should fail to reject the null hypothesis. I therefore had to be careful about biasing the test results toward accepting the null.

I use the standard z test to test the hypotheses. Both *PRED* and $ACTUAL_1$ are ideal point estimates that are distributed $N(\alpha_i, \sigma_{\alpha_i})$. As for $ACTUAL_2$, the simulated distributions of the medians are also approximately normal with mean, μ_m and standard deviation, σ_m.

In the comparison of *PRED* and $ACTUAL_1$, I compare ideal points and use the standard errors of the ideal points in the z-statistic for the hypothesis tests. More precisely, I calculate the following z-statistic that uses the standard errors of both *PRED* and $ACTUAL_1$: $z = \frac{PRED - ACTUAL_1}{\sigma_{PRED-ACTUAL_1}}$ where $\sigma_{PRED-ACTUAL_1} = \sqrt{\sigma^2_{PRED} + \sigma^2_{ACTUAL_1} - 2COV(PRED, ACTUAL_1)}$. The estimates of σ^2_{PRED}, $\sigma^2_{ACTUAL_1}$, and $COV(PRED, ACTUAL_1)$ are available from the estimation of the ideal points.

In the comparison of *PRED* and $ACTUAL_2$, I compare an ideal point, *PRED*, to the mean of the distribution of the medians. Unlike in the comparison of *PRED* and $ACTUAL_1$, it would not make sense to use σ_{PRED} and σ_m in the z-statistic because both are calculated from very different methods. It would make more sense to find σ_{PRED} through means similar to those for σ_m.

However, I cannot reasonably simulate the distribution of the predicted medians due to a limitation of the theoretical model. The model does not provide precise enough predictions of the appointee's location, that is the appointee's specific α_i and σ_{α_i}. The model only specifies a range in which the appointee may be placed in order to reach the desired FOMC median. In that range, multiple combinations of α_i and σ_{α_i} may result in the same FOMC median. Without assuming an arbitrarily exact mean and standard

deviation for the appointee, I was unable to run the simulations as I did for $ACTUAL_2$.

Thus I compare $ACTUAL_2$ to the fixed quantity *PRED*. As will become clear soon, treating *PRED* as a constant biases the results against the predictions of my formal model. In addition, because $ACTUAL_1$ and $ACTUAL_2$ are close to one another, it is likely that *PRED* and the simulated *PRED* would also be similar.

The comparisons of *PRED* to both *ACTUAL*s are an attempt to get at the true tests. Neither set of tests is perfect, but the truth does lie somewhere between them. On the one hand, comparing *PRED* to $ACTUAL_1$ biases the results in the model's favor. In each case, both *PRED* and $ACTUAL_1$ are the ideal point estimates of the median member, and each estimate has a standard error that is likely to be larger than the standard deviation of the median's true distribution, because individuals tend to vary more than the median of the individuals. Thus the *z*-statistic, $\frac{PRED-ACTUAL_1}{\sigma_{PRED-ACTUAL_1}}$, has a relatively large denominator that tends to push the *z*-statistic down and leads to more acceptances of the null than warranted. This method basically rewards large estimation errors.

On the other hand, comparing *PRED* to $ACTUAL_2$ biases the results *against* the model. Because it is not possible to simulate a distribution for *PRED* similar to that for $ACTUAL_2$, I compare the value of *PRED* without its standard error to $ACTUAL_2$. The *z*-statistic is thus $\frac{PRED-ACTUAL_2}{\sigma_{ACTUAL_2}}$. Without the standard error of *PRED* in the denominator, and a comparable estimated statistic, σ_{PRED}, should be in the denominator, the *z*-statistic is artificially large, which leads to more rejections of the null than there should be.

Therefore, the true results are somewhere between these two sets of results – one of which favors the model's predictions, and the other of which works against the model's predictions. The testing strategy is to find both sets of *p*-values and examine the range of *p*-values between the two sets. The range should give us a sense of whether or not we should accept the null hypotheses.

4.3 HYPOTHESIS TESTS – FOMC

4.3.1 Hypothesis Tests 1: Political Influence on Monetary Policy?

The first hypothesis corresponds to the first main question – whether politicians influence monetary policy through appointments to the Fed. As a first cut, Figure 4.1 presents a graph of the president's ideal point, the

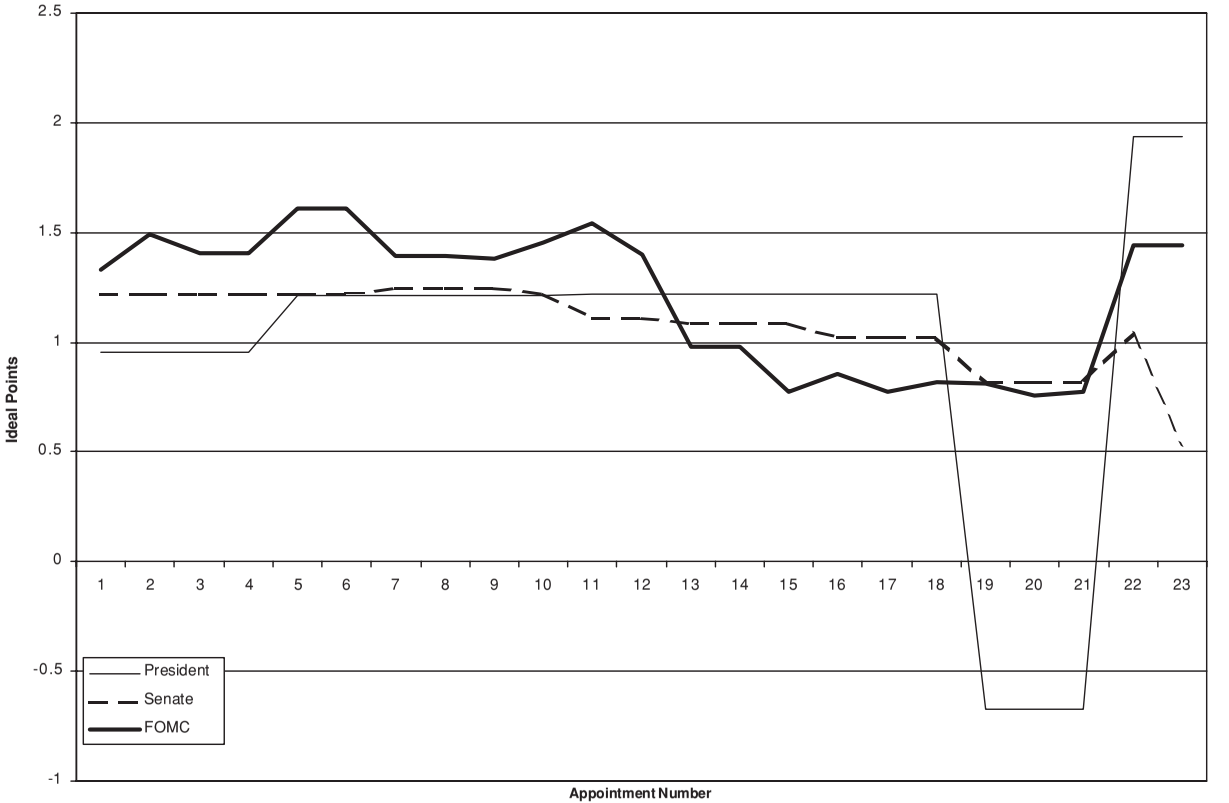

Figure 4.1: Graph of President, Senate, and FOMC Ideal Points

Senate Banking Committee median's ideal point, and the FOMC median's ideal point after the appointee took office ($ACTUAL_1$). The three lines exhibit the same general trend: higher until the late 70s, then a dip or plunge during the 80s, followed by a sharp increase in the early 90s. However, the relationship among the three is not particularly clear; in particular, the FOMC seems to vary more than either the president or the Senate. In fact, the ideal point correlations of the president/FOMC and Senate/FOMC are fairly low: 0.518 and 0.484.

The reasons for this lack of relationship are twofold. First, the rotating memberships of the reserve bank presidents, over which the president and Senate have no control, change the FOMC median even in the absence of any change in the president or Senate. Second, the same president and Senate may bargain successively over more than one appointment; thus with each appointment, the FOMC median changes incrementally even if the president and Senate do not change.

The formal model from Chapter 2 takes into account both these features, and its predictions set up each appointment as an opportunity to test the hypothesis that political influence on monetary policy occurs through Fed appointments. Because the appointment process model predicts how, when, and if politicians influence monetary policy through appointments, every match of actual to predicted FOMC median change is evidence in favor of this hypothesis.

More precisely, I use a z-test to test the hypothesis in Equation 4.1 for each of the twenty-three appointment opportunities. Table 4.3 provides the data used for the hypothesis tests on each appointment. This table shows that the appointments themselves exhibit a number of interesting characteristics. First, most of the retirements are at the extremes rather than near the FOMC median; there are nineteen Range 1 or 4 appointments, only four Range 2 appointments, and no Range 3 appointments. Of the Range 1 and 4 retirements, fifteen are in the two seats on the ends (1, 2, 11, and 12). This pattern seems to indicate that those who retire are at the fringes and may be frustrated or pushed out of the FOMC. Second, most of the appointments are made in Case 2: presidential compromise situations. This means that the president is usually farther out from the $SQ1$ compared to the Senate. Thus the Senate exerts its maximum leverage in most of the appointments. Third, both the president and Senate are out of the range of possible outcomes for the vast majority of appointments (nineteen of twenty-three). In other words, the president and Senate are relatively far from the current policy point.

Table 4.3: *FOMC Hypothesis Tests 1, Data for the Hypothesis Tests*

APPT.	RANGE	CASE	*PRED*	$ACTUAL_1$	$ACTUAL_2$
1	1	2	1.113	1.332	1.234
2	4	2	1.456	1.493	1.450
3	1	2	1.403	1.403	1.428
4	4	2	1.375	1.403	1.387
5	1	2	1.545	1.607	1.462
6	1	2	1.607	1.607	1.606
7	2, 4	2	1.377	1.394	1.493
8	2, 4	2	1.377	1.394	1.451
9	4	2	1.376	1.379	1.451
10	4	2	1.379	1.457	1.464
11	2	1	1.440	1.541	1.512
12	2	1	1.400	1.400	1.304
13	4	3	1.187	0.976	0.988
14	4	3	1.187	0.976	0.988
15	4	2	0.976	0.773	0.803
16	4	2	0.852	0.852	0.715
17	4	2	0.852	0.777	0.675
18	4	2	0.817	0.817	0.794
19	1	2	0.815	0.815	0.730
20	1	3	0.687	0.757	0.786
21	1	3	0.767	0.777	0.786
22	1	3	1.343	1.440	1.457
23	1	3	1.343	1.440	1.457

Table 4.4 shows the exact form of the hypothesis for each appointment along with the results of the tests. The results of the hypothesis tests strongly support the model's predictions. Using $ACTUAL_1$, we accept the null in twenty-one of twenty-three cases (91 percent) at the standard $\alpha = 0.10$ level. This is relatively conservative because higher levels of α make it more difficult to accept the null. Even using $ACTUAL_2$, which biases the results against the model, the p-values indicate that we accept the null for twenty out of twenty-three cases (87 percent) at the $\alpha = 0.10$ level. At lower standard α levels (e.g., $\alpha = 0.05$ or $\alpha = 0.01$), all twenty-three predicted values match the actual values using either $ACTUAL_1$ or $ACTUAL_2$. Recall that the true results lie somewhere between the results using $ACTUAL_1$ and $ACTUAL_2$. Thus *at worst* the model predicts 87 percent of the cases and *at best*, 91 percent of the cases at the $\alpha = 0.10$ level.

Regression results make the case strongly as well. Recall that the correlations of president/FOMC and Senate/FOMC are quite low, and that

Table 4.4: *FOMC Hypothesis Tests 1, Results*

	$ACTUAL_1$					$ACTUAL_2$				
APPT.	NULL	ALTERNATIVE	z	p	ACCEPT NULL?[a]	NULL	ALTERNATIVE	z	p	ACCEPT NULL?[a]
1	P <= A	P > A	0.587	0.278	yes	P <= A	P > A	1.029	0.152	yes
2	P <= A	P > A	0.263	0.396	yes	P >= A	P < A	−0.057	0.477	yes
3					yes	P <= A	P > A	0.271	0.393	yes
4	P <= A	P > A	0.203	0.419	yes	P <= A	P > A	0.106	0.458	yes
5	P <= A	P > A	0.410	0.341	yes	P >= A	P < A	−0.691	0.245	yes
6					yes	P >= A	P < A	−0.032	0.496	yes
7	P <= A	P > A	0.107	0.458	yes	P <= A	P > A	1.192	0.117	yes
8	P <= A	P > A	0.107	0.458	yes	P <= A	P > A	0.746	0.228	yes
9	P <= A	P > A	0.013	0.495	yes	P <= A	P > A	0.756	0.225	yes
10	P <= A	P > A	0.744	0.229	yes	P <= A	P > A	0.903	0.183	yes
11	P <= A	P > A	0.763	0.223	yes	P <= A	P > A	0.728	0.233	yes
12					yes	P >= A	P < A	−0.784	0.217	yes
13	P >= A	P < A	−1.434	0.076	no	P >= A	P < A	−1.458	0.072	no
14	P >= A	P < A	−1.434	0.076	no	P >= A	P < A	−1.458	0.072	no
15	P >= A	P < A	−1.155	0.124	yes	P >= A	P < A	−1.241	0.107	yes
16					yes	P >= A	P < A	−1.000	0.159	yes
17	P >= A	P < A	−0.241	0.405	yes	P >= A	P < A	−1.448	0.074	no
18					yes	P >= A	P < A	−0.200	0.421	yes
19					yes	P >= A	P < A	−0.791	0.214	yes
20	P <= A	P > A	0.254	0.400	yes	P <= A	P > A	0.787	0.216	yes
21	P <= A	P > A	0.041	0.483	yes	P <= A	P > A	0.152	0.439	yes
22	P <= A	P > A	0.593	0.277	yes	P <= A	P > A	0.789	0.215	yes
23	P <= A	P > A	0.593	0.277	yes	P <= A	P > A	0.789	0.215	yes
					21					20

[a] At the 0.10 level

Figure 4.1 shows no discernible relationships among the three sets of ideal points. In contrast, the 0.949 correlation between *PRED* and $ACTUAL_1$, and the 0.947 correlation between *PRED* and $ACTUAL_2$ indicate that the model works much better than trying to predict FOMC medians based on the separate ideal points of the appointing president and Senate median. The graph in Figure 4.2 shows this more clearly. Note the marked difference between Figures 4.1 and 4.2.

More rigorously, I tested how well *PRED*, the model's predictions, does versus the president and Senate's ideal points in predicting *ACTUAL*:

$$H_0 : ACTUAL_i = \beta_0 + \beta_1 PRED_i + \epsilon_i \tag{4.3}$$

$$H_a : ACTUAL_i = \beta_0 + \beta_1 PRES_i + \beta_2 SEN_i + \epsilon_i \tag{4.4}$$

where *PRES* and *SEN* are respectively the ideal points of the president and Senate median.

The regression results for both equations are in Table 4.5. As for which values of *ACTUAL*, I used $ACTUAL_2$ rather than $ACTUAL_1$ for all of the regression results in this chapter. The results with $ACTUAL_1$ are virtually identical because the two variables are very close in value.

The Cox test statistic of 1.247 with a p-value of 0.106 and the J test statistic of -1.377 with a p-value of 0.084 indicate that we accept the null at up to the $\alpha = 0.05$ level and almost the $\alpha = 0.10$ level.[36] Reversing the hypotheses with the *PRES* and *SEN* model as the null and the *PRED* model as the alternative, the results are even more clear-cut: the Cox test statistic is -16.68, and the J test statistic is 10.39. Thus we can reject the null in favor of the alternative, the *PRED* model.

Thus the evidence – both direct hypothesis tests and regressions – strongly favors the model's predictions. Politicians can instrumentally affect policy through appointments. This leaves the question of influence by whom.

4.3.2 Hypothesis Tests 2: Who Influences?

The results from the last section support the existence of political influence on the Fed through appointments, thereby answering the book's first main question. But they also partially answer the book's second question of who influences: the answer being both the president and Senate. Because the appointment process model is a model of presidential anticipation,

[36] See Greene (1993: 224) for details regarding the calculation of these statistics. The p-values for both test statistics come from the standard normal table.

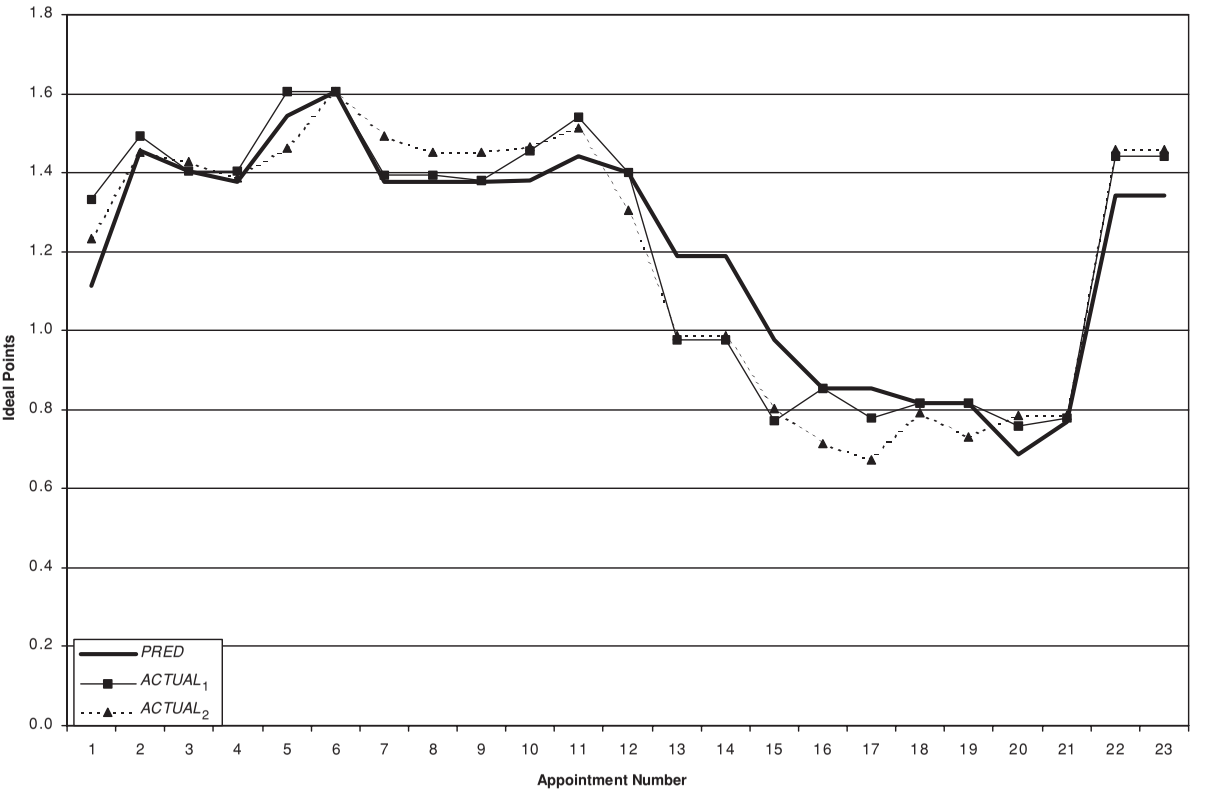

Figure 4.2: FOMC Hypothesis Tests 1, Graph of the Results

Table 4.5: *FOMC Hypothesis Tests 1, Regression Results*

Dependent Variable: $ACTUAL_2$		
	Coefficient	Coefficient
C	0.330	−0.147
	(−1.91)	(−11.27)
PRES	0.188	
	(−9.22)	
SEN	0.627	
	(−1.11)	
PRED		1.113
		(1.37)
Number of Observations	23	23
R-squared	0.369	0.897
Corrected R-squared	0.306	0.892
Sum of Squared Residuals	1.510	0.247
Standard Error of the Regression	0.275	0.109

t-statistics for H_0: $\beta = 1$ are in parentheses; for the model to be true, it is best to accept the null.

support for the model constitutes support for the influence on the Fed of both the president and Senate – if the influence is through the mechanisms of the presidential anticipation model.

However, the previous direct hypothesis tests do not indicate who exactly influences the Fed if it is not *both* the president and the Senate through the exact mechanisms of the model. The alternative hypothesis is that the entire model of presidential anticipation does not work, but this test does not show what indeed does work if the presidential anticipation model does not work. The Cox and J tests were more precise in this regard. Basically they test the model's predictions against an alternative model in which the president's and Senate's ideal points separately affect the FOMC median.

In terms of the question of who influences, it would be better to be still more precise. We would like to know that holding everything else constant, does the president *fail* to anticipate the Senate, and if so, does the president dominate the process? We could also test whether the Senate dominates the process, but I do not know of anyone who argues for Senate dominance of the appointment process. This is logical given the nature of the constitutional process that grants substantial power to the president – the power to appoint – and less power to the Senate – the power to block appointments. It is difficult to argue that the Senate dominates, and

Table 4.6: *FOMC Hypothesis Tests 2, Data for the Hypothesis Tests*

APPOINTMENT	RANGE	*PRED*	$ACTUAL_1$	$ACTUAL_2$
1	1	1.092	1.332	1.234
2	4	1.456	1.493	1.450
3	1	1.403	1.403	1.428
4	4	1.375	1.403	1.387
5	1	1.545	1.607	1.462
6	1	1.607	1.607	1.606
7	2, 4	1.377	1.394	1.493
8	2, 4	1.377	1.394	1.451
9	4	1.376	1.379	1.451
10	4	1.379	1.457	1.464
11	2	1.440	1.541	1.512
12	2	1.400	1.400	1.304
13	4	1.219	0.976	0.988
14	4	1.219	0.976	0.988
15	4	0.976	0.773	0.803
16	4	0.852	0.852	0.715
17	4	0.852	0.777	0.675
18	4	0.817	0.817	0.794
19	1	0.815	0.815	0.730
20	1	0.617	0.757	0.786
21	1	0.757	0.777	0.786
22	1	1.440	1.440	1.457
23	1	1.440	1.440	1.457

the president has no power in this process.[37] For the question of who influences, as for the question of influence itself, there are both: (1) direct hypothesis tests and (2) regression results.

In terms of the direct hypotheses, we can answer these questions by assuming presidential dominance for the entire period, using the model to derive new presidential dominance predictions, testing those predictions, and comparing the results to those from testing the presidential anticipation model. The results of the direct hypothesis testing of the dominance model are presented in Table 4.7; the basic information for calculating the test statistics are in Table 4.6.

[37] For the sake of completeness, I performed a Cox and J test for Senate dominance. For the test of $H_0 : ACTUAL_i = \alpha_i + \beta_1 PRED_i + \epsilon_i$ versus $H_a : ACTUAL_i = \alpha_i + \beta_1 SEN_i + \epsilon_i$, the Cox statistic is 0.82, and the J statistic is -0.84. For the reverse hypotheses, the Cox statistic is -25.47, and the J statistic is 11.63. Thus both sets of results support the null – the presidential anticipation model.

Table 4.7: *FOMC Hypothesis Tests 2, Results*

	$ACTUAL_1$					$ACTUAL_2$				
APPT.	NULL	ALTERNATIVE	z	p	ACCEPT NULL?[a]	NULL	ALTERNATIVE	z	p	ACCEPT NULL?[a]
1	P <= A	P > A	2.245	0.012	no	P <= A	P > A	1.207	0.114	yes
2	P <= A	P > A	0.263	0.396	yes	P >= A	P < A	−0.057	0.477	yes
3					yes	P <= A	P > A	0.271	0.393	yes
4	P <= A	P > A	0.203	0.419	yes	P <= A	P > A	0.106	0.458	yes
5	P <= A	P > A	0.410	0.341	yes	P >= A	P < A	−0.691	0.245	yes
6					yes	P >= A	P < A	−0.032	0.496	yes
7	P <= A	P > A	0.107	0.458	yes	P <= A	P > A	1.192	0.117	yes
8	P <= A	P > A	0.107	0.458	yes	P <= A	P > A	0.746	0.228	yes
9	P <= A	P > A	0.013	0.495	yes	P <= A	P > A	0.756	0.225	yes
10	P <= A	P > A	0.744	0.229	yes	P <= A	P > A	0.903	0.183	yes
11	P <= A	P > A	0.763	0.223	yes	P <= A	P > A	0.728	0.233	yes
12					yes	P >= A	P < A	−0.784	0.217	yes
13	P >= A	P < A	−1.234	0.109	yes	P >= A	P < A	−1.692	0.045	no
14	P >= A	P < A	−1.234	0.109	yes	P >= A	P < A	−1.692	0.045	no
15	P >= A	P < A	−1.155	0.124	yes	P >= A	P < A	−1.241	0.107	yes
16					yes	P >= A	P < A	−1.000	0.159	yes
17	P >= A	P < A	−0.241	0.405	yes	P >= A	P < A	−1.448	0.074	no
18					yes	P >= A	P < A	−0.200	0.421	yes
19					yes	P >= A	P < A	−0.791	0.214	yes
20	P <= A	P > A	0.306	0.380	yes	P <= A	P > A	1.342	0.090	no
21	P <= A	P > A	0.051	0.480	yes	P <= A	P > A	0.232	0.408	yes
22					yes	P <= A	P > A	0.118	0.453	yes
23					yes	P <= A	P > A	0.118	0.453	yes
					22					19

[a] At the 0.10 level

Essentially, in the theoretical models, the differences in predictions between the presidential dominance and presidential anticipation models are in Case 2, the presidential compromise case, and Case 3, the deadlock case. As the name, presidential dominance, suggests, the president never compromises in this model. In the presidential anticipation model, Case 2 yielded either the president's ideal point, P, or the Senate's indifference point, SQ^{-}, as the RR equilibrium policy. In contrast, if the president always dominates the process, SQ^{-} will never be the long-run policy; it will instead always be P. In Case 3 of the presidential dominance model, the deadlock is broken by the president; whatever he wants, he gets. Predictions from Case 1 will remain the same as previously, because it is the case of presidential dominance.

From an examination of the appointment-by-appointment direct hypothesis tests, it is difficult to say whether the president anticipates or dominates the Fed appointment process. Overall presidential anticipation predicts twenty-one cases versus twenty-two for presidential dominance using $ACTUAL_1$ at the $\alpha = 0.10$ level. With $ACTUAL_2$, the values are twenty-one for presidential anticipation versus nineteen for presidential dominance.

There are sixteen overlapping predictions between the two models and seven different predictions on appointments: 1, 13, 14, 20, 21, 22, and 23. First, in an examination of *PRED* versus $ACTUAL_1$, three of the seven, appointments 1, 20, and 21, favor presidential anticipation in that the p-values for presidential anticipation compared to those for presidential dominance more likely indicate acceptance of the null. The other four appointments favor presidential dominance. However, for five of the seven appointments (1, 13, 14, 20, and 21), the predictions for anticipation and dominance are very close to one another. For instance, in appointment 21, the anticipation prediction is 0.767, while the dominance prediction is 0.757.

Second, the results from the direct tests of *PRED* to $ACTUAL_2$ yield similarly unclear conclusions. As Table 4.7 indicates, appointments 1, 13, 14, and 20 are in favor of the presidential anticipation model. However, for four of those five appointments – 1, 13, 14, and 21 – the two models' predictions are very close to one another, and thus the four appointments only barely favor presidential anticipation. Of the three remaining appointments with different predictions, appointment 20 definitely favors presidential anticipation, while appointments 22 and 23 definitely favor presidential dominance.

Table 4.8: *FOMC Hypothesis Tests 2, Regression Results*

Dependent Variable: $ACTUAL_2$			
	Coefficient	Coefficient	Coefficient
C	0.956	−0.147	−0.083
	(−0.42)	(−11.27)	(−10.24)
PRES	0.239		
	(−8.64)		
PRED		1.113	
		(1.37)	
PRESPRED			1.054
			(0.64)
Number of Observations	23	23	23
R-squared	0.369	0.897	0.880
Corrected R-squared	0.306	0.892	0.875
Sum of Squared Residuals	1.510	0.247	0.286
Standard Error of the Regression	0.275	0.109	0.117

t-statistics for H_0: $\beta = 1$ are in parentheses; for the model to be true, it is best to accept the null.

Thus in both sets of comparisons, given the closeness of the predictions, it is not quite clear whether the president anticipates or dominates the Fed appointment process, although there is slightly more evidence for presidential anticipation.

However, the regression results strongly favor presidential anticipation (Table 4.8). In order to test for presidential anticipation versus presidential dominance, I started with Cox and J tests of the following hypotheses:

$$H_0 : ACTUAL_i = \beta_0 + \beta_1 PRED_i + \epsilon_i \tag{4.5}$$

$$H_a : ACTUAL_i = \beta_0 + \beta_1 PRES_i + \epsilon_i \tag{4.6}$$

We can accept the null at α as high as 0.15: the Cox statistic is 0.976 with a p-value of 0.165, and the J statistic is −1.028 with a p-value of 0.152. In reversing the hypotheses, we can reject the null that $PRES_i$ alone best predicts $ACTUAL_i$ compared to $PRED_i$; the Cox statistic is −22.510 and the J statistic is 11.445.

But these tests do not give presidential dominance a fair shake because the dominance model in this case simply posits a relationship between movements in $ACTUAL_i$ with movements in $PRES_i$. This setup does not give dominance the benefit of a theoretical model as it does to presidential

anticipation. If we do provide dominance that benefit, as we did with the direct hypothesis tests, we can test the following hypotheses:

$$H_0 : ACTUAL_i = \beta_0 + \beta_1 PRED_i + \epsilon_i \tag{4.7}$$

$$H_a : ACTUAL_i = \beta_0 + \beta_1 PRESPRED_i + \epsilon_i \tag{4.8}$$

where *PRESPRED* is the prediction from a presidential dominance model. Basically, for the presidential dominance model, assume that P is always the RR equilibrium policy in Chapter 2's appointment process model. Then *PRESPRED* provides the point in the range of possible outcomes that is closest to P.

The results again strongly favor presidential anticipation. It is extremely difficult to reject the null in favor of the alternative because the Cox test yields 0.403 with a p-value of 0.303, and the J test yields −0.387 with a p-value of 0.349. With a reversal of the hypotheses, the Cox test statistic is −2.046 with a p-value of 0.02, and the J test statistic is 1.827 with a p-value of 0.034, both of which indicate that we can reject the null of the *PRESPRED* model in favor of the alternative, the *PRED* model.

Thus, while the evidence is not as clear-cut as that for political influence on monetary policy, it seems on balance to favor presidential anticipation versus presidential dominance. Not only do the direct hypothesis tests slightly favor anticipation, but also the regression results strongly favor anticipation.

4.4 HYPOTHESIS TESTS – BOG

4.4.1 Hypothesis Tests 1: Political Influence on Monetary Policy?

Because the president and Senate have greater potential control of the BOG compared to the FOMC, does the model more accurately predict BOG policy compared to FOMC policy?

The BOG is composed entirely of presidential appointees while the FOMC has five additional members, the reserve bank presidents, over whom the president and Senate have no control. In the model, I assume that the president and Senate can accurately predict the timing and location of each reserve bank president.

However, if that assumption is the slightest bit off, the model will inaccurately predict the FOMC median. For instance, consider a president and Senate who wish to move the median one seat to the right of the status quo. If they fail to correctly anticipate a new bank president who

Table 4.9: *BOG Hypothesis Tests 1, Data for the Hypothesis Tests*

APPT.	RANGE	CASE	*PRED*	$ACTUAL_1$	$ACTUAL_2$
1	1	1	0.899	0.899	0.966
2	1	2	1.430	1.585	1.499
3	1	2	1.585	1.585	1.506
4	1	2	1.430	1.585	1.342
5	1	2	1.585	1.650	1.632
6	1	2	1.650	1.650	1.639
7	1	2	1.650	1.650	1.629
8	1	2	1.650	1.650	1.524
9	3	2	1.409	1.505	1.524
10	3	2	1.409	1.505	1.522
11	1	1	1.505	1.582	1.537
12	1	1	1.582	1.582	1.523
13	3	1	1.295	1.295	1.203
14	3	1	1.295	1.295	1.203
15	3	2	1.168	0.469	0.624
16	3	2	0.448	0.448	0.486
17	3	2	0.448	0.448	0.469
18	3	2	0.469	0.469	0.551
19	1	3	0.623	0.617	0.598
20	1	3	0.697	0.777	0.904
21	1	3	0.817	0.857	0.915
22	1	2	1.093	1.535	1.349
23	1	2	1.093	1.535	1.349

also comes in to the right of the status quo, the median will move two seats to the right rather than one seat. The prediction will then be off by the distance between the two seats.

Nevertheless the model should still accurately predict the BOG median because such mistakes about the reserve bank presidents do not affect the BOG. On the BOG, the president and Senate do not have to contend with the appointments they do not control. Moving the median by one seat really means moving it by one seat rather than potentially by two, three, or up to six seats. In contrast, on the FOMC, because of the reserve bank presidents, the median can move the other way even if the president and Senate make the correct appointment for their desired direction of change. In terms of the BOG, if the president and Senate have more control at their disposal compared to the FOMC, this model of instrumental control should better predict the results for the BOG.

In fact, the model impressively predicts the BOG median (Tables 4.9 and 4.10). First, a comparison of *PRED* to $ACTUAL_1$ in direct hypothesis

Table 4.10: *BOG Hypothesis Tests 1, Results*

	$ACTUAL_1$					$ACTUAL_2$				
APPT.	NULL	ALTERNATIVE	z	p	ACCEPT NULL?[a]	NULL	ALTERNATIVE	z	p	ACCEPT NULL?[a]
1					yes	P <= A	P > A	0.402	0.344	yes
2	P <= A	P > A	0.511	0.305	yes	P <= A	P > A	0.470	0.319	yes
3					yes	P >= A	P < A	−0.582	0.280	yes
4	P <= A	P > A	0.511	0.305	yes	P >= A	P < A	−0.493	0.311	yes
5	P <= A	P > A	0.244	0.404	yes	P <= A	P > A	0.376	0.353	yes
6					yes	P >= A	P < A	−0.093	0.463	yes
7					yes	P >= A	P < A	−0.174	0.431	yes
8					yes	P >= A	P < A	−1.048	0.147	yes
9	P <= A	P > A	0.332	0.370	yes	P <= A	P > A	0.957	0.169	yes
10	P <= A	P > A	0.332	0.370	yes	P <= A	P > A	0.894	0.186	yes
11	P <= A	P > A	0.275	0.392	yes	P <= A	P > A	0.258	0.398	yes
12					yes	P >= A	P < A	−0.437	0.331	yes
13					yes	P >= A	P < A	−0.463	0.322	yes
14					yes	P >= A	P < A	−0.463	0.322	yes
15	P >= A	P < A	−0.746	0.228	yes	P >= A	P < A	−2.676	0.004	no
16					yes	P <= A	P > A	0.248	0.402	yes
17					yes	P <= A	P > A	0.148	0.441	yes
18					yes	P <= A	P > A	0.552	0.290	yes
19	P >= A	P < A	−0.022	0.491	yes	P >= A	P < A	−0.161	0.436	yes
20	P <= A	P > A	0.519	0.302	yes	P <= A	P > A	1.428	0.077	no
21	P <= A	P > A	0.351	0.363	yes	P <= A	P > A	0.635	0.263	yes
22	P <= A	P > A	0.386	0.350	yes	P <= A	P > A	1.258	0.104	yes
23	P <= A	P > A	0.386	0.350	yes	P <= A	P > A	1.258	0.104	yes
					23					21

[a] At the 0.10 level

tests shows that predicted match actual in all twenty-three cases up to the $\alpha = 0.20$ level. Even at $\alpha = 0.30$, there is a match in twenty-two of twenty-three cases. Comparing these results to those for the FOMC, there are twenty-one matches at $\alpha = 0.20$ and fifteen matches at $\alpha = 0.30$. Thus the match of *PRED* to $ACTUAL_1$ is greater with respect to the BOG compared to the FOMC.

Second, a comparison of *PRED* to $ACTUAL_2$ reveals that predicted match actual in twenty-two of twenty-three cases up to the $\alpha = 0.05$ level, while it is all twenty-three cases for the FOMC. At $\alpha = 0.10$, there are twenty-one matches for the BOG and twenty matches for the FOMC. At $\alpha = 0.20$, there are sixteen matches for the BOG versus fifteen matches for the FOMC. While the results support the model's predictions for the BOG, in terms of whether the model does better in predicting the BOG versus the FOMC, these results are less clear-cut than those using $ACTUAL_1$.

As with the FOMC, the true results lie somewhere in between the comparisons of $PRED/ACTUAL_1$ and $PRED/ACTUAL_2$. At best (using $ACTUAL_1$) the model predicts 100 percent of cases at the $\alpha = 0.10$ level, while at worst (using $ACTUAL_2$), the model predicts 91 percent of the cases. Thus compared to the FOMC in which the range is 87 percent to 91 percent, the BOG predictions are better born out in the data.

The regression results (Table 4.11) also strongly support the model's predictions. As a first cut, the correlations are again high, although a bit lower than those for the FOMC: the correlation between *PRED* and $ACTUAL_1$ is 0.901, and the correlation between *PRED* and $ACTUAL_2$ is 0.924.

As before, I ran Cox and J tests for the following hypotheses:

$$H_0 : ACTUAL_i = \beta_0 + \beta_1 PRED_i + \epsilon_i \tag{4.9}$$

$$H_a : ACTUAL_i = \beta_0 + \beta_1 PRES_i + \beta_2 SEN_i + \epsilon_i \tag{4.10}$$

The tests support the model; they allow us to accept the null. The Cox statistic for these hypotheses is 0.814 (compared to 1.237 for the FOMC) with a p-value of 0.208, while the J statistic is -0.761 (-1.377 FOMC) with a p-value of 0.223. Reversing the hypotheses also provides support for the model with a Cox statistic of -18.599 (16.68 FOMC) and a J statistic of 9.21 (10.39 FOMC). Both allow us to reject the null of the regression model with *PRES* and *SEN* as independent variables in favor of one with only *PRED*. Compared to the FOMC, these results allow us to accept the *PRED* model with greater confidence.

Table 4.11: *BOG Hypothesis Tests 1, Regression Results*

Dependent Variable: $ACTUAL_2$		
	Coefficient	Coefficient
C	0.121	0.120
	(−1.86)	(−8.59)
PRES	0.140	
	(−7.25)	
SEN	0.867	
	(−0.29)	
PRED		0.908
		(−1.13)
Number of Observations	23	23
R-squared	0.264	0.855
Corrected R-squared	0.191	0.848
Sum of Squared Residuals	2.741	0.542
Standard Error of the Regression	0.370	0.161

t-statistics for $H_0 : \beta = 1$ are in parentheses; for the model to be true, it is best to accept the null.

The evidence thus suggests that the results for the BOG are stronger compared to the FOMC. This raises the question of whether the president and Senate really try to control the BOG rather than the FOMC. Despite the evidence, this is doubtful; most discussion of candidates revolve around their influence on monetary policy which is set by the FOMC rather than the BOG.

But it certainly does not hurt to control the BOG, whose members all sit on the FOMC. As in the model, the president and Senate probably try to the best possible extent to influence the FOMC through BOG appointments, but unlike the model's assumptions, they are not always successful due to the rotations of the bank presidents.

As for the features of the appointments (Table 4.9), there are more similarities than differences from those of the FOMC appointments. First, like the FOMC predictions, most of the retirees are in the two outside ranges, Ranges 1 and 3. However, unlike the FOMC predictions, the seat numbers are more widely distributed – nearly all seat numbers are represented in the distribution. Second, like the FOMC predictions, most of the appointments are in Case 2 situations, requiring compromise between the president and Senate. Third, like the FOMC predictions, the president and Senate are within the range of possible outcomes in only one case – Heller's appointment.

4.4.2 Hypothesis Tests 2: Who Influences?

Just as I did for the FOMC, I examined whether the president anticipates or dominates the Senate in the BOG appointments. I developed a presidential dominance version of the model for the BOG and tested its predictions in both direct hypothesis tests and regression tests.

Compared with the FOMC, the results are more ambiguous for the BOG. First, the correlation results are virtually identical although they favor dominance very slightly. The correlation between *PRED* and $ACTUAL_1$ is 0.927 compared to 0.901 for anticipation; for $ACTUAL_2$, the correlations are 0.925 for dominance and 0.924 for anticipation. These are extremely small differences.

Second, testing the predictions of the dominance model with direct hypothesis tests shows slightly more support for anticipation at the $\alpha = 0.10$ level. Overall, using $ACTUAL_1$ (see Tables 4.12 and 4.13),

Table 4.12: *BOG Hypothesis Tests 2, Data for the Hypothesis Tests*

APPT.	RANGE	*PRED*	$ACTUAL_1$	$ACTUAL_2$
1	1	0.899	0.899	0.966
2	1	1.430	1.585	1.499
3	1	1.585	1.585	1.506
4	1	1.430	1.585	1.342
5	1	1.585	1.650	1.632
6	1	1.650	1.650	1.639
7	1	1.650	1.650	1.629
8	1	1.650	1.650	1.524
9	3	1.409	1.505	1.524
10	3	1.409	1.505	1.522
11	1	1.505	1.582	1.537
12	1	1.582	1.582	1.523
13	3	1.295	1.295	1.203
14	3	1.295	1.295	1.203
15	3	1.219	0.469	0.624
16	3	0.448	0.448	0.486
17	3	0.448	0.448	0.469
18	3	0.469	0.469	0.551
19	1	0.469	0.617	0.598
20	1	0.617	0.777	0.904
21	1	0.777	0.857	0.915
22	1	1.535	1.535	1.349
23	1	1.535	1.535	1.349

Table 4.13: *BOG Hypothesis Tests 2, Results*

	$ACTUAL_1$					$ACTUAL_2$				
APPT.	NULL	ALTERNATIVE	z	p	ACCEPT NULL?[a]	NULL	ALTERNATIVE	z	p	ACCEPT NULL?[a]
1					yes	P <= A	P > A	0.402	0.344	yes
2	P <= A	P > A	0.511	0.305	yes	P <= A	P > A	0.470	0.319	yes
3					yes	P >= A	P < A	−0.582	0.280	yes
4	P <= A	P > A	0.511	0.305	yes	P >= A	P < A	−0.493	0.311	yes
5	P <= A	P > A	0.244	0.404	yes	P <= A	P > A	0.376	0.353	yes
6					yes	P >= A	P < A	−0.093	0.463	yes
7					yes	P >= A	P < A	−0.174	0.431	yes
8					yes	P >= A	P < A	−1.048	0.147	yes
9	P <= A	P > A	0.332	0.370	yes	P <= A	P > A	0.957	0.169	yes
10	P <= A	P > A	0.332	0.370	yes	P <= A	P > A	0.894	0.186	yes
11	P <= A	P > A	0.275	0.392	yes	P <= A	P > A	0.258	0.398	yes
12					yes	P >= A	P < A	−0.437	0.331	yes
13					yes	P >= A	P < A	−0.463	0.322	yes
14					yes	P >= A	P < A	−0.463	0.322	yes
15	P >= A	P < A	−3.388	0.000	no	P >= A	P < A	−2.928	0.002	no
16					yes	P <= A	P > A	0.248	0.402	yes
17					yes	P <= A	P > A	0.148	0.441	yes
18					yes	P <= A	P > A	0.552	0.290	yes
19	P <= A	P > A	0.470	0.319	yes	P <= A	P > A	0.840	0.200	yes
20	P <= A	P > A	0.519	0.302	yes	P <= A	P > A	1.982	0.024	no
21	P <= A	P > A	0.351	0.363	yes	P <= A	P > A	0.893	0.190	yes
22					yes	P >= A	P < A	−0.912	0.181	yes
23					yes	P >= A	P < A	−0.912	0.181	yes
					22					21

[a] At the 0.10 level

the dominance model predicts twenty-two appointments while anticipation predicts twenty-three; with $ACTUAL_2$, dominance predicts twenty-one and anticipation also predicts twenty-one.

The two models differ on six appointments: 15, 19, 20, 21, 22, and 23. First, with $ACTUAL_1$, on appointments 15, 19, 22, and 23, presidential dominance better predicts the outcome, while on the other two, the predictions are virtually identical. On the last two appointments, 22 and 23, presidential dominance exactly predicts the outcomes, while anticipation only significantly predicts them. Second, with $ACTUAL_2$, anticipation better predicts the outcome on appointments 15, 19, 20, and 21, but appointments 15 and 20 are extremely close calls. The bottom line is that both make very similar predictions with regard to the BOG, and both are generally successful in predicting the outcomes.

The regression results are also ambiguous (Table 4.14). As was the case with the FOMC, testing the *PRED* model against the *PRES* model:

$$H_0 : ACTUAL_i = \beta_0 + \beta_1 PRED_i + \epsilon_i \tag{4.11}$$

$$H_a : ACTUAL_i = \beta_0 + \beta_1 PRES_i + \epsilon_i \tag{4.12}$$

results in support for the *PRED* model. The Cox and J statistics are respectively -0.285 ($p = 0.388$) and -0.761 ($p = 0.223$). For the reverse hypotheses, the Cox and J statistics are respectively -39.347 and 10.008.

Table 4.14: *BOG Hypothesis Tests 2, Regression Results*

Dependent Variable: $ACTUAL_2$			
	Coefficient	Coefficient	Coefficient
C	0.987	0.120	0.162
	(−0.09)	(−8.59)	(−8.56)
PRES	0.211		
	(−6.80)		
PRED		0.908	
		(−1.13)	
PRESPRED			0.853
			(−1.94)
Number of Observations	23	23	23
R-squared	0.129	0.855	0.856
Corrected R-squared	0.088	0.848	0.849
Sum of Squared Residuals	3.244	0.542	0.537
Standard Error of the Regression	0.393	0.161	0.160

t-statistics for $H_0 : \beta = 1$ are in parentheses; for the model to be true, it is best to accept the null

However, in the more fair test of the *PRED* versus the *PRESPRED* model:

$$H_0 : ACTUAL_i = \beta_0 + \beta_1 PRED_i + \epsilon_i \quad (4.13)$$

$$H_a : ACTUAL_i = \beta_0 + \beta_1 PRESPRED_i + \epsilon_i \quad (4.14)$$

the results of the forward hypothesis tests contradict the results of the reverse tests. The Cox and J statistics for the hypotheses as written – the forward tests – are respectively −2.330 and 1.854. Thus we would reject the null, the *PRED* model, in favor of the alternative model, the *PRESPRED* model. However, the Cox and J statistics for the *PRESPRED* model as the null and the *PRED* model as the alternative – the reverse tests – are respectively −2.26 and 1.80. Thus based on this set of tests, we reject the null, the *PRESPRED* model, in favor of the alternative, the *PRED* model.

Thus the results are rather inconclusive. The evidence can go either way on anticipation versus dominance with respect to the BOG. Definitive answers await further observations on appointments that will allow for the examination of greater numbers of different predictions from the two models.

4.5 POLICY EFFECTS

Up to this point, we do not really know what this analysis means for actual policy, the interest rates set by the FOMC and the BOG. I have used the FOMC or BOG median interchangeably with the term "policy" without really examining what the medians mean for the FOMC's federal funds rate and the BOG's discount rate – the actual policy of the two bodies. In this section, I examine the relationship between the medians and the interest rates and what they mean in terms of how the appointment process model predicts policy.

First, let us examine the relationship between the FOMC median and the federal funds rate – the rate over which the FOMC has most control. The FOMC median is either $ACTUAL_1$ or $ACTUAL_2$, the FOMC median after an appointee takes office. For the federal funds rate, I used the average of the real federal funds rate from an appointee's date of appointment to the next appointee's date of appointment. For example, Jackson was appointed on May 22, 1975, and Gardner, on November 15, 1975. For Jackson's appointment, I averaged the real federal funds rate from May 1975 through October 1975. The relationship is moderate

with a correlation of 0.410 for $ACTUAL_1$ and 0.422 for $ACTUAL_2$. The graph in Figure 4.3 plots the three variables: the two measures of the FOMC median ($ACTUAL_1$ and $ACTUAL_2$) and the real federal funds rate (*Federal Funds Rate*).

Going back to the direct hypothesis tests, suppose we conservatively use the $\alpha = 0.15$ level and $ACTUAL_2$; then the model correctly predicts the FOMC median 78 percent (eighteen of twenty-three) of the time. If we combine this fact with the fact that the FOMC median correlates with the average real federal funds rate at 0.422, we can predict the average federal funds rate between appointments 32.9 percent of the time.

Given that this analysis only takes into account the political process for making appointments, the results are promising. This analysis does not account for anything else including the fact that the federal funds rate is determined not only by the FOMC, but also by market forces.

Second, let us look at the relationship between the BOG median and the discount rate – the rate that the BOG controls. As for the FOMC, the BOG median is either $ACTUAL_1$ or $ACTUAL_2$, the BOG median after an appointee takes office. The discount rate is the average from the date of a nomination to the date of the next nomination. The relationship is almost identical to that for the FOMC and the real federal funds rate; the correlation between the discount rate and $ACTUAL_1$ is 0.411, while the correlation with $ACTUAL_2$ is 0.488. As before, with the same conservative assumptions, we can predict the average discount rate between appointments about 38.1 percent of the time. Figure 4.4 plots the three variables.

It is surprising that the correlation between the discount rate and $SQ2$ is not much higher for the BOG compared to the FOMC. While the FOMC cannot totally control the federal funds rate, the BOG does control the discount rate. Two points can be made in this regard. First, although the FOMC does not control the federal funds rate 100 percent, it does control it very closely; the federal funds rate is its primary target.

Second, as with the FOMC and the federal funds rate, this analysis does not take into account any other political or economic factors – only those factors associated with political appointments. Both bodies may be subject to other political pressures such as direct pressures from the president or Congress, or to economic pressures such as that caused by rising oil prices. Although averaging over time smooths out some of those factors, it does not eradicate all of them. In both cases, these factors will influence the correlation. Given that this is the case, it is still encouraging that the correlations are as high as they are.

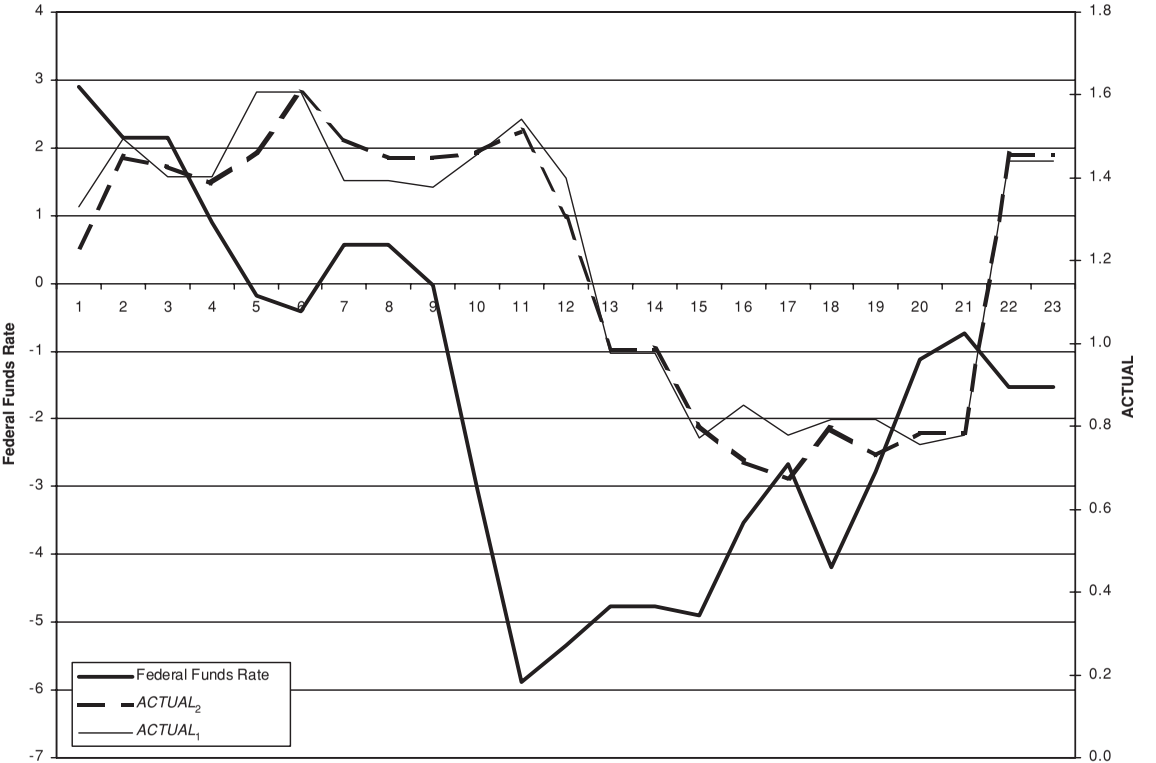

Figure 4.3: The FOMC Median and the Real Federal Funds Rate

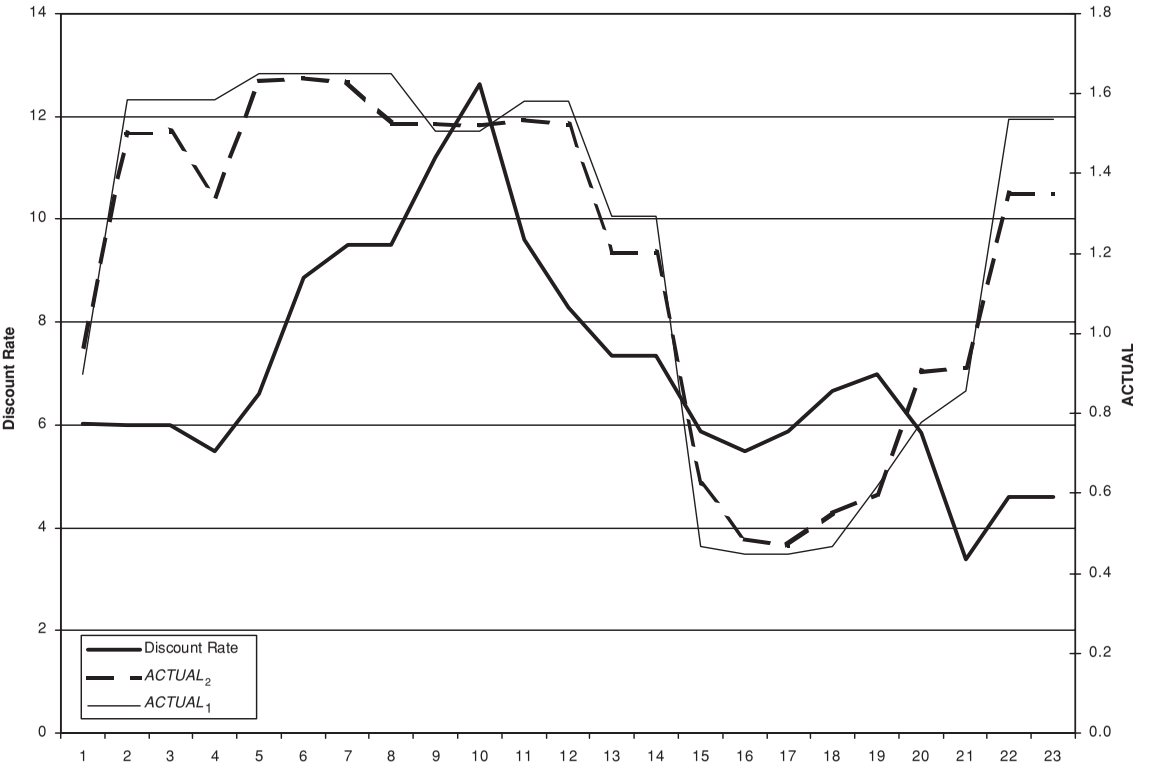

Figure 4.4: The BOG Median and the Discount Rate

4.6 SUMMARY

In this chapter, I directly tested the predictions of the model from Chapter 2 with the ideal point estimates from Chapter 3. By doing so, I answered two of the book's main questions.

First, in answer to the question of whether political influence occurs through appointments, the answer is – it does. In both institutions, the results strongly support the model's predictions.

Second, in answer to the question of who influences, the answer is less clear. With respect to the FOMC, anticipation does better on balance, but in the case of the BOG, anticipation and dominance do equally well. However, the FOMC is the more important policy body, and at least there, the results indicate influence by both the president and Senate, rather than the president alone.

Finally, the results suggest that the model predicts actual policy to some extent. In terms of both the federal funds rate and the discount rate, the FOMC median after appointment predicts the rates with about 32.9 percent success. The success rate is encouraging given that the analysis does not take into account any other political or economic context variables.

In the next chapter, I examine another application of the appointment process model – an application to the newly created ECB.

5

Appointments to the European Central Bank

Italy's membership in the EMU was unthinkable in early 1996. At that time, Italy fulfilled none of the Maastricht convergence criteria, a number of economic requirements for entry into the EMU.[38] Among European Union (EU) countries, with the exception of Greece, Italy's budget deficit, inflation rate, and interest rates were the highest, and its gross debt was the second highest. In addition, the Italian lira left the Exchange Rate Mechanism (ERM) in 1992.

Within months, the situation changed drastically. In the fall, Italy released its budget forecasts for 1997 and 1998 (*Financial Times*, September 28, 1996). Surprisingly, the deficit figures nearly achieved the 3 percent convergence criterion level, which raised expectations of Italy's entrance into EMU. Consequently, the Italian inflation and interest rates began to drop, and Italy rejoined the ERM (*Financial Times*, November 25, 1996). Combined with the fact that the German and French budgets

[38] The Maastricht Treaty is the Treaty on European Union signed in 1992 in the Dutch city of Maastricht. There are four main criteria based on price stability, government fiscal position, the ERM, and interest rates. The criteria are defined in Articles 104c, 109j, and the Protocols on the Excessive Deficit Procedure and the Convergence Criteria. For price stability, a member state's average inflation rate over the year before examination cannot exceed that of the three best performing states in terms of price stability. The deficit criteria are "3% for the ratio of planned or actual government deficit to gross domestic product at market prices," and "60% for the ratio of government debt to gross domestic product at market prices" (Art. 1, Protocol on the Excessive Deficit Procedure). For the ERM, the currency of a country must have stayed for at least two years within the normal bands of fluctuations "without severe tensions" and without devaluations (Art. 3, Protocol on the Convergence Criteria). Finally, for the interest rate, a country's average nominal long-term interest rate (usually the ten-year government bond rate) cannot exceed by more than two percentage points that of the three best countries in terms of price stability (Art. 4, Protocol on the Convergence Criteria).

indicated problems with the 3 percent level and that the Belgian gross debt was even higher than the Italian debt, Italy's prospects looked markedly better.

Still, the core EMU countries[39] forcefully raised concerns about Italy's economic fitness for EMU entry. French president Jacques Chirac stated that Italy needed to get its financial house in order and that, "[joining EMU] may take a little bit longer for those who are further behind, like Italy" (*Financial Times*, October 2, 1996). Hans Tietmeyer, president of the German Bundesbank, proclaimed, "Italy certainly has more to do" (*Financial Times*, November 29, 1996). The concerns culminated in a possible plan for Italy's late entry into EMU, which Italy angrily rejected (*Financial Times*, February 7, 1997). Despite the considerable hoopla, in the end, Italy was a founding member of the then eleven-country EMU in 1998.[40]

What was the basis of the concerns regarding Italy? It is not clear. In the press and in academic circles, the concerns themselves centered on the past economic and political instability of Italy and its potential future contribution to easy monetary policy and a weak euro (Coleman 1998; Kosters, et. al. 1998). But what was the exact path from Italy's EMU membership to easy policy and a weak euro? It is as if the naysayers envisioned a sort of mean monetary policy among the preferred policies of the member countries: because Italy's preferred policy was historically very easy and its currency very weak, Italy's entry would automatically lead to easier policy by dragging down the mean.

As this chapter shows, these arguments neglect the political institutions of European monetary policy – the new ECB, the appointment process by which the ECB's members are appointed, and how that process influences policy. This chapter demonstrates that a mean monetary policy is never the case, and Italian influence can be very limited.

The impact of a single country is generally limited; it cannot unduly influence the ECB. The reason: the EMU founders created a highly independent ECB, which when combined with the appointment process and the conditions at the start of EMU, guaranteed tight policy for years to come. First, the founders created an appointment process that locked in the current policy at the start of EMU. Second, the current policy at EMU's start was relatively tight due to expansionary economic growth

[39] Austria, Belgium, France, Germany, Luxembourg, and the Netherlands.

[40] The other ten members were Austria, Belgium, France, Luxembourg, Germany, the Netherlands, Ireland, Finland, Spain, and Portugal. Greece joined in January 2001.

at the time. Third, the founders shielded the ECB from political influence by providing an explicit price stability mandate, lacking even of the Bundesbank and the Fed, and severely minimizing the ECB's responsibility to other governmental institutions.

Along this line of reasoning, this chapter examines the ECB's appointment process and attempts to answer three sets of questions – two of which correspond to those for the Fed. First, what is the appointment process? Second, who influences appointments? Third, what does the process mean for the direction of monetary policy?

To answer the first two questions, I adapt the appointment process model from Chapter 2 to the ECB appointment process. In the process, the veto power of each Head of State drives two sets of results. In the first, the model demonstrates that extreme Heads of States, those who prefer the most easy or most tight policy, can dominate the process by virtue of their veto power. Second, the model shows that the Heads of States can easily deadlock and agree only to disagree; they maintain the current status quo.

As for the third question, under a reasonable set of assumptions regarding the situation at the time of the initial appointments, the chapter predicts that the appointments made in May of 1998 will preserve the pre-May status quo policy – relatively tight, low-inflation monetary policy. This result counters the alarm regarding the entry of the noncore countries, that is Italy as well as Spain, Portugal, and Greece.[41]

The model in this chapter also shows how single countries like Italy can be limited in their influence on the ECB. The model further provides a framework for considering the implications of EMU's enlargement. Greece's recent membership loosened policy slightly, partially in line with the model's prediction. The chapter also briefly considers the potential memberships of Sweden, the United Kingdom, and the ten new members of the EU in 2004.

5.1 A COMPARISON OF THE UNITED STATES AND EUROPEAN MONETARY UNION MONETARY SYSTEMS

The European System of Central Banks (ESCB), which began functioning on January 1, 1999, has many similarities to the Federal Reserve System. Despite the similarities, key institutional differences emphasize the most

[41] The entrance of Ireland and Finland never raised the level of concern directed at the three southern countries.

obvious difference between the two monetary systems – that the U.S. system functions within a single unified federal government whereas the European system does not. As a result, the European system emphasizes federal (national) rather than central (EU) power to set monetary policy, whereas the opposite is true in the Federal Reserve System.

5.1.1 The Appointing Actors

Nowhere is this difference more apparent than in the actors involved in the appointment process, and more specifically, the powers of those actors. Three sets of EU actors are statutorily involved in the appointment process. First, the *European Councils* are summits of the Heads of States of the fifteen EU member countries[42] in which decisions are made by common accord, that is unanimity rule. Second, the *Council of Ministers* consists of the cabinet ministers from the fifteen EU countries. Depending on the type of issue, the council makes decisions by unanimity rule or qualified majority (a 71 percent majority; see Table 5.1)[43] in which larger countries vote with more weight.[44] Third, the *European Parliament* is the EU's popularly elected legislature. The European Parliament makes decisions by simple majority; the larger countries have more European Parliament representatives.

All truly important EU decisions – for example, EMU's creation, its membership, and central bank appointees – have been made in the European Councils at the level of the Heads of States. In the United States, this would be comparable to having the state governors decide crucial national issues by a unanimous vote. Lesser decisions are made by the Council of Ministers and the European Parliament, which together have the power to pass EU laws and the budget. But between the two, the European Parliament is much less powerful. For example, on taxation, the European Parliament can only provide nonbinding opinions.

This general pattern holds true for the ECB's appointment process. Regarding the process, the Maastricht Treaty, Article 11.2 of the Statute

[42] Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

[43] A qualified majority is sixty-two votes of the eighty-seven possible votes in the Council of Ministers (71 percent).

[44] Particular sets of ministers decide on the issues for which they are responsible in their home countries; finance ministers decide on issues relating to monetary policy.

Table 5.1: *Voting Weights in the European Union*

	European Parliament		Council of Ministers	
	Votes	% of Total Votes	Votes	% of Total Votes
Germany	99	15.81%	10	11.49%
France	87	13.90%	10	11.49%
Italy	87	13.90%	10	11.49%
United Kingdom	87	13.90%	10	11.49%
Spain	64	10.22%	8	9.20%
Netherlands	31	4.95%	5	5.75%
Belgium	25	3.99%	5	5.75%
Greece	25	3.99%	5	5.75%
Portugal	25	3.99%	5	5.75%
Sweden	22	3.51%	4	4.60%
Austria	21	3.35%	4	4.60%
Denmark	16	2.56%	3	3.45%
Finland	16	2.56%	3	3.45%
Ireland	15	2.40%	3	3.45%
Luxembourg	6	0.96%	2	12.30%
TOTAL	626		87	

Source: European Union

of the ESCB states:

"... the President, the Vice President, and other members of the Executive Board shall be appointed from among persons of recognized standing and professional experience in monetary or banking matters by common accord of the government of the Member States at the level of the Heads of State or Government, on a recommendation from the Council after it has consulted the European Parliament and the Governing Council."

The treaty's language implies the following sequence for the appointment process. First, the European Parliament and the Governing Council, the main decision-making body of the ECB, suggest potential nominees. Second, the Council of Ministers recommends the suggested nominees or makes its own recommendation. Third, the Heads of States can approve the recommendation or choose someone else altogether.

However, neither recommendations nor consultations are binding. Thus in reality, the Heads of States hold all the cards; neither the European Parliament nor the Governing Council has any real power in this process. In its recommendation role, the Council of Ministers ultimately seems powerless as well, especially since the ministers are all cabinet members in their home countries, handpicked by the respective Heads of States.

This unequal distribution of power was apparent at the May 1998 European Council, when the first appointees were chosen. Except for a row over the ECB presidency, the appointment choices were a *fait accompli* with clear prior agreement among the Heads of States. Over the previous few months, finance ministers and central bankers influenced the choices, but seemingly through their own heads of states rather than through the various EU institutions. The subsequent European Parliament reviews of the appointees were largely uneventful and resulted in the unsurprisingly high majority recommendations of the candidates.

A similar process occurred when a new appointment opportunity arose in 2002 – the first since the start of EMU. This time, the Heads of States, through the Council of Ministers, chose Greece's Lucas Papademos to replace Christian Noyer as the new vice president. A slight problem occurred when the Belgians abstained due to their preference for their own candidate, Paul de Grauwe, but the Belgians later agreed to Papademos. In the weeks following, the European Parliament, Governing Council, and European Council essentially rubber stamped the choice.

The distribution of powers in this process differs substantially from that in the Fed appointment process. In the latter, a major difference is that both sets of actors, the president and Senate, are from central government institutions. Furthermore, although the Senate represents state interests, in the appointment process, both the president and Senate have different binding powers that constrain one another. The president has proposal power, but his proposal must be approved by the Senate. The Senate cannot bypass the president with proposals of its own. The difference in the ECB process is that the Council of Ministers' proposals, unlike the president's proposals, are not binding. If the Heads of States decide against the proposals, they can propose and appoint their own candidates. The Senate, on the other hand, must await a favorable presidential nominee. Thus in the ECB process, the preferences of the Heads of States are ultimately supreme – it is all about the federal units – whereas in the Fed process, both the president and Senate's preferences matter – the central units matter as well.

5.1.2 The Institutions of Monetary Policy

In terms of who appoints, the individual countries maintain control versus the EU institutions. Furthermore, even if all the Heads of States agree on the appointees, these centrally appointed members do not alone control monetary policy. The structure of the monetary institutions limits their

powers. This again contrasts with the Federal Reserve System in which, once appointed, the central appointees have majority power.

At first glance, the two sets of institutions look very similar. First, both systems are federal. The Federal Reserve System consists of twelve district reserve banks, one for each region of the country. The ESCB consists of twelve national central banks, one for each EMU country.

However, an important difference lies in the boundaries of the federal units. On the ESCB, national borders determine those boundaries. For the Federal Reserve System, the district lines bound regional areas with economic centers *from the year 1913*; the boundaries have remained fixed since then. Thus the ESCB's boundaries are of countries with defined national interests and political power at the EU level. Nothing could be farther from the truth for the Fed, whose district boundaries cross state lines and define, in some cases, obsolete centers of former financial prowess.

Second, two central decision-making institutions control both federal systems, but the balance of power between the central and federal units is reversed in each system.[45] Similar to the Fed's central structure, the ESCB has two central decision-making bodies: the Executive Board and the Governing Council, which are comparable to the BOG and the FOMC respectively (see Table 5.2).[46] These two institutions make up the ECB.

The Executive Board. The Executive Board consists of six members: a president, vice president, and four other members (Art. 11.1, Statute of the ESCB). The president and vice president are also the Governing Council's president and vice president. The Executive Board members must be citizens of the member states and are appointed to staggered, eight-year, nonrenewable terms by the Heads of States on recommendation from the Council of Ministers who consult with the European Parliament and the Governing Council of the ECB (Art. 11.2, Statute of the ESCB).

The Executive Board is responsible for the implementation of monetary policy and the preparation of the Governing Council's meetings (Art. 12.1, 12.2, Statute of the ESCB). It makes decisions using a simple majority rule

[45] Both sets of regional banks have no decision-making powers with respect to monetary policy. The main function of the ESCB's national banks is to act as depositories of reserves, and the Fed's reserve banks clear checks for the payments system and regulates banks in the regions.

[46] The Protocol on the Statute of the European System of Central Banks and of the European Central Banks sets out the structure and functions of the ESCB and ECB. Henceforth, I will refer to this protocol as the Statute of the ESCB.

Table 5.2: *The Structure of the European System of Central Banks*

Institution	Number of Members	Functions
Executive Board	6–President, Vice President, 4 other members	Implementation of monetary policy
Governing Council	6+ number of EMU countries: The first 6 are executive board members with the remaining members each representing one EMU member	Formulation of monetary policy
National Central Banks	One bank for each member state	Mainly depositories of reserves

with the President casting the decisive vote in the case of a tie (Art. 11.5, Statute of the ESCB). Just as all BOG members are also members of the FOMC in the Federal Reserve System, all Executive Board members are also members of the Governing Council, which is the main monetary policy decision-making body.

The Governing Council. The Governing Council consists of the Executive Board members and the national bank governors. EMU started with eleven members with Greece rounding it out to twelve in 2001. Thus the Governing Council has eighteen members: the six Executive Board members plus one governor from each of the twelve national banks.

The appointment procedures for the national bank governors may vary, but the Maastricht Treaty and the Statute of the ESCB mandate certain basic requirements. First, once appointed, national bank governors cannot take instructions from their governments or EU institutions (Art. 107, Title II of the Maastricht Treaty; Art. 7, Statute of the ESCB). Second, the terms of each governors' office must last at least five years (Art. 14.2, Statute of the ESCB). Third, appointees cannot be dismissed unless "he no longer fulfills the conditions required for the performance of his duties or if he has been guilty of serious misconduct" (Art. 14.2, Statute of the ESCB).

The primary function of the Governing Council is to formulate monetary policy (Art. 12.1, Statute of the ESCB). The treaty specifies that this function may include the setting of intermediate monetary objectives, key interest rates, and the supply of reserves in the ESCB (Art. 12.1, Statute of

the ESCB). The Governing Council makes decisions on the basis of simple majority rule with the president casting the decisive vote in the case of a tie.

A key difference between the FOMC and the Governing Council – the main decision-making bodies for monetary policy in each system – is the balance of power between the central government and the federal units. On the FOMC, presidential appointees, the BOG members, control the majority; of the twelve members, the regional reserve bank presidents occupy only five of the twelve seats. On the Governing Council, the EU appointees, the Executive Board members, are a minority; the national central bank governors make up twelve of the eighteen members. As in the ECB appointment process, the federal elements are emphasized over the central elements. The structure of the ECB's Governing Board ensures that national interests are represented over pan-European interests.

In theory, the ECB is the most independent central bank in the world. The statutes do not specify its responsibility to anyone; the ECB does not have to defend its actions to any EU or national body, although it does have to provide annual reports to the European Commission, European Parliament, Council of Ministers, and European Council (Art. 15, Statute of the ESCB). Even the Fed, considered one of the most independent central banks in the world, until recently had to defend its actions to the U.S. Congress in semiannual monetary policy hearings. Furthermore, the Fed is ultimately responsible to Congress (which can alter the basic Fed law with the President's signature). Changing the ESCB statutes requires unanimity of the European Council and possibly referenda in the various EU countries.

The irony is that despite its independence, it can be highly immobile in policy due to its structure. As the subsequent sections show, unanimous approval of nominees makes it very difficult to move long-term policy. Furthermore, even if the appointees would like to move policy, national bank governors can stop policy movement by ganging up against the appointees. Both of these features, especially the appointment process, have the potential to render the ECB the most immobile of central banks, even if it is the most independent.

5.2 THE MODEL

5.2.1 The Model's Assumptions

1. Actors and their preferences. The actors are the Heads of States (HS) and the Governing Council (GC) of the ECB. The assumptions about

preferences are essentially identical to those previously stated: all individuals have well-behaved preferences defined on a single dimension of monetary policy measured by the short-term real interest rate $r \in [0, 1]$ on a scale of lower to higher rates representing respectively easier to tighter policy. A utility function for an individual i is, as before, in the form, $U_i = \theta(|r_i - SQ|)$ in which r_i is the individual's ideal real interest rate, SQ is the current real interest rate implied by the median member of the Governing Council, and θ is a monotone, decreasing function. As in the Fed model, particular appointments do not enter the utility functions, and individuals care about the effects of appointments on policy rather than about the appointments themselves.

2. *Actions.* The Heads of States can unanimously choose a nominee, x, on the set of $r \in [0, 1]$; the nominee maps to a specific GC median, $SQ2$. The next section describes the exact mapping. The Governing Council members vote on monetary policy according to the rule: Vote = tighter policy if $r_i > SQ$, Vote = easier policy otherwise.

3. *Other assumptions and implications.* As in the Fed model, complete and perfect information characterizes this game. I also assume, as before, that the Heads of States are perfectly informed about the locations of the national bank governors. Like the FOMC, the Governing Council is a majority rule institution, and from the preceding assumptions, the median voter theorem applies. As for the Heads of States, I assume unanimity rule because they must unanimously approve the appointees.

4. *Definition: appointments and policy.* Policy in this model refers specifically to the Governing Council's formulation of monetary policy. For appointments, however, the focus is on the Executive Board appointments. But I am only interested in these appointments insofar as they affect the Governing Council's policy, much as I previously concentrated on the BOG appointments as they affected FOMC policy.

An alternative is to focus explicitly on the Executive Board's policy because it does have potentially important policy-implementation powers. However, it is not yet clear whether these powers will be consequential; to date, most of the action seems to have been on the Governing Council. If history is any guide, in the Federal Reserve System, the Federal Reserve Bank of New York has powers similar to those of the Executive Board, but under the institutional reforms of 1935, the New York Fed has very little discretion. In fact, the Maastricht Treaty's language does not

grant the Executive Board much power independent of the Governing Council:

> "The Executive Board shall implement monetary policy *in accordance with the guidelines and decisions laid down by the Governing Council*. . . . In addition the Executive Board may have certain powers delegated to it *where the Governing Council so decides*" (Art. 12.1, Statute of the ESCB, emphasis added).

An important question regards how the Executive Board appointments translate to the monetary policy set by the Governing Council. The Executive Board members are the only ones on the Governing Council appointed by EU-level institutions. All other members are national bank governors, who are appointed by a myriad of different institutions and procedures in different countries. The national bank governors outnumber the Executive Board members twelve to six. The opposite is true on the Fed in which presidential appointees outnumber the reserve bank presidents seven to five.

Nevertheless, despite their relative small numbers, the Executive Board could have substantial influence on monetary policy depending on how they match up to the national bank governors in terms of policy preferences. If the Executive Board members are all on one side of the policy dimension, for example, then their influence will tend to be smaller than if they are dispersed among the other Governing Council members. In the latter situation, it is more likely that one of the Executive Board members will be the median, policy-determining member. Dispersion rather than the extremity of Executive Board members is somewhat more likely as all heads of the member states, who may all have different policy preferences, must approve the Executive Board appointees.

5.2.2 Sequence

This game is much more simple compared to the Fed game. For each appointment opportunity, each Head of State simultaneously proposes a point as the new policy point, $SQ2$. The proposal that garners unanimous support is the RR equilibrium policy. Depending on the range of possible outcomes, the Heads of States make an appointment that achieves either the RR equilibrium policy or the closest boundary point, L or H.

5.2.3 Possible Outcomes

As mentioned previously, Greece joined EMU in 2001. Thus there are now twelve EMU countries and an eighteen-member Governing Council.

But to assess the implications of the important 1998 appointment process in Section 5.3, the following exposition of the model sticks with the initial setup in 1998 with eleven Heads of States and a seventeen-member Governing Council. The results follow for an eighteen-member Governing Council with slight adjustments of seat numbers and medians.

The possible outcomes are analogous to those for the BOG that, like the 1998 seventeen-member Governing Council, has an odd rather than even number of members. There are three ranges defined by (1) the first eight seats, (2) the ninth median seat, and (3) the last eight seats. As with the FOMC members, the Governing Council members are numbered in order of easiest to tightest policy, $x1$ to $x17$.

Range 1: *if* $y \in \{x1, x2, \ldots, x8\}$

For any $y \in \{x1, x2, \ldots, x8\}$, $SQ1 = \frac{x9+x10}{2}$. The nonunique correspondences between x and $SQ2$ are defined for any x such that:

$$(1)\ x \leq x9 \quad \Rightarrow \quad SQ2 = x9 = SQ0 = L1$$
$$(2)\ x \geq x10 \quad \Rightarrow \quad SQ2 = x10 = H1$$

The unique correspondences are defined for any x such that:

$$(3)\ x9 < x < x10 \quad \Rightarrow \quad L1 < SQ2 = x < H1$$

Range 2: *if* $y \in \{x9\}$

For any $y \in \{x9\}$, $SQ1 = \frac{x8+x10}{2}$. The nonunique correspondences are:

$$(1)\ x \leq x8 \quad \Rightarrow \quad SQ2 = x8 = L2 < L1$$
$$(2)\ x \geq x10 \quad \Rightarrow \quad SQ2 = x10 = H2 = H1$$

The unique correspondences are:

$$(3)\ x8 < x < x10 \quad \Rightarrow L2 < SQ2 = x < H2$$

Range 3: *if* $y \in \{x10, x11, \ldots, x17\}$

For any $y \in \{x10, x11, \ldots, x17\}$, $SQ1 = \frac{x8+x9}{2}$. The nonunique correspondences are:

$$(1)\ x \leq x8 \quad \Rightarrow \quad SQ2 = x8 = L3 = L2 < L1$$
$$(2)\ x \geq x9 \quad \Rightarrow \quad SQ2 = x9 = H3 < H1 = H2$$

The unique correspondences are:

$$(3)\ x8 < x < x10 \quad \Rightarrow \quad L3 < SQ2 = x < H3$$

In overall comparisons, Range 2 is the largest of all three. Whether Range 1 is greater than Range 3 and vice versa depends on the distance between $x9$ and $x10$ for Range 1 and between $x8$ and $x9$ for Range 3.

5.2.4 Actual Outcomes: Adding the Heads of States

In the Fed game, the president and Senate first agree on a RR equilibrium policy. Given the range of possible outcomes, depending on the location of the retiree, the president and Senate then try to get as close as possible to the RR equilibrium policy.

The setup is quite similar with respect to the ECB game with two key differences. First, there is no agenda setter. There is no one akin to the president in this game. Second, there is a unanimity requirement; each Head of State must unanimously approve any policy point. If we were to apply both these features analogously to the Fed game, there would be no president, and it would be as if each senator, rather than the Senate median, makes a proposal, and each senator must approve a proposal in order for it to pass.

The exact location of the actual policy ($SQ2$) depends on (1) the location of the Heads of States relative to the current policy ($SQ1$), and (2) the location of the existing Governing Council members. Based on (1), there are two cases. In Case 1: dominance by extreme heads of states, all of the Heads of States are on one side of the status quo. In these situations, the most extreme heads of states dictate exactly how far policy will go.

In Case 2: deadlock, at least one Head of State is on the opposite side of the status quo from the others. In this case, there is deadlock, and policy will not move because any proposed move will be vetoed by at least one Head of State. For example, suppose all Heads of States are to the left of the status quo, and the Netherlands is to the right of the status quo. Then the Netherlands rejects all movements to the left of the status quo, and the others reject all movements to the right of the status quo.

Case 1: Dominance by Extreme Heads of States

Head of State Indifference Point. Similar to the definition for the Senate indifference point, define a Head of State's indifference point as HS^{-}, where $|HS - SQ1| = |HS - HS^{-}|$.

Heads of States Labels. The Heads of States are numbered consecutively from left to right in order of easiest to tightest policy and labeled HS1 through HS11.

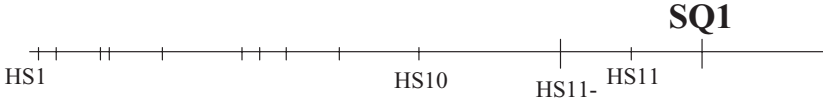

Figure 5.1: Example 1, Case 1

Figure 5.2: Example 2, Case 1

In this case, all of the Heads of States are either on the left or right side of $SQ1$. Within Case 1, there are two possible types of situations with two possible sets of outcomes.

First, suppose that there does not exist any other Head of State in the range between the most extreme Head of State (either $HS1$ or $HS11$) and her indifference point ($HS1^-$ or $HS11^-$). If they are all on the left side of $SQ1$, any one of them can propose the indifference point for the rightmost Head of State, the eleventh member, $HS11^-$ (see Figure 5.1). This point will be closer to the ideal points of every other Head of State, and thus, the Heads of States will collectively approve this point as the new policy point. Analogously, if the Heads of States are all on the right side of $SQ1$, a Head of State can propose the indifference point of the first member, $HS1^-$, and it will be unanimously approved as the new policy point. The Heads of States will then make the appointment to get as close as possible to that new policy point.

More formally,

$$\begin{aligned}
&(1)\ \text{if } HS \leq SQ1 \textit{ and } \forall HS,\quad HS \leq HS11^- \\
&\qquad\qquad \Rightarrow SQ2 = HS11^- \textit{if } HS11^- \in [L, H],\ SQ2 = L \textit{ otherwise} \\
&(2)\ \text{if } HS \geq SQ1 \textit{ and } \forall HS,\quad HS \geq HS1^- \\
&\qquad\qquad \Rightarrow SQ2 = HS1^- \textit{if } HS1^- \in [L, H],\ SQ2 = H \textit{ otherwise}
\end{aligned}$$

Second, suppose that there does exist another Head of State (either $HS2$ or $HS10$) in the range between the most extreme Head of State and her indifference point (see Figure 5.2). Then that Head of State can propose her ideal point as the new policy point. $HS1$ through $HS9$ will agree because for each one of them, that point is closer to them than the reversion

point, $SQ1$. For $HS11$, $HS10$ is also in its preferred set. More formally,

(3) if $HS \leq SQ1$ *and* $HS10 \in [HS11^{-}, HS11]$
$\Rightarrow SQ2 = HS10$ *if* $HS10 \in [L, H]$, $SQ2 = L$ *otherwise*

(4) if $HS \geq SQ1$ *and* $HS2 \in [HS1, HS1^{-}]$
$\Rightarrow SQ2 = HS2^{-}$ *if* $HS2 \in [L, H]$, $SQ2 = H$ *otherwise*

Case 2: Deadlock. In this case, at least one Head of State is on the opposite side of $SQ1$ from at least one other Head of State. In such a case, it is impossible to move policy. Any moves to the right of $SQ1$, no matter how small, will be vetoed by the Heads of States to the left of $SQ1$. Analogously, any moves to the left of $SQ1$ will be vetoed by the Heads of States to the right of $SQ1$. Thus the predicted new policy point is the same as the old policy point, $SQ1$. More formally,

(1) if there exists at least one $HS \leq SQ1$ and one $HS \geq SQ1$
$\Rightarrow SQ2 = SQ1$

What is interesting is that policy can change at all with ECB appointments. Because all Heads of States have veto power, at least one Head of State should reject any incremental policy change. That occurs in Case 2 but not in Case 1. The model shows that when all the Heads of States agree on the direction of change, all gain from some policy movement. But all such movements are potentially small since they are dictated by the most extreme Head of State.

What influence does a traditionally inflationary country like Italy have? With its one national bank seat, Italy automatically does move policy a bit in an easier direction. In terms of influence on the appointment process, it depends on the case. In Case 1, a country like Italy can potentially have much positive policy influence, positive in the sense of moving policy. Italy could in fact dictate the outcome. But if the extreme country is not Italy, then Italy has absolutely no influence, and the fears are unjustified. In Case 2, Italy can only have a negative effect on policy; it can only dictate that policy will not change at all. While Italy also has this power in Case 1, it will not be in Italy's interest to veto policy moves because the new policy makes it better off.

Thus there is always some reason for concern in adding the membership of an inflationary country because that country does get a minimum of one seat on the Governing Council and that moves policy in an easier direction. But the extent of further influence is rather limited due to the

setup of the appointment process. Basically the model delineates when a particular country is influential and when it is not. The question is, what situation characterized the initial situation in May of 1998, when the Heads of States made the first ECB appointments? Section 5.3 tries to answer this question.

5.2.5 Extensions and Comparisons to the Fed

In the ECB game, the veto power of each Head of State and the lack of an agenda setter drives the major differences in policy outcomes compared to the Fed game.

First, veto power means that extreme regional interests can influence ECB policy to a much greater extent than Fed policy. The only way to move policy in the ECB setup is to satisfy, in Case 1, the most extreme or the two most extreme Heads of States. Without the support of either $HS1$ or $HS11$, the policy reverts back to the status quo.

On the Fed, the analogous setup would be if all the Senate members had the right to veto the president's choice; then the senators closest to the status quo would have the most influence. But with majority rule in the Senate, the influence of extreme interests is very limited because the president only has to satisfy the moderate, by definition, Senate median; forty-nine senators can disagree with the president, but as long as he obtains fifty-one votes, policy will move to his proposed point.

Second, veto power also means that the ECB appointment process favors the status quo policy while the Fed's process does not. Disagreement is guaranteed in all "Case 2: deadlock" situations, when at least one Head of State is on the opposite side of $SQ1$ from the other Heads of States. Whereas one veto is enough for deadlock to occur in the ECB game, deadlock is less likely in the Fed game because it requires fifty-one senators to be on the other side of the status quo from the president.

Third, the addition of agenda-setting powers only changes the outcomes slightly, if at all, in the ECB game, while they can dramatically change the outcomes of the Fed game. For the ECB, the extent of possible change depends on who is designated the agenda setter. On the one hand, if the agenda setter was the Council of Ministers, a non–Head of State, the outcomes would not change over those of the current setup. Consider the case when all Heads of States are left of $SQ1$. In this Case 1 situation, the Council of Ministers would have to choose either $HS11^{-}$ or $HS10$ – the outcomes without the agenda setter. On the other hand, if

$HS11$ were the agenda setter, the outcome would be $HS11$'s ideal point – different from the previous outcomes of $HS11^{-}$ or $HS10$.

Still, in a comparison of the sheer magnitude of policy changes, the Council of Ministers as agenda setter would lead to bigger changes than the Heads of States as agenda setters. Both $HS11^{-}$ and $HS10$, the outcomes with the Council of Ministers as the agenda setter, are farther from the status quo than $HS11$ – the outcome with $HS11$ as the agenda setter.

If an agenda setter were to be chosen, the Council of Ministers seems the more likely choice than $HS11$. It is difficult to believe that the appointment process would ever change to accommodate the most extreme Head of State because all other Heads of States must approve this change. It is easier to envision the delegation of binding proposal power to the Council of Ministers by a qualified majority, since the EU Heads of States have made greater numbers of important decisions in this fashion.

But even with the Council of Ministers as the agenda setter, the changes are potentially very small. In contrast, the outcomes in the Fed game would be quite different if, for instance, the Senate set the agenda rather than the president. In Case 2 of the current Fed game, when the president is farther from the status quo compared to the Senate, the president sometimes gets his ideal point as the outcome – he sometimes still dominates. If, however, the Senate were the agenda setter, it would sometimes dominate instead. Basically flipping the agenda setter means that the player with the agenda-setting power has much more power, whereas in the ECB game, changing the agenda setter means moving policy by a Head-of-State position or two.

In order for the possibility of greater policy change, not only would there have to be a designated agenda setter, but also a change in the unanimity rule. In the Fed setup, the agenda-setting power of the president combined with the Senate's majority rule allows for greater changes in policy. The analogous ECB setup would be if the Council of Ministers gained binding proposal power, and the Heads of States decided to accept proposals by majority rule. Then in a situation with the Council of Ministers to the left of the Heads of States and all Heads of States to the left of the status quo, the Council of Ministers would only have to propose the indifference point for $HS6$, which must be farther from $SQ1$ than either $HS10$ or $HS11^{-}$. But all this would only matter if the Council of Ministers could be independent from the Heads of States, and it is not clear if this could ever be the case.

Why might EMU members desire the possibility of greater policy change? There are two related reasons. First, the ECB could be more responsive to the current economic and political context without totally

losing its independence. Second, with greater responsiveness, the ECB might gain more public support which is crucial for its long-term survival.

5.3 A PREDICTION

What does the preceding model mean empirically for the future monetary policy in Europe? With some reasonable assumptions about the current relevant players, I use the preceding model to predict the policy outcomes of the initial appointment process in May 1998. The prediction contradicts the recent charge that a larger monetary union with traditionally high inflation countries like Italy will necessarily mean easy monetary policy. In fact, the model shows how the institutional structure of the appointment process, together with the monetary policy status quo, ensures relatively tight monetary policy in Europe during the first four years of EMU.

The preceding model deals with the appointment process beyond the initial stages of EMU. In May of 1998, the appointment game was different; the Heads of States did not have to contend with just one Executive Board appointment but all six. Assuming that the beginning status quo was the median of the eleven-member Governing Council, the six appointments allowed the Heads of States to move the median policy point anywhere they wished; the possible outcome ranges of Section 5.2.3 did not apply.

It was a rare, one-time opportunity to move policy a great deal – if Case 1 had prevailed; recall that in Case 1, either all $HS < SQ1$ or all $HS > SQ1$, and because all the Heads of States agree on the direction of policy change, it is the only case that allows for policy change. However, as will be shown, Case 2: deadlock prevailed, and policy did not change at all.

For the first round of appointments in May 1998, a few qualifications to the appointment process were in effect. First, the Council of the European Monetary Institute (EMI), the ECB's forerunner, served in the consultation role of the Governing Council of ECB because the latter did not yet exist.[47] Second, in order to stagger the appointment terms from the

[47] The EMI was the forerunner of the ECB. The Council of the EMI consisted of a president and one governor from each of the fifteen national central banks (Art. 9.3, Statute of the European Monetary Institute). The Statute of the EMI is also contained in the Treaty on European Union Protocols. The Council of the EMI made decisions using a simple majority rule.

start, the president was appointed for a full term of eight years,[48] the vice president for four years, and the other four members for between five and eight years (Art. 50, Statute of the ESCB).[49] Third, non-EMU participants could not participate in the Council of Ministers' and European Council's decisions on appointees (Art. 109k, ¶3, Title II of the Maastricht Treaty).[50] Since May 1998, these nonparticipants are called "Member States with a derogation" (Art. 109k, ¶1, Title II of the Maastricht Treaty). However, the treaty does not seem to have barred such states from participating in the consultation roles provided by the European Parliament and the Council of the EMI. In reality, these countries – the United Kingdom, Sweden, and Denmark – participate in the Council of Ministers' and European Council's decisions, but the opinions that really matter are those of the EMU countries.

5.3.1 Ideal Points

Unlike the Fed, there are no voting records for the ECB. One of the first actions taken by Duisenberg was to close the records to the public for at least sixteen years. Without voting records, it is not possible to estimate ideal points for the Governing Council according to the method from Chapter 3. Similarly, it is difficult to estimate ideal points for the Heads of States.

Faced with these limitations, I used the averages of past inflation rates as a proxy for the monetary policy preferences of the various countries. From the five- and ten-year average inflation rates in Table 5.3, I constructed the following ideal points. First, for the Heads of States, I assumed that the ten-year average inflation rates of each country represent

[48] Although Wim Duisenberg "voluntarily" agreed to step down after four years as part of an alleged agreement between Germany and France. He recently announced his date of departure as July 2003.

[49] Therefore, the first appointment opportunity arose in 2002, followed by two in 2003, and one appointment opportunity will arise in every one of the subsequent four years. However, one of the two 2003 appointments is the president's position that is already designated to be filled by Jean-Claude Trichet, if he survives various legal inquiries. There will be no appointments in the next subsequent three years: 2007, 2008, and 2009. In 2010, the same cycle of appointments will begin again. This means that an unusually high number of appointment opportunities will arise in the first seven years of EMU.

[50] Title II of the Maastricht Treaty: Provisions Amending the Treaty Establishing the European Economic Community with a View to Establishing the European Community. Henceforth, references will be to Title II of the Maastricht Treaty.

Table 5.3: *Inflation Rates for European Union Countries*

	10 years (1987–96)		5 years (1992–6)
Netherlands	1.93	Finland	1.55
Luxembourg	2.34	Denmark	1.91
Belgium	2.36	France	1.98
Germany	2.41	Ireland	2.21
France	2.61	Belgium	2.23
Austria	2.72	Luxembourg	2.36
Denmark	2.79	Sweden	2.43
Ireland	2.69	Netherlands	2.52
Finland	3.33	Germany	2.68
United Kingdom	4.58	United Kingdom	2.73
Sweden	4.84	Austria	2.94
Italy	5.14	Italy	4.53
Spain	5.30	Spain	4.69
Portugal	8.42	Portugal	5.56
Greece	14.19	Greece	11.69

Source: IMF International Financial Statistics Line 64: Consumer Prices

the preferences of each Head of State. The ten-year period includes the period prior to 1992 when central bank independence from governments was not required. Thus this ten-year average reflects a mixture of central bankers' and governments' preferences. Inflation rates averaged over fifteen years yield an almost identical rank ordering of countries.

Second, for the members of the EMI Council, I used five-year inflation rates. In particular, for the initial *SQ*1, I used the five-year average inflation rate of the Netherlands (2.52 percent), the median of the EMI Council (see Table 5.3). After the signing of the Maastricht Treaty in 1992, countries wishing to qualify for EMU were required to grant independence to their central banks. Thus the five-year average inflation rates reflect, to a large extent, the preferences of independent central bankers. Although nonindependent central banks became independent at different times during the five-year period 1992–6, these rates are the best reflection of the central bankers' preferences.

5.3.2 May 1998: The Game, Equilibrium, and Policy Outcome

Given these assumptions, the numbers in Table 5.3 lead to the spatial configuration in Figure 5.3.

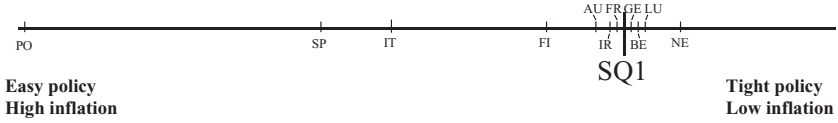

Figure 5.3: The ECB Game in May 1998

*SQ*1 is the median of the EMI Council (2.52 percent – the Netherlands), and the country acronyms stand for the Heads of States positions.[51] Because monetary policy preferences throughout this chapter are measured by the short-term interest rate, and preferences over inflation are negatively related to preferences for short-term interest rates, the figure presents the players in reverse order of inflation preferences. Thus Portugal, with the highest inflation rate, is at the lowest end of the scale in terms of short-term interest rates.

This particular configuration is a Case 2: deadlock situation, and therefore, the status quo is the equilibrium point of the game. There are seven Heads of States to the left and four to the right of the status quo.

In order to maintain *SQ*1, the equilibrium policy point, the politicians could have appointed three members of the Executive Board to the right and three members to the left of the status quo point. Alternatively, they could have appointed all six member right on the status quo point. A final option was to appoint a combination of some members on the status quo and some on either side.

In fact, the politicians took the last option and almost took the first option: the European Council appointed two members left of *SQ*1, one on *SQ*1, and three to the right of *SQ*1. They appointed Wim Duisenberg from the Netherlands as president; Christian Noyer from France as vice president; and Eugenio Domingo Solans from Spain, Sirkka Hämäläinen from Finland, Otmar Issing from Germany, and Tommaso Padoa-Schioppa from Italy as the other members.

If I assume, as before for the EMI Council members, that the five-year inflation rates of a country reflect the preferences of each board member from that country, the result is the configuration for the new Governing Council in Figure 5.4. The "2"s indicate that after the Executive Board appointments, two members are at a particular position. Both before and after the appointments, the status quo is the Dutch position at an inflation rate of 2.52 percent.

[51] PO: Portugal, SP: Spain, IT: Italy, FI: Finland, AU: Austria, IR: Ireland, FR: France, GE: Germany, BE: Belgium, LU: Luxembourg, and NE: Netherlands.

Figure 5.4: The New Governing Council after May 1998

Thus the veto power of the tight monetary policy countries combined with the current status quo ensured the continuation of the status quo. That status quo happened to coincide with relatively tight monetary policy. This simple model demonstrates how the institutional structure of the appointment process, essentially the unanimity rule for the Heads of States, together with the initial status quo favors tighter rather than easier monetary policy despite the entry of high-inflation countries. Given the status quo, Italy, Spain, and Portugal as well as Greece, will essentially have very little power in the appointment decisions.

Discussions regarding a larger EMU have neglected to deal with the institutional structure of the appointment process. Employing a mean inflation idea, discussions have assumed that the entrance of traditionally higher inflation countries will automatically increase inflation by raising the mean inflation rate. Some have argued that these higher inflation countries will put pressure on the ECB to lower interest rates. The model shows that this is a possibility (Case 1) but not in the context of the 1998 situation (Case 2). If the assumptions made here are reasonable and the initial status quo is for relatively tight monetary policy, then given the institutional structure of the appointment process, appointees to the Executive Board of the ECB will maintain tight monetary policy. In fact, the ECB has been criticized for relatively tight policy to date.

What would have happened if the Council of Ministers possessed the power to make binding proposals? Assume that the Council of Ministers would make such proposals using a qualified majority. Then Italy's ten-year average inflation rate of 5.14 percent is the qualified majority point. Based on the ordering of ten-year average inflation rates, Italy is the point at which the weighted votes exceed the qualified majority requirement (Table 5.4). But even with proposal power, the Council of Ministers would not have changed anything in the face of the veto power of the Heads of States to the right of the status quo; the equilibrium policy point would have remained at *SQ*1.

However, if the Council of Ministers only had to satisfy the median, it could have proposed France's indifference point, which would have

Table 5.4: *Voting Weights on the Council of Ministers*

	10-year Inflation	Voting Weights % of Total Council of Ministers Votes[a]	Cumulative Sum of Voting Weights
Netherlands	1.93	7.70	7.70
Luxembourg	2.34	3.10	10.80
Belgium	2.36	7.70	18.50
Germany	2.41	15.40	33.90
France	2.61	15.40	49.30
Ireland	2.69	4.60	53.90
Austria	2.72	6.20	60.10
Finland	3.33	4.60	64.70
Italy	5.14	15.40	80.10
Spain	5.30	12.30	92.40
Portugal	8.42	7.70	100.10

[a] I calculated these voting weights in the following manner. First, I calculated percent of total Council of Ministers votes for all fifteen EU countries. After omitting the non-initial-EMU countries of Denmark, Sweden, the UK, and Greece, I normalized the vote percentages of the remaining countries to 100.

Source: European Union; http://www.eu.int/inst/en/ep.htm#intro; IMF International Financial Statistics.

moved policy to the left of the median to about the location of Ireland's ideal point. Thus under this set of institutional arrangements with a Council of Ministers with binding proposal power and majority rule for the Heads of States, easier policy would have ensued. In effect, with a different set of institutions, the outcome would have been the feared outcome. With the set of adopted institutions, however, the fear was unjustified.

5.3.3 *The Enlargement of the European Monetary Union*

When Greece joined in 2001, the addition of Greece's national governor to the Governing Council moved $SQ1$ slightly from 2.52 percent to 2.60 percent – halfway between the Netherlands and Germany. Thus in Figure 5.3, there should be one more Head of State to the left of Portugal, and $SQ1$ should be slightly lower. Despite these changes, the case remained Case 2: deadlock.

Thus the Heads of States should have maintained $SQ1$. In 2002, the only appointment was for the vice chair position, held by Christian Noyer of France. The model predicts the appointment should have been to the right of the Netherlands in Figure 5.4 – the side of $SQ1$ on which France is located.

The prediction was almost right, but in the final outcome, it proved wrong. Belgium's Paul de Grauwe was a leading candidate, but he was beaten out by Greece's Lucas Papademos, which moved *SQ*1 from 2.60 percent to 2.68 percent – Germany's position. However, the difference between the model's predictions and the actual result is very slight – 0.08 percent – and the model's real verification or discreditation requires further observations.

The next round of appointments will be in 2003 with the replacements of Wim Duisenberg and Sirkka Hämäläinen. It is highly likely that Duisenberg will be replaced by Jean-Claude Trichet of France, and if not Trichet, another Frenchman. This appointment will not affect the median. Hämäläinen will be replaced by someone from a smaller country: Austria, Luxembourg, or Ireland. As long as Hämäläinen's replacement is not from Austria, this appointment should also not affect the median. Thus the model's predictions should be borne out by next year's appointments; policy should stay put at a relatively tight level.

The countries most likely to join in the next decade are the United Kingdom, Sweden, and the ten new EU countries as of 2004: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. Among all the countries under consideration, Sweden, the Czech Republic, Latvia, Estonia, and Lithuania look most likely to join sooner than later. The group may join in a wave together about three years from now. All have very good inflation records in the last five years and are unlikely to affect much the tightness of policy. The other countries are more problematic in terms of inflation records, but their membership looks set to come several years later.

5.4 SUMMARY

The EMU is still a relatively new phenomenon. In January of 1999, exchange rates were irrevocably fixed, and the ECB began to formulate monetary policy for eleven EU countries and for a twelfth in 2001. Who will be making policy? How will they be appointed? What does the structure of the process mean for the kind of resulting policy? These are the questions I have tried to answer in this chapter by applying a suitably modified appointment process model from Chapter 2.

The appointment process is driven by the veto power of each Head of State. In Case 1, when all the Heads of States are on one side of the status quo, policy change is possible. In Case 2, when at least one Head

of State is on the other side of the statuo quo from the other Heads of States, policy change is impossible, and the status quo reigns.

In terms of the immediate future, the relevant questions are, are all the Heads of States located on one side of the status quo, and what does the status quo look like? In answer to the first question, there are some Heads of States on each side of the status quo – therefore, deadlock ensues. In answer to the second question, the status quo appears to favor relatively tight monetary policy. Thus the institutional structure of the appointment process seems to favor relatively tight monetary policy for the first few years of monetary union – even with the addition of Greece.

This runs counter to most discussions today regarding the possibility of a larger monetary union. The presumption in these discussions is that the inclusion of traditionally inflationary countries will necessarily lead to easy monetary policy. However, this chapter has shown that the institutional structure of the appointment process limits the influence of these countries given the circumstances.

The application has shown how different structures lead to different types of policies. In the Fed model, the circumstances can favor the president or the Senate median or the status quo. In the ECB process, the extreme Heads of States can dominate under certain circumstances, or the status quo will prevail. The policy outcomes are different due to two differences between the processes. First, there is no agenda setter; the Council of Minsters' proposals are not binding. Second, a unanimity rule characterizes the approval of the proposed nominees by the Heads of States. Those two differences have serious consequences for the types of policies produced under each setting. The conclusions in the final chapter suggest other possible applications and further discusses the implications of the different appointment structures.

6

The Origins of the Federal Reserve Appointment Process

In the previous chapters, the appointment process is exogenous; I take the process as given and explain how it affects policy. In this chapter, the appointment process is an endogenous object of choice – a dependent variable. I examine the development of the appointment process and claim that it is related to the centralization of the Federal Reserve System. Specifically, I compare and contrast the different appointment structures envisioned in the banking bills from 1903 to 1935.

6.1 THE THEORETICAL FRAMEWORK

6.1.1 Assumptions and Definitions

1. The Dependent Variable: Appointment Power. Appointment power is the extent to which the president and Senate can influence policy through appointments. It is related to the *appointment structure*, the structure of the appointment process and its effects on policy. The appointment structure's components are:

THE NUMBER OF APPOINTED MEMBERS. This variable refers to the number of members appointed by the president and Senate to the Fed's central decision-making board. On the FOMC, by appointing a larger proportion of the central board, the president and Senate have greater control over its decisions, because there is a greater likelihood that the FOMC median is one of their appointees. Because of political uncertainty, the president and Senate will not necessarily advocate a board composed totally of political appointees. With such a board, once in office, opponents can quickly reverse policy gains made by the current president and Senate.

THE LENGTH OF TERMS. This variable refers to how long each central board member serves. The longer the terms are, the greater the policy lock-in by politicians. But once in office, opponents will have the same advantage, and therefore, the politicians will not make terms too long.

THE FREQUENCY OF APPOINTMENTS. This variable refers to how often the president and Senate are allowed to make appointments. The more frequent the appointments are, the greater the policy influence is. Because of political uncertainty, politicians will often insulate the board by staggering appointment opportunities.

2. *The Independent Variable: Centralization.* Centralization is the extent to which the Federal Reserve Board between 1913 and 1935 and the FOMC since 1935 created and enforced monetary policy relative to the twelve district reserve banks. More specifically, I use the term to compare different proposals for the Fed: the National Reserve Association as envisioned in the Aldrich Bill of 1911, the Fed created in 1913, and the restructured Fed in 1935.

3. *The Actors.* The main actors are (1) various interest groups: bankers, Chambers of Commerce, and trade associations, and (2) parties: the Democrats and Republicans. The background section describes the actors more fully. I assume that the interest groups care about their respective businesses' long-term profitability and that the parties care about reelection and their legislative majorities.

6.1.2 The Theory: Relating Centralization and Appointment Power

Politicians can counteract decentralization by increasing appointment power – appointing a higher proportion of a board's members, lengthening appointment terms, and increasing the frequency of appointments.[52] In short, decentralization decreases the policy influence of politicians, but politicians can consolidate the remaining central authority through greater appointment power.

This study claims that the Fed's appointment structure resulted from political trade-offs between appointment power and centralization. In

[52] These three factors of appointment power have different potencies with respect to appointment power. In particular, as an anonymous referee pointed out, there is a linear relationship between term length and appointment power; doubling the terms leads to doubled delays in a president's ability to gain a majority on a board. However, doubling either board size or frequency does not have double the effect.

the Fed's creation in 1913, the Democrats traded the Republicans less centralization for more appointment power. Conversely, in the 1935 restructuring, the Democrats obtained less appointment power but more centralization.

6.2 BACKGROUND

6.2.1 *The Pre-Federal Reserve Banking System*

The pre-Fed era (before 1913) was characterized by a high frequency of severe economic panics. During the post–Civil War era, panics occurred approximately every ten years in 1873, 1884, 1890, 1893, and 1907 (Friedman and Schwartz 1963: 8). The last two panics preceding 1913 were the most severe, ultimately serving to galvanize efforts to reform the banking system.

The sequence of events for each panic was strikingly similar to that of the others. A failure of one bank would lead to runs,[53] then failures, of other banks. The problem was that because banks covered only a small proportion of their total liabilities in reserves, they could not cope with the sudden deluge of withdrawal requests. The drawdown of reserves then threatened to shut down the entire banking system. As a preventative measure, banks would temporarily suspend all payments (banking holidays). Lacking a payments system, the economy would slow down substantially.

The previously described snowball effects of a single bank failure were caused by the general instability of the banking system, which itself had three main causes: the pyramiding of bank reserves, no lender of last resort, and the inelasticity of the currency.

1. Pyramiding of Bank Reserves. The provisions of the National Banking Act of 1864 encouraged the pyramiding of reserves – a phenomenon in which smaller banks held reserves in medium-sized banks, who in turn held their reserves in large banks. The pyramiding of reserves increased the banking system's vulnerability to panics by providng the potential for one bank failure to draw down reserves in the entire banking system.

More precisely, the National Banking Act established the national banking system,[54] and allowed smaller national banks (also called *country*

[53] A bank run is a situation in which most bank depositors demand withdrawals of all their funds.

[54] The act defined national banks as those banks with a certain set of capital, reserve, and portfolio requirements that were higher than those of state banks.

banks) to maintain three-fifths of their reserves in other national banks (*city banks*) that were located in designated reserve cities. Later modifications allowed city banks to keep their reserves in New York's largest banks.

The National Banking Act's limitations on branch banking further promoted the pyramiding of assets. Because a bank could not operate beyond its local area, it could not expand and diversify its portfolio. Thus, most country banks' portfolios consisted of agricultural loans collaterized by land mortgages. Through city banks, country banks could invest excess reserves in the money market, thereby taking advantage of needed diversification. City banks also offered clearinghouse services, which allowed smaller banks to clear checks in a central location rather than dealing individually with one another (White 1983: 65–74). In turn, farther up the pyramid, city banks could place their reserves in the New York banks, thereby taking advantage of large clearinghouses, and through New York banks, city banks could invest their excess reserves in the stock market (White 1983: 28).

2. *No Lender of Last Resort.* A lender of last resort provides banks the liquidity necessary to meet the demands of its customers in times of crisis. Even more important than providing the actual cash on hand, the mere existence of a lender of last resort provides general confidence in the banking system.

The pre-Fed banking system lacked a true lender of last resort. Large private clearinghouse associations, especially the New York Clearinghouse Association, attempted to serve as lenders of last resort during the panics of 1857, 1860, 1893, and 1907.

Unfortunately, clearinghouse associations could not bear the system's load as the lender of last resort. The associations covered only a small proportion of the entire financial system because their stringent membership requirements excluded the growing number of different types of financial institutions. But when nonmember institutions failed, the credibility of member institutions was damaged. Thus clearinghouse associations sometimes bailed out nonmember institutions who had no incentive to play by the rules set by the clearinghouse associations. In the end, the associations could not afford to bail out all of the failing institutions.

3. *Inelasticity of the Currency.* Inelastic currency refers to the inability of the currency to expand and contract according to the needs of the economy. Currency inelasticity was a direct result of the National Banking

Act, which tied currency to government bonds. Because the number of government bonds increased according to the demands of fiscal policy rather than those of the economy, the act effectively fixed currency to fiscal policy.

The *demand* for currency, however, tended to increase seasonally and during panics. At the end of every summer, farmers required loans to harvest their crops and move them to market (Kettl 1986: 18). As for panics, they always resulted in a cash crunch for reserve drawdowns.

Whether season or panic related, sudden increases in currency demand required reserve withdrawals by banks, but the pyramiding of reserves restricted banks' abilities to recall their reserves. Thus together with the pyramiding of reserves, the inelasticity of the currency caused a number of major and minor panics.

Through monetary policy, a central bank could have alleviated problems caused by the sudden increased demand for currency by anticipating seasonal fluctuations in currency demand and increasing currency in the system through open market operations.[55] Open market operations are also an alternative or complementary method of injecting liquidity into the banking system during panics.

Realizing that this was the case, after fifty-five years of attempting to manage the system through private clearinghouses, most bankers agreed by the end of 1907 that some governmental steps were required to reform the banking system. Not surprisingly, they wanted to control the process of reform. However, the bankers were not a particularly cohesive group, as the next section describes.

6.2.2 *The Actors Behind Banking Reform*

1. *The Bankers.* By 1900 three distinct groups of bankers were interested in banking reform (Wiebe 1962: 24). The first group, country bankers, consisted of small, rural bankers whose banks' portfolios consisted mainly of agricultural and small business loans. The second group, city bankers, had portfolios with larger business loans and some financial market assets. The third group, *Eastern*, primarily *New York financiers*, dealt heavily in large business financing and loans to investors in the stock market.

[55] By buying domestic assets, a central bank increases the money supply because it buys those assets from banks and pays them with currency they create. By selling assets, a central bank decreases the money supply because it takes back some currency as payment for the assets.

These divisions among the bankers tended to be regional, with more country banks in the south and west, city bankers in the midwest (mainly in Chicago), and large financiers in the north and east.

These three groups fundamentally disagreed with one other regarding banking reform. The Eastern financiers wanted a central bank controlled by bankers and a currency backed by state, municipal, and railroad bonds, because they dealt often in such financial instruments. Both city bankers and country bankers feared that centralization meant control by the Eastern financiers at their expense. They also opposed a bond-backed currency because their dealings with such instruments were limited or nonexistent.

Although country bankers and city bankers agreed on decentralization and opposed a bond-backed currency, they disagreed with each other in other respects. The city bankers wanted to expand at the expense of country banks by proposing currency based on the liquid assets of a bank (generally nonmortgage and short-term commercial paper).[56] Because city banks tended to serve as reserve banks for smaller banks, they possessed liquid assets to a far greater degree than country banks who tended to hold agricultural and mortgage loans as assets. By proposing a currency based on the liquid assets of a bank, city bankers would have ensured control of the currency without interference from country banks.[57] Country banks would have backed an assets currency if the assets included agricultural credits, but city bankers' plans never included such assets. In addition to assets currency plans, city banks also tried to legalize branch banking, which was forbidden by the National Banking Act. Legalizing branch banking would have enabled city bankers to directly compete with country banks in their territory. Thus country banks strongly opposed branch banking.

These groups organized themselves into various banking associations. City bankers, particularly those from the midwest, dominated the largest of these organizations, the American Bankers' Association (ABA). However, country bankers controlled the state banking associations (Wiebe 1962: 24). Although country bankers were also members of the ABA, they seldom participated in its meetings, except to outvote the city bankers on very contentious issues such as the ABA's official position on pending congressional legislation. Eastern financiers never joined state

[56] Commercial paper usually constitutes short-term debt issues of large companies that can be bought and sold on the market.

[57] This idea was known as *assets currency*.

associations, and although some joined the ABA, they rarely participated in its activities. In promoting legislation, Eastern financiers usually worked separately from the ABA (Wiebe 1962: 24–5).

2. *Other Business Interests.* In 1908, the Boston Chamber of Commerce; the Merchants' Association and the Board of Trade and Transportation in New York; the Philadelphia Trades' League; the National Association of Credit Men; and other nonbanking business organizations formed the National Currency League. The purpose of the National Currency League was to protect the interests of businesses in banking reform. Although some businessmen supported central bank plans, many opposed such plans and preferred a decentralized system (Wiebe 1962: 76–9).

3. *The Political Parties.* The Republicans tended to back the interests of the powerful Eastern financiers, with whom some had close ties. Senator Nelson Aldrich, for example, had connections to the House of Morgan (Wiebe 1962: 75). The Republicans' earliest legislation on banking reform, not surprisingly, supported the existing private clearinghouse systems with the addition of the government as a lender of last resort.[58] Later legislation and the Republicans' platform for the 1912 election supported a central bank with the balance of the appointment power in favor of bankers.

Following the turn of the century, the Democrats provided far less leadership than the Republicans on the issue of banking reform. However, by the 1912 elections, the Democrats heavily attacked the Republican plans for a central bank by supporting a decentralized system with government appointment power. When they won the elections, the Democrats obtained the authority to set the banking reform agenda.

Bankers generally tended to support the Republicans, but country bankers and some city bankers defected to the Democrats' side during the debate over the Federal Reserve Act of 1913. The country bankers and half the city bankers fundamentally opposed a central bank, although they liked the idea of banker-controlled appointees. But they also feared, perhaps correctly, that those appointees would be controlled by Eastern financiers. Thus they tended to support the Democratic platform of a decentralized system with governmental appointees.

Table 6.1 summarizes the preferences of the actors with respect to the two dimensions of centralization and appointment power.

[58] The Aldrich-Vreeland Act of 1908.

Table 6.1: *Configuration of Interests in Banking Reform – Prior to 1913*

		Centralization	
		Low	High
Appointment Power	Low	Small minority of country bankers	Republicans Eastern and New York financiers Half of the city bankers Minority of business interests
	High	Democrats Majority of country bankers Half of the city bankers Majority of business interests	

6.3 THE CREATION OF THE FEDERAL RESERVE

The history of the Fed's creation and restructuring effectively illustrates the trade-offs between centralization and appointment power. In 1913, the Fed began as a decentralized institution in which regional reserve banks, rather than the central board, controlled the primary instrument of monetary policy – open market operations. The 1935 restructuring drastically centralized the Fed, placing most control of monetary policy in the newly created FOMC. However, with the centralization in 1935, elected officials lost appointment power. Whereas elected officials appointed all members of the central board prior to 1935, they appointed only seven of twelve members after 1935.

This section provides a detailed history of the Fed's creation and restructuring using the framework presented in Section 6.1. Sections 6.3.1 and 6.3.2 present the first legislative attempts undertaken by the Republicans. The Republican plans served as initial blueprints for the successful Democratic legislation presented in Sections 6.3.3 and 6.3.4.

6.3.1 The First Legislative Attempts: The Republican Plans

The first attempts to reform the banking system through legislative means began in 1903 with the Fowler Plan and Aldrich Plan, both Republican-sponsored bills. Rather than comprehensively reforming the banking system, the bills attempted to reshuffle interests in the current system.

1. The First Fowler Bill (1903). The Fowler Bill supported city bankers' interests by legalizing an asset-backed currency and branch banking (Livingston 1986: 151–2). Due to the exclusion of agricultural credits from the list of assets and their opposition to branch banking, the country bankers did not support this bill. At the 1902 annual ABA meetings, country bankers succeeded in blocking a motion to support the Fowler Bill. However, ABA support was secured by some parliamentary trick (Wiebe 1962: 63; White 1983: 85–6). Country bankers subsequently used their state associations to issue resolutions in opposition to the bill and more significantly, they informed their congressional representatives of their opposition (Livingston 1986: 154).

Eastern financiers also opposed the bill. The then-current system of bond-backed currency worked to their competitive advantage because they had access to the bonds while other smaller banks, particularly city banks, did not. An asset-backed currency would have eroded this competitive advantage (Wiebe 1962: 64).

The two-pronged opposition by the country bankers and Eastern financiers doomed the Fowler Bill. The bill never made it out of the House.

2. The First Aldrich Bill (1903). The Aldrich Bill of 1903 supported the interests of the New York and Eastern financiers. The bill allowed banks to form associations in times of crisis in order to issue emergency bond-backed currency, thereby legalizing the preexisting system of clearing-houses and their issuance of loan certificates during panics (White 1983: 88). The bill also allowed for a slight expansion of the assets on which currency was issued by including certain state, municipal, and railroad bonds (Wiebe 1962: 64). As with federal government bonds, Eastern financiers had ample access to these additional categories of bonds, while city and country bankers did not. In essence the bill did little other than to legitimize the status quo system of centralized reserves and currency issuance.

Not surprisingly, the New York and Eastern financiers heavily supported this bill and its sponsor, Senator Nelson Aldrich. The two other major banking groups, city and country bankers, opposed the Aldrich Bill mainly because of the bond-backed currency provisions. With two of the three major banking groups against the legislation, the Aldrich Bill, like the Fowler Bill, failed to pass.

3. The Second Fowler Bill (1906). The midwestern city bankers again tried to introduce a carbon copy of the earlier Fowler Bill in 1906. As in the

earlier round, the country bankers effectively attacked the plan, and the second Fowler Bill of 1906 died in committee (Wiebe 1962: 64).

4. Summary of the First Republican Bills. Although none of the Republican plans passed, they mobilized interests with respect to the centralization of the banking system. In this context, centralization refers to the Eastern clearinghouse associations versus the regional banks' powers to control the money supply.

The legislative thrust came from either city bankers or Eastern financiers, but neither group's legislators were strong enough to win legislative battles without the support of legislators backed by the country bankers. Eastern financiers wanted to further legitimize the current centralized reserve and currency issuance system. City bankers wanted to decentralize that system by allowing for the issuance of currency on assets more accessible to them. Country bankers also wanted more decentralization, and they did not necessarily oppose the idea of an assets currency, but they would not endorse assets currency plans that did not include agricultural credits in the list of assets and that were connected with plans to legalize branch banking.

It should be pointed out that the split in interests described in this subsection occurred *within* the Republican party. In these earlier rounds of legislative banking reform, the Democrats tended to steer clear of the issue, having been severely defeated on the issue of silver-backed currency in the late nineteenth century.

6.3.2 Bigger and Better Republican Plans

1. The Panic of 1907 and Renewed Reform Attempts. A severe panic occurred in 1907, serving to galvanize further banking reform attempts. Just before the annual movement of crops, the European banks raised discount rates, and together with a downturn in the business cycle, these actions led to a severe credit and liquidity crunch in New York. When New York's second-largest trust company,[59] Knickerbocker Trust Company, suspended payments, this began a run on other financial institutions in New York. City and country bankers subsequently found that they could

[59] Trust companies began as firms that managed large trust funds for wealthy families. However, over time they began to offer services comparable to any bank: for example, loans and demand deposit accounts. Trust companies were not usually clearinghouse association members (White 1983: 38).

not draw on their New York balances, and they too had to suspend payments. To ease the situation, the Treasury intervened and deposited $25 million in the New York banks (White 1983: 77–8).

This chain of events convinced many that the financial system had grown beyond the abilities of the large clearinghouse associations to provide a remedy during panics. Knickerbocker was not a member of the New York Clearinghouse Association because it did not, nor did it desire, to meet the stringent membership requirements. But the solvency of nonmember institutions, like Knickerbocker, had a profound effect on the solvency of the entire financial system. Clearinghouse associations often had to bail out nonmember institutions in order to maintain confidence in the system. Essentially, the clearinghouse associations were providing a public good by assuming responsibility for the healthiness of the entire system, and the nonmember institutions were free-riding off this system. As the number of free-riders, nonmember institutions, grew, the largest clearinghouses had a difficult time controlling the system.

2. *The Second Aldrich Bill (1907).* Rather than comprehensive reform, the Aldrich Bill of 1907 was designed as a stop-gap measure to legalize and bolster, with Treasury funds, the actions of clearinghouse associations during panics. The bill was very similar to the 1903 Aldrich Bill, and like it, it was largely written to reflect the recommendations of the New York and Eastern financiers – this was their bill. The bill allowed any national bank to issue emergency currency upon approval by the Comptroller of the Currency and the deposit of state, municipal, or railroad bonds (Livingston 1986: 182).

The bill further stipulated the creation of a National Monetary Commission to study the problems of the banking system. The commission was to be composed of five members from each house of Congress and five members to be appointed by the president. No more than three of each set of five could be from the same party (*Congressional Record*, 60th Congress, 1st Session, pp. 1908–3852). Because the Republicans controlled both houses as well as the presidency, this scheme biased representation on the commission toward the Republicans.

Not surprisingly, the city and country bankers opposed the bill. Both groups objected to the railroad bond provision – the category of bonds to which New York and Eastern financiers had almost exclusive access. In response, the Senate amended the bill to eliminate the railroad bonds provision and managed to pass the bill. In the House, a still more compromising version of the Aldrich Bill passed: the Vreeland Act. The

Vreeland Act contained a local government bond provision that placated the city bankers but did not satisfy the country bankers. Eastern merchants and manufacturers also opposed the bill because it gave too much control to the large financiers. But with the support of city bankers and the Eastern financiers, the Republicans had enough support to pass the Aldrich-Vreeland Act of 1908 along partisan lines (*Congressional Record*, 60th Congress, 1st Session, pp. 7078, 7263).

3. The Third Aldrich Bill (1911). After four years, the National Monetary Commission produced the Aldrich Bill of 1911, a Republican bill designed to comprehensively reform the banking system. For the first time in the U.S. legislative history of banking reform, the Aldrich Bill included provisions for a new system of governmental institutions for regulating the banking industry. Compared to later bills, the Aldrich Bill provided for a relatively centralized institution and very little appointment power for elected officials.

a. Centralization and Appointment Power

a1. Centralization: Medium.[60] The Aldrich Bill would have created a centralized institution called the National Reserve Association. It was to consist of a central bank with fifteen branches. The central bank would have stored the capital of the member institutions of the National Reserve Association, dealt with open market operations, and set a uniform discount rate; thus the central bank would have had substantial powers over monetary policy.[61] Some decentralized power would have existed in the form of individual branches' right to rediscount paper, that is buy and sell commercial paper (Livingston 1986: 207).

a2. Appointment power: Low. Appointment power was to be in the district branches, and thus bankers, rather than politicians, would have controlled appointments.

a2(1) Number of appointed members: five of forty-six. The Aldrich Bill allowed elected officials to appoint only five of forty-six total

[60] Henceforth, high, medium, and low with respect to centralization and appointment power refer to relative comparisons among the three bills: the Aldrich Bill of 1911, the Federal Reserve Act of 1913, and the Banking Act of 1935.

[61] Discount policy has to do with the Fed's role as lender of last resort. Banks can borrow money from the Fed at the discount window at the discount rate. In practice borrowing by banks is done more frequently than in times of crisis, but the discount market constitutes a far smaller part of the money market than the federal funds market. Therefore, the premier decision-making body of the Federal Reserve System is the FOMC and not the BOG.

members on a *National Board of Directors*. The board would have consisted of thirty-nine directors, two from each district and nine chosen to represent stock holders,[62] and seven ex officio members, for a total membership of forty-six. The ex officio members were to consist of a governor (also the chairman of the board), two deputy governors, the Secretary of Agriculture, the Secretary of Treasury, the Comptroller of Currency, and the Secretary of Commerce and Labor. The president would have appointed the governor, but the directors, elected by the districts (the Elected Board), would have chosen the list of potential nominees. These same elected directors would have had the right to remove the governor with a two-thirds vote. The Elected Board would have chosen the two deputy governors who could be removed by a majority vote of the board. These latter provisions served to further limit the power of elected officials' appointees (West 1977: 74).

In addition, an *executive committee* would have consisted of nine members. The executive committee would most probably have been the working body of the association. Five members would have been chosen from the Elected Board in addition to the governor, the two deputy governors, and the Comptroller of Currency (West 1977: 74). As with the National Board of Directors, elected officials would have had the power to appoint very few members of the executive committee – only the governor and the Comptroller of Currency. However, due to the district directors' provision of the list of possible appointees, and the Elected Board's right to remove the governor, the president's power to appoint even the governor would have been, in fact, highly proscribed.

Because member banks would have elected the branches' board members, who in turn would have controlled forty-two of the forty-six members of the National Board of Directors and eight of the nine members of the executive committee, bankers would have heavily influenced the decisions of the National Reserve Association. With the dominance of the member banks, elected board members would have secured the dominance of the bankers over the government appointees.

a2(2) Length of terms: three years. All members of the board, except the Secretary of Agriculture, Secretary of Commerce and Labor,

[62] Member banks were required to purchase stocks of the National Reserve Association and were thus the true owners of the association.

Table 6.2: *Relative Comparisons of Significant Banking Reform Bills*

	Aldrich NRA Bill	Federal Reserve Act of 1913	Banking Act of 1935
Centralization	Medium	Low	High
Appointment Power	Low	High	Medium
(a) Number of appointments	5/46	7/7	7/12
(b) Length of terms	3 years	10 years	14 years
(c) Frequency of appointment opportunities	3 years	2 years	2 years

The entries high, medium, and low refer to relative comparisons among the three bills.
NRA: National Reserve Association

Secretary of Treasury, and Comptroller of Currency, were to serve three years (West 1977: 74). This gave a slight advantage to elected officials over the bankers because the secretaries often served four years. However, the nonelected officials' appointments so vastly outnumbered the elected officials' appointments as to completely negate this advantage.

a2(3) Frequency of appointments: every three years. No staggering of appointments was envisioned. Every three years, a whole new board would be in place. Normally, staggering matters for elected officials' abilities to appoint a substantial proportion of a central board; by limiting their abilities to appoint all members, staggering restricts the potential for influence through appointments. In this case, because elected officials would have had so little power to make appointments in the first place, the lack of staggering would not have affected their power over appointments.

Table 6.2 summarizes the provisions of the Aldrich Bill.

b. The Death of the Aldrich Bill

Even before its introduction in 1912, the Aldrich Bill[63] received quite a bit of negative publicity because of the National Reserve Association's similarity to a traditionally centralized central bank. The Democrats assisted in the negative publicity and used the general suspicion of the bill to their advantage. The Democrats captured the House in 1910 and shortly following the bill's introduction, the Democrats won the Senate and the presidency in the 1912 elections, partially

[63] Henceforth, references to the Aldrich Bill refer to the 1911 bill unless otherwise noted.

by emphasizing their opposition to the Aldrich Bill (Kettl 1986: 20). With the Democrats' achievement of unified government for the first time in twenty years, they controlled the future direction of banking reform – at least for the time being.

6.3.3 The Advent of the Federal Reserve System: The First Democratic Plan

Despite rejection by Congress, the Aldrich Bill set the starting point for banking reform. Following the Democratic victory in 1912, Carter Glass became chairman of the House Banking Committee's subcommittee on banking reform (Kolko 1967: 219). Basically inexperienced in banking affairs, Glass hired H. Parker Willis, an economist and former student of J. Laurence Laughlin. Laughlin was the head of the National Citizens' League, a branch of the ABA created to educate the public on the Aldrich Bill. Glass took the advice of Willis regarding the new banking reform bill, and not surprisingly, the eventual Federal Reserve Act closely resembled the Aldrich Bill. Both specified reserve systems with some powers given to reserve banks, although the Aldrich Bill would have created a much more centralized system.

1. The Federal Reserve Act of 1913. In drafting the Federal Reserve Act, Glass started with the Aldrich Plan and altered it to suit the interests of the Democratic party – by trading off less centralization for more appointment power.

a. Centralization and Appointment Power

a1. Centralization: Low. The Glass Bill decentralized the reserve system, twelve reserve banks with a coordinating central body – the Federal Reserve Board – to a far greater extent than the Aldrich Bill would have. First, members of the Federal Reserve System were to keep their required capital in reserve banks rather than a central bank, as they would have in the National Reserve Association. Second, reserve banks could perform open market operations whereas the National Reserve Board would have controlled such operations. Third, reserve banks could set their own discount rates, and the Federal Reserve Board did not require them to be uniform throughout the system, as the National Reserve Board would have done. Fourth, more reserves could be kept in member banks' own vaults and in the reserve banks rather than in the central bank as required in the Aldrich Bill.

Fifth, reserve banks under both schemes could rediscount paper, but in the Federal Reserve Act, eligible paper included agricultural credits. This enabled reserve banks to lend money based on local agricultural conditions.

Despite giving considerable policy-making powers to regional reserve banks, the Federal Reserve Act also gave important powers to the Federal Reserve Board. Most significantly, although regional banks could rediscount paper, the board could require regional banks "to rediscount the discounted paper of other Federal reserve banks at rates of interest to be fixed by the Federal Reserve Board" (Federal Reserve Act §11[b]). Essentially, the board could coordinate the monetary actions of the several regional reserve banks. The board also had a variety of other powers such as the power to review regional reserve banks; suspend any of the act's provisions for thirty days; issue and retire Federal reserve notes; add reserve cities; and suspend or remove officers and directors of reserve banks (Federal Reserve Act §11[a]-[l]).

a2. Appointment power: High. Government appointees controlled the Federal Reserve Board.

a2(1) The number of appointed members: seven of seven. The president and Senate appointed all seven members of the Federal Reserve Board, which consisted of the comptroller of currency, secretary of the treasury, and five other members appointed by the president with the advice and consent of the Senate.

a2(2) Length of terms: ten years. Every noncabinet board member was to serve for ten years except for the first five members: "One shall be designated by the President to serve for two, one for four, one for six, one for eight, and one for ten years" (Federal Reserve Act §10). For the Democrats, this meant that despite possible losses in the 1914 midterm congressional elections, the next presidential election in 1916, and all other elections until 1923, they would still retain at least six board seats for three years, three seats for six years, two seats for eight years, and one seat for ten years. In other words, they would have had a majority representation for at least three years and a just-under-majority for at least six years.

a2(3) Frequency of appointments: every two years. The president and Senate could make appointments to the board every two years. Unless board members retired early, this meant that every administration could only make a maximum of two appointments, and each unaltered Senate could only make a maximum of one appointment.

Staggering appointment opportunities in this manner limited the potential of future Republican victories to quickly alter the policy composition of the board.

Table 6.2 summarizes the structural features of the 1913 Fed.

b. Interest group opposition and support for the Glass Bill

Opposition. Opposition to the Glass Bill was led by the large Eastern financiers and the half of the city bankers who supported the Republican Aldrich Bill. The large financiers especially opposed the government control provisions of the bill, because this cut directly into their current control of the banking system. They called for a banker-controlled system. Half of the city bankers also opposed government control and wanted a banker-controlled central bank. They too supported the Aldrich Bill and joined the Republican opposition to the Glass Bill (Wiebe 1962: 131).

Support. Support for the bill was provided by the other half of the city bankers and all of the country bankers. Those city bankers decided some legislation was better than none and supported the bill, although they too complained that the bill would lead to too much government control and too little centralization (Wiebe 1962: 131–2). Most of the country bankers supported the bill because they preferred government control to control by the large financiers. Many businessmen, especially small businessmen, supported the bill as well. Both the National Association of Manufacturers and the U.S. Chamber of Commerce supported portions of the bill. However, Wall Street businessmen generally opposed the bill. Table 6.1 lays out the configuration of interests.

c. Passage of the bill

From 1912 to 1913, the Pujo subcommittee of the House Banking Committee investigated the growing accumulation of financial interests in New York, the so-called "Money Trusts," epitomized by J.P. Morgan and his enterprises (Wiebe 1962: 78). The negative publicity generated by these hearings finally killed the Aldrich Bill, and convinced the Democrats, especially President Wilson, that their constituents wanted government control rather than banker control of a new banking system (West 1977: 122; Kettl 1986: 21).

With the sufficient support of their constituents (see Table 6.1), the Democrats passed the Federal Reserve Act on December 23, 1913. With a united government, the Democrats achieved everything they could hope for: both decentralization and government control.

Table 6.3: *Configuration of Interests in Banking Reform – 1935*

		Centralization	
		Low	High
Appointment Power	Low	Small minority of country bankers	*Aldrich NRA Bill – Republicans* Eastern and New York financiers Half of the city bankers Wall Street businessmen
	High	*Federal Reserve Act – Democrats* Majority of country bankers Half of the city bankers Small businessmen U.S. Chamber of Commerce National Association of Manufacturers Farmers	

6.3.4 *Restructuring the Federal Reserve: The Second Democratic Plan*

The Banking Act of 1935 drastically restructured the Federal Reserve system by making it much more centralized. However, in gaining centralization, elected officials lost some appointment power (see Tables 6.2 and 6.3).

1. The Great Depression: The Context for Restructuring. The new banking act primarily reflected the ideas of Marriner S. Eccles, a prominent Utah banker. Eccles believed that the Depression required expansionary fiscal policy, an idea very popular with the Roosevelt administration. According to Kettl, "[Eccles] was a Keynesian who had never heard of Keynes and who, in fact, publicly argued the virtues of compensatory fiscal policy before Keynes published his famous *General Theory*" (Kettl 1986: 47). His ideas greatly appealed to Roosevelt's administration, which soon began to float his name for the recently vacated Fed governor position.[64] Eccles,

[64] Before the passage of the 1935 act, the chairman of the Federal Reserve Board was called the "governor."

however, asked that major changes occur in the structure of the Fed before he considered the job (Kettl 1986: 48).

Eccles felt that three key problems plagued the Fed. First, its stated purpose was to accommodate the annual business cycles, but the Fed had no instructions with respect to periodic crises. Second, decentralization confused the issue of responsibility for monetary policy. Third, the Treasury influenced the Fed a great deal in its day-to-day operations because both the Secretary of the Treasury and the Comptroller of Currency held seats on the Federal Reserve Board, and the Secretary of the Treasury was the formal chairman of the Federal Reserve Board meeting, whenever he attended. In addition, the Federal Reserve Board had no facility of its own and was physically located in the Treasury. Especially during World War I, the Fed was often pressured to follow the Treasury's preferences in setting policy (Kettl 1986: 43)

These problems combined to produce disastrous results during the Depression. Without guidance and the power to make and effect unilateral decisions, the Fed did very little to alleviate the Depression. The Fed's inaction eventually worsened the Depression (Timberlake 1993: 266–9); its refusal to inject additional liquidity into the financial system meant that banks could not deal with the increasing cash crunch caused by bank runs, which were in turn exacerbated by failing businesses.

Eccles and Lauchlin Currie, one of Roosevelt's economic advisors, proposed a restructuring to deal with these three problems. First, the Fed would be given power to *actively promote* stable business conditions, rather than its previous mandate to *passively accommodate* business conditions.

Second, the system would be drastically centralized under the power of the BOG and the new FOMC. Discount policy would be designated the exclusive power of the BOG rather than that of the reserve banks. To further reduce reserve bank power, Eccles preferred no reserve bank representation on the new FOMC. The BOG would confirm the appointments of reserve bank presidents.

Third, the plan called for closer integration of monetary and fiscal policies. Kettl nicely sums up Currie's beliefs:

> Currie contended that the old arguments about the Fed's independence from the presidency were dangerous, and he argued, 'There is no economic problem more important than achieving and maintaining prosperity, and since the actions of the monetary authority have a direct bearing upon the strength of

business activity they must be subject to the control of the Administration.' (Kettl 1986: 49).

Essentially it was the explicit purpose of the Democratic framers of the bill to place the Fed under administration, that is Democratic control. According to Eccles' original plan, all members of the FOMC were to be administration appointees, including the Treasury Secretary and Comptroller of the Currency.

Eccles succeeded in obtaining a drastic centralization of the system, but only at the cost of elected officials losing their complete control of appointments in the central decision-making body. The restructured Fed looked very similar to the Fed envisioned by Eccles but with some significant changes.

2. *The Banking Act of 1935*

a. Centralization and Appointment Power

a1. Centralization: High. The Banking Act of 1935 truly centralized the powers over monetary policymaking. Previously regional banks could set their own discount rates and perform open market operations. The Banking Act transferred those powers to central bodies in the Federal Reserve System. The power to set the discount rate was given to the BOG, while the power to set open market operations policy was given to the newly created FOMC. Through its control over open market operations, the FOMC has the power to set monetary policy by which the regional reserve banks must abide. In addition, although the regional banks' board of directors can elect their own bank presidents, their election is subject to veto by the BOG.

That elected officials lost the ability to appoint all members of the FOMC is quite significant. Although they retained the ability to appoint all members of the BOG, the FOMC is, and was known to be, the more important of the two because it has the power to determine open market operations. Discount policy, which is determined by the BOG, is also a component of monetary policy but a much smaller one compared to open market operations.

a2. Appointment power: Medium. Centralization came at the cost of lower appointment power.

a2(1) Number of appointed members: seven of seven for the BOG, seven of twelve for the FOMC. Elected officials retained the power to appoint all seven members of the BOG, but only managed to

obtain the power to appoint seven of the twelve members of the newly created FOMC, the remaining five being regional reserve bank presidents.

Eccles originally did not want the five regional reserve bank presidents on the FOMC. Their inclusion on the FOMC was part of a compromise in which he gained centralization of open market policy in the FOMC (Kettl 1986: 52).

a2(2) Length of terms: fourteen years for the appointed members, one year for the reserve bank presidents. The terms of appointed members were lengthened from ten to fourteen years. The members sitting on the BOG at the time of the bill's passage served out the remainder of their ten-year terms. These provisions meant that in addition to an appointment opportunity in 1934, if they won the 1936 election, the Democrats faced at least three more expiring terms in 1936, 1938, and 1940. In addition, because the Comptroller of Currency and the Secretary of the Treasury were no longer members of the BOG, and their seats were designated as appointed seats, the Democrats had two additional appointment opportunities. Therefore, between 1932 and 1940, the Democrats could appoint six of the seven presidential appointees of the FOMC, *and* most of these appointees had fourteen-year rather than ten-year terms. Because fourteen years spanned three and a half presidential administrations and seven sessions of congress, the Democrats had the ability to install their preferences over monetary policy in the FOMC for a long period of time.

Although reserve bank presidents serve on the FOMC, their influence is limited by their minority representation as well as their short one-year terms on the FOMC. All reserve bank presidents serve five-year terms at their respective reserve banks and one-year terms on the FOMC with the exception of the New York reserve bank president, who always sits on the FOMC.

a2(3) Frequency of appointments: every two years. Appointment opportunities are staggered such that they occur every two years. In theory this limits political influence because an administration has the ability to appoint a maximum of two members and each Senate can appoint only one member. Thus the initial appointment opportunities provided the Democrats the chance to pack the FOMC; the Republicans' influence would have been limited if they had won the 1940 election.

Table 6.2 summarizes the structural features of the Fed according to the Banking Act of 1935.

b. Passage of the bill

The Roosevelt administration sent the bill to the House, where it was introduced by Representative Henry Steagall. As a senator, Carter Glass, now the chairman of the Senate Committee on Banking and Currency, was not consulted in the drafting of the bill. Although he packed committee hearings with bankers who feared political control of the Fed, Glass and his committee members unanimously provided a favorable report, albeit with an amendment that removed the Treasury Secretary and the Comptroller of the Currency from the BOG and added the five reserve bank presidents to the FOMC (*Congressional Record*, 63rd Congress, 1st Session, p. 11777–8). Large financiers bitterly opposed the bill, but a coalition of other bankers, similar to that in 1913, supported the bill (Kettl 1986: 51–2)(see Table 6.3). Eccles and the administration opposed the amendment to the bill on the FOMC composition but accepted it as a part of the larger compromise in which the Fed was highly centralized.

After conference sessions, the bill passed on August 23, 1935. Essentially Eccles and the administration obtained almost everything they had hoped for. Eccles subsequently became chairman of the new BOG and FOMC, and promptly instituted easier monetary policy in line with the needs of the New Deal (Kettl 1986: 54–5).

Although Kettl places more weight on the informal relationship between Eccles and Roosevelt during Eccles' term as chair, the new structural arrangements in fact institutionalized greater control of monetary policy by elected officials. Presidential appointees outnumbered reserve banks seven to five on the FOMC. In addition, the BOG, made up exclusively of presidential appointees, could veto appointments of reserve bank presidents. Finally, the new FOMC, dominated by presidential nominees, had greater control than ever before over the twelve reserve banks and over monetary policy.

6.4 SUMMARY

Banking reform in the United States between 1903 and 1935 was characterized by trade-offs between centralization and appointment power. The first attempts at banking reform were dominated by Republicans. The various banking groups worked through the Republicans, with the New York and Eastern financiers gaining the most representation. In general, bankers were Republicans. But due to their distrust of New York bankers, the country bankers sometimes sided with the Democrats. When

the Democrats swept both houses of Congress and the presidency in 1912, the control over banking reform shifted in a different direction toward less centralization and more appointment power by elected officials.

With the exception of small minority groups, both parties and their banking and business constituents favored some sort of reform by 1912. However, they disagreed on the exact nature of the reform. Debates on banking reform focused on two dimensions: the degree of centralization and degree of appointment power by elected officials. Republicans, backed by large financiers, favored a central bank under banker control. Directly opposed to the Republicans, the Democrats, backed by country bankers and business, favored a decentralized system under control of elected officials. With their political domination, Democrats passed the Federal Reserve Act of 1913, which established a decentralized system with substantial appointment power by elected officials.

In 1935, Depression politics made the Democrats realize that they needed to effectively control monetary policy in order to stimulate the economy with various government plans. They succeeded in drastically centralizing the system but at the cost of appointment power. The newly created FOMC completely controlled monetary policy, but elected officials could no longer appoint all members of the central board.

7

Conclusions

When Clinton nominated Edward Gramlich and Roger Ferguson to the BOG in the fall of 1997, the Senate reaction was notable for its absence. In stark contrast to the critical attack on Rohatyn, the senators barely commented on these nominations except to praise the nominees' "extraordinary backgrounds" (Senator D'Amato, Chairman of the Senate Banking Committee, quoted in Wessel 1997: A10). The hearings were short, and the full Senate voted quickly to appoint Gramlich and Ferguson.

Clinton had learned a great deal from the Rohatyn nomination. He had discovered that Rohatyn was too far on the easy side relative to what the Senate would tolerate. Perhaps even Rivlin was a bit problematic; the Senate's confirmation vote on her appointment was not unanimous – a rare occurrence. Clinton needed to nominate someone like Meyer, who supported the current Fed policy and thus seemed likely to be a future median member of the FOMC. According to this criterion, Gramlich and Ferguson were good choices. At the time of their confirmation hearings, the FOMC was split into two factions; one side expected an imminent inflation rise while the other side claimed the possibility of a golden age with continued low inflation and high growth. In the hearings, Gramlich and Ferguson both staked a middle position with neither taking sides in the FOMC debate. Satisfied with this anticipated choice by Clinton, the Senate approved both the nominees.

This story bolsters the claims made in this study: that politicians appoint with an eye toward policy and that both the president and the Senate may matter in the appointment process. But like the Rohatyn anecdote, it too is just another supporting story. The purpose of this study has been to generalize the claims made from the anecdotes. With this aim in mind, the study began with three questions and now ends with three answers.

Question 1: Do politicians influence monetary policy through appointments to the Federal Reserve? The answer is "yes" – that the results support influence. I developed a formal model of the appointment process that predicted the location of policy following every appointment; the model specified the exact constraints of the process. I then developed a new method to estimate monetary policy preferences and used the resulting estimates to empirically test the model's predictions. In approximately 87–91 percent of the FOMC cases and 91–100 percent of the BOG cases, the median changed as predicted by the model. Furthermore, the results support political influence on actual policy; the model predicts the FOMC's federal funds rate about 33 percent of the time and the BOG's discount rate about 38 percent of the time.

Thus despite the sometimes widely acclaimed, and at other times widely criticized independence of the Fed, appointments are an important avenue of political influence on the Fed. Returning to this book's opening paragraphs, independence does not mean absolute independence from political authority. Politicians may delegate monetary policy powers to the Fed, but they have never taken a completely hands-off attitude toward it. Appointments constitute one of the ways in which politicians maintain some control over the Fed and its policies.

As this study has shown, appointments are neither a quick nor a surefire way to influence the Fed. For either the president or the Senate to obtain their desired policy, it usually takes both time and luck because the right seats must become vacant at the right time for influence to occur in the desired direction. For example, when the president and Senate are far left of the status quo, a vacancy in the last five seats produces the largest policy change toward their ideal points. Timing matters because if the vacancy occurs when the president is closer to the status quo, his ideal point may be the outcome, whereas if the Senate is closer, the outcome will be more favorable toward the Senate.

But rather than luck, perhaps the locations of the vacancies also have a general logic. From a cursory look at the twenty-three appointments from the study, it seems that sometimes members leave when they become the extreme members of the FOMC. For instance, when Volcker entered the Fed among Carter appointees in 1979, he was a moderate compared to the other FOMC members. When he left in 1987, he did so as the strongest inflation hawk in a largely Reagan-appointed FOMC. Perhaps an extreme member feels alone and frustrated on an FOMC that does not pay attention to her preferences, and which is, in her view, changing inhospitably with each appointment. This remains a possible topic for future research.

Question 2: Who influences appointments to the Fed? The answer is sometimes just the president, sometimes both the president and Senate, and sometimes neither. Although the president is alert to the Senate's wishes at all times, sometimes he does not have to pay attention to the Senate's preferences, while at other times, he really must. It depends on the situation: whether the president and Senate agree on the direction of policy change, and where the president and the Senate are located on the monetary policy dimension relative to one another and the current policy. There are times when both agree on the direction in which policy should move, but either the president or the Senate is closer to the current policy. The closer party then decides just how far policy will move. At other times, they do not even agree on the direction of policy. In that case, they deadlock and maintain the current policy.

But does the president always dominate? The answer to this question is "no" for the FOMC and "maybe" for the BOG. The results supported both the influence of the president and Senate on the FOMC, while the results for the BOG were inconclusive.

In any case, the results do support dominance within an anticipation framework. In the model and analysis presented here, the president always anticipates the Senate. Even within that anticipation framework, the model showed that the Senate can be completely powerless against a president, often because of the president's agenda-setting power. While the vice versa is never true, the president nevertheless sometimes has to compromise with the Senate. Thus there is sometimes presidential dominance and sometimes presidential compromise, all within presidential anticipation. Thus the resolution of the debate between the presidential anticipation and presidential dominance theories is that even when anticipation is always the case, dominance can occur within anticipation under the specified conditions.

In these results, the intent of the Constitution's Framers is clearly realized. No branch fully dominates this process, demonstrating the functioning of the checks-and-balances system. However, the extent to which certain situations occur and to which one branch has influence over another in those situations will, more likely than not, vary across agencies. This possibility is suggested in Bailey and Chang's (1999) analysis of Supreme Court appointments. In that model, for any given spatial configuration, the influence of one branch over another depends on the costs of another round of nominations and confirmations. For example, if the president wishes to influence long-term policy and elections are approaching, it is better for him to appoint someone now rather than later unless

he is certain of reelection. Thus, costs may be high for him in this situation. In the Senate, the cost of a major confirmation battle may be in terms of the time lost on other legislation. Beyond the Supreme Court and across agencies, these costs may vary. Certainly there are appointments over which the president seems to have more control such as cabinet appointments. Likewise, the Senate seems to control other appointments such as lower-court appointments. A comparative study across agencies, like McCarty and Razaghian's (1999) study of confirmation times, may shed more light on these considerations.

An alternative comparative route is to go across countries rather than across American agencies. As mentioned in the introduction, countries vary quite a bit in terms of how they appoint their central bankers. In some countries, the executive branch has complete power to appoint, and in others, the legislative branch has that power. Sometimes the two share the power with one party nominating and the other confirming the appointment. From a cursory view, it seems that in parliamentary systems, either the legislature or the cabinet appoints (e.g., Sweden, Japan), and in separation of powers systems, the power is left up to the executive branch (e.g., Australia). But still, there are exceptions to this rule. In the United States, the president shares the power with the Senate. Germany is a mixed system and has elements of both; some members are appointed by the president upon nomination by the cabinet, while others are appointed by the president upon nomination by the Bundesrat. A comparative study of appointment processes would yield some interesting insights into whether this conjecture regarding governmental systems and processes holds up. It may also shed light on whether these systematic differences in process affect the existence and level of political influence on policy: the answer to this book's first question.[65]

Question 3: What explains the current appointment structure of the Federal Reserve? The answer is greater centralization. I conducted detailed qualitative comparisons of the important Fed-related legislation during the period 1903–35. I found that in 1913, the Democrats obtained much appointment power and not much centralization. In 1935, the last major restructuring of the Fed, the Democrats sacrificed appointment power for greater centralization. Specifically, they gave up the ability to appoint

[65] Moser (1997) shows in a comparative study that central bank independence only solves the time inconsistency problem when legislative systems have two veto players as in a bicameral system.

all members of the central board, the FOMC, for the centralization of open market operations in the FOMC. The result was a more coherent, powerful Federal Reserve, which meant that the president's remaining appointees to the FOMC would have greater influence on policy than previously.

This question would also benefit from a comparative investigation, both across American agencies and across countries. Across agencies, there is a great deal of variation in the degree to which policy is centralized. Take the examples of the Occupational Safety and Health Administration (OSHA) and the National Labor Relations Board (NLRB). In the former, OSHA creates the national standards but allows states the power to enforce those standards. In the latter, the NLRB's central board controls both policy making and enforcement. Similarly, the agencies vary in appointment power. With regard to the number of appointees on the central board, OSHA has one – the Assistant Secretary of Labor for OSHA – while the NLRB has five board members. With regard to term lengths, the Assistant Secretary of Labor for OSHA serves at the pleasure of the president. The NLRB's members serve for five years. In terms of the frequency of appointments, the president really controls this for OSHA. The NLRB appointment opportunities occur every year. Thus the structures of these two agencies are quite different, despite their both dealing with workers' rights to some extent. OSHA is less centralized but the president and Senate have higher appointment power compared to the NLRB, which is more centralized. The comparison between the two holds up the theory presented in this study regarding the trade-offs between centralization and appointment power, but real support for the theory awaits further cross-sectional evidence.

Across countries, the structure of central banks varies greatly although not in terms of centralization; most are highly centralized with the branches having little to no power to determine monetary policy. Most of the variation occurs in terms of appointment power. The Bundesbank has up to seventeen members on its central board, eight of whom are appointed by the federal government. The Bank of Japan's central board has nine members, all of whom are appointed by the federal government. The Bank of Japan's directors serve five years, while the Bundesbank's members serve eight years. Therefore, the Japanese federal government can influence the Bank of Japan in greater proportion and more often compared to the German federal government in the Bundesbank setup. In this comparison, centralization does not vary much, but appointment power

does; it seems to be higher in Japan compared to Germany.[66] As with the question of who influences, the governmental system may explain the differences in appointment power. In a parliamentary system like Japan, the principle of government is to give power to those in power; thus there is greater potential for quick political influence through appointments in Japan. In a separation of powers system, like parts of the German system, the opposite principle prevails, a principle of balance between the branches and influence by them together. The latter may lead to a process in which it is more difficult to influence the central bank through appointments.

Adapting the model. In addition to studying these three questions cross-sectionally across American agencies and/or across countries, the approach used in this study can be applied to a series of appointments within a specific agency or country over time. The methodological approach used in this study has been comprehensive. I started with an anecdotal observation: appointments seem to affect policy. I then used a formal model to logically derive if and how appointments could affect policy within the institutional constraints provided by the American constitutional system. The model yielded testable predictions based on the spatial configuration of the actors' preferences. The next logical step was to estimate the actors' preferences by using methods suited to the particular problems of the data. I therefore developed a new method that controls for swings in the business cycle and produces estimates that are comparable across the president, Senate, and the FOMC. I then used these preference estimates to test the model's predictions. I next looked into whether or not the process under study was the result of political intention. For this analysis, I used comparative case-study methods by looking at several variables across different legislative bills and acts.

The approach developed is a start-to-finish way of looking at inter-branch interaction not only in the American system, but in other systems as well. The details will vary, but the general problem will not. In any system, there will be strategic interaction between different institutional actors with heterogenous preferences. In the ECB, for example, the sequence of the appointment process is similar to the nomination/confirmation sequence in the American system. However, the actors and their powers are very different. The Council of Ministers does not have the power to make

[66] Some of these considerations are discussed at length by Lohmann (1997) with respect to the Bundesbank.

binding commitments like the president of the United States. The Heads of States must unanimously accept a nominee whereas the Senate has only to approve a nominee by majority vote. As Chapter 5 showed, these differences have important implications for the types of policies produced in each setting. In the United States, politicians who represent median interests gradually move policy through appointments. In the European setting, either extreme countries dominate policy, or the current policy is extremely hard to change.

The results in Chapter 5 lend some, but not absolute, support for the concerns surrounding the entry of traditionally inflationary countries like Italy, Spain, and Portugal (Coleman 1998; Kosters, et al. 1998). These countries were seen as possible threats to economic convergence and the stability of EMU. But the arguments against the entry of these countries was based on an idea of a mean monetary policy among the EMU member countries: for example, if Italy joins, it automatically decreases the mean stability and increases the mean inflationary policy. As such, these arguments neglected the appointment process and its possible effects on policy.

Through an analysis of the appointment process, Chapter 5 has shown that the entry of these countries *could* lead to inflationary policy under certain conditions but that it is not a foregone conclusion. If a current policy is relatively different from the preferences of all the member countries, then the preferences of an extreme country, as Italy has been labeled, may dominate. But did these conditions exist at the start of EMU? The answer is "no". The latter part of Chapter 5 demonstrated that the pre-EMU European monetary policy and the countries' preferences dictated the continuation of the status quo – relatively tight monetary policy. Thus the entrance of Italy, Spain, and Portugal did not contribute to more inflationary policy in the first few years of EMU.

We can also use this approach to look in detail at other appointments in the American system. In Bailey and Chang (1999, 2001, 2003), we use a similar model to examine Supreme Court appointments. The basic process is the same as that for the Fed: presidential nomination followed by Senate confirmation. There are, however, differences that affect whether influence occurs and who is influential. The first difference is the time lag between appointments. Supreme Court appointments occur infrequently relative to Fed appointments. For the latter, presidents are guaranteed at least one appointment every other year. In contrast, there are no guarantees for Supreme Court appointments; presidents have to wait for deaths or retirements that can take many years. In the Supreme Court setting,

politicians can never be sure that there will be further appointment opportunities that will get them closer to the RR equilibrium policy. Second, Supreme Court appointments are made to another major branch of government and have life terms. They are therefore very high-profile and highly publicized appointments compared to Fed appointments.

In such a setting, one might expect greater conflict between the president and Senate compared to the Fed appointment setting. Because each appointment is rare and high profile, it may be more important for both the president and Senate to obtain exactly what they each want. We allow for this conflict through the different costs that either party bears in the case of a repeat-nomination process. Preliminary results indicate that political influence occurs but perhaps not to the extent that it does for the Fed.

These are only two examples, but they illustrate how the approach from this book can be flexibly adapted to different governmental systems and to different appointment settings within the American system. Making these sorts of detailed comparisons is important to our understanding of how different institutional structures lead to different types of policy outcomes. Comparing the Fed and the ECB, we saw that the ECB structure is more likely to yield extreme policies or no change in policy at all. In comparisons of the Fed and the Supreme Court, perhaps politicians are unable to influence the Supreme Court through appointments as effectively as the Fed. What other differences will reveal themselves from a further investigation of other appointment processes remains to be seen.

With this understanding of the relationship between institutions and outcomes, there is also a normative implication. If we know the mapping from structures to outcomes, and if society can decide what type of policy it wants, then it can implement the correct structures for the correct types of policies. But making normative statements was never the intent of this book; that's a topic for another book altogether.

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To my grandchildren

Jade, Morgan, Charles, and Ray

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INTRODUCTION

This book was almost never written—several different times. In the winter of 1963 at Harvard Business School, I was, like all my classmates, looking for a job. My attention was drawn to a three-by-five piece of yellow paper posted at eye level on a bulletin board in Baker Library. In the upper left corner was printed "Correspondence Opportunities" and typed to the right was the name "Goldman Sachs." As a Boston securities lawyer, my dad had a high regard for the firm, so I read the brief description of the job with interest but was stopped by the salary: $5,800.

My then wife had just graduated from Wellesley with three distinctions: she was a member of Phi Beta Kappa, a soprano soloist, and a recipient of student loans. I was determined to pay off those loans, so I figured I'd need to earn at least $6,000. With no thought of the possibility of earning a bonus or a raise, I naively "knew" I could not make it on $5,800. So Goldman Sachs was not for me. If I had joined the firm, like everyone else who has made a career with Goldman Sachs I would never have written an insider's study of Goldman Sachs.*

* John Whitehead and Robert Rubin have both included a few stories about the firm in their books but have certainly not tried to provide a complete picture. Lisa Endlich, a fine writer but with limited access to the full range of

In the early 1970s, while promising future partners that we would develop our fledgling consultancy, Greenwich Associates, into a truly superior professional firm, I had to laugh at myself: "You dummy! You make the promise, but you don't even know what a truly superior professional firm is all about or how to get there. You've never even worked for one. You'd better learn quickly."

From then on, at every opportunity I asked my friends and acquaintances in law, consulting, investing, and banking which firms they thought were the best in their field and what characteristics made them the best. Over and over again, well past the bounds of persistence, I probed those same questions. Inevitably, a pattern emerged.

A truly great professional firm has certain characteristics: The most capable professionals agree that it is the best firm to work for and that it recruits and keeps the best people. The most discriminating and significant clients agree that the firm consistently delivers the best service value. And the great firms have been and will be, sometimes grudgingly, recognized by competitors as the real leaders in their field over many years. On occasion, challenger firms rise to prominence—usually on the strength of one exciting and compelling service capability—but do not sustain excellence.

Many factors that contribute to sustained excellence vary from profession to profession, but certain factors are important in every great firm: long-serving and devoted "servant leaders"; meritocracy in compensation and authority; disproportionate devotion to client service; distinctively high professional and ethical standards; a strong culture that always reinforces professional standards of excellence; and long-term values, policies, concepts, and behavior consistently trumping near-term "opportunities." Each great organization is a "one-firm firm" with consistent values, practices, and culture across geographies, across very different lines of business, and over many years. All the great firms have constructive "paranoia"—they are always on the alert for and anxious about challenging competitors. However, they seldom try to learn much from competitors: they see themselves as unique. But like Olympic athletes who excel in different events, they are also very much the same.

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partners, wrote a thoughtful and wide-ranging study centered on the development of the firm in the 1980s and 1990s. Bob Lenzner, a gifted writer for *Forbes* who had worked in arbitrage at Goldman Sachs a generation ago, started a book but set it aside, saying he didn't want to lose his friends at the firm.

Armed by Greenwich Associates' extensive proprietary research and working closely as a strategy consultant with all the major securities firms, I was in a unique position to make comparisons between competing firms on the dozens of salient criteria on which they were evaluated by their own clients market by market, year after year, and particularly over time. Over the years, I became convinced that my explorations were producing important discoveries that would be of interest to others who are fascinated by excellence, who retain professional firms for important services, or who will spend their working careers in professional firms. One discovery surprised me: In each profession, one single firm is usually recognized as "the best of us" by the professional practitioners—Capital Group in investing, McKinsey in consulting, Cravath in law (nicely rivaled by Davis Polk or Skadden Arps), and the Mayo Clinic in medicine (nicely rivaled by Johns Hopkins). And Goldman Sachs in securities.

Ten or twenty years ago, many people in the securities business would have argued that other firms were as good or better, but no longer. (Much further back, few would have ever chosen Goldman Sachs.) For many years, it has seemed clear to me that Goldman Sachs had unusual strengths. Compared to its competitors, the firm recruited more intriguing people who cared more about their firm. Their shared commitments, or "culture," was stronger and more explicit. And the leaders of the firm at every level were more rigorous, more thoughtful, and far more determined to improve in every way over the longer term. They took a longer-horizon view *and* were more alert to details. They knew more about and cared more about their people. They worked much harder and were more modest. They knew more *and* were hungrier to learn. Their focus was always on finding ways to do better and be better. Their aspirations were not on what they wanted to be, but on what they wanted to do.

Goldman Sachs has, in the last sixty years, gone from being a marginal Eastern U.S. commercial-paper dealer, with fewer than three hundred employees and a clientele largely dependent on one improbable investment banker, to a global juggernaut, serially transforming itself from agent to managing agent to managing partner to principal investor with such strengths that it operates with almost no external constraints in virtually any financial market it chooses, on the terms it chooses, on the scale it chooses, when it chooses, and with the partners it chooses.

Of the thirty thousand people of Goldman Sachs, fewer than half of one percent are even mentioned in this book, but the great story of Goldman Sachs is really their story—and that of the many thousands who joined the firm before them and enabled it to become today's Goldman Sachs. Goldman Sachs is a partnership. The legal fact that after more than a hundred years it became a public corporation may matter to lawyers and investors, but the dominating reality is that Goldman Sachs is a true partnership in the way people at the firm work together, in the way alumni feel about the firm and each other, and in the powerful spiritual bonds that command their attention and commitment.

The leaders of Goldman Sachs today and tomorrow may have even tougher jobs than their predecessors. The penalties of industry leadership, particularly the persistent demand to meet or beat both internal and external expectations for excellence—over and over again on the frontiers of competitive innovation—are matched by the persistent challenges of Lord Acton's warning: "Power tends to corrupt. Absolute power corrupts absolutely."

Three great questions come immediately to any close observer: Why is Goldman Sachs so very powerful on so many dimensions? How did the firm achieve its present leadership and acknowledged excellence? Will Goldman Sachs continue to excel?

The adventures that crowd the following pages point to the answers.

Charles D. Ellis
New Haven, Connecticut
June 2008

THE PARTNERSHIP

1

BEGINNINGS

On November 16, 1907, an unremarkable event took place that would have remarkable importance for Goldman Sachs: Looking for a job, sixteen-year-old Sidney Weinberg headed back to Wall Street. The territory was familiar. Young Weinberg had worked there briefly as a "flower and feather horse," delivering millinery goods for two dollars a week, and one summer as a runner for three odd-lot brokerage houses[1]—until each of these employers found out he held two other identical jobs and all three firms promptly fired him.

Earlier in 1907 Weinberg had learned from a pal on the Brooklyn-to-Manhattan ferry that there was a panic on Wall Street, which Weinberg later admitted "meant no more to me than if you said it was raining." The panic caused a run on the Trust Company of America, so Weinberg could make even more money—up to five dollars a day—by standing in the long queue of anxious depositors who lined up to withdraw their balances and, when he got close to the bank's door, selling his place in the line to a late-arriving, desperate depositor. Quickly getting back in line to work his way up to the door, he did the same thing all over again. Pocketing all the money he could, Weinberg skipped school, but

after having played hooky for a full week, he was not allowed to return to school at PS 13. So now he needed a real job.

His father, Pincus Weinberg, was a struggling, Polish-born wholesale liquor dealer and sometime bootlegger who, having been widowed with eleven children, had recently remarried. His new wife did not want the third-eldest child—that fresh kid—around the house, so Sidney was pushed out to fend for himself. As a seventh-grade dropout, he had only one apparent advantage—a general letter of introduction signed by one of his teachers, saying: "To whom it may concern: It gives me great pleasure to testify to the business ability of the bearer, Sidney Weinberg. He is happy when he is busy, and is always ready and willing to oblige. We believe he will give satisfaction to anyone who may need his services."

Short—his legs were only twenty-six inches long—and with a speaking voice that was heavily larded with a thick Brooklyn Jewish accent in which girls were "goils," oil was "erl," and turmoil was "toi-merl," Weinberg went looking for a job—*any* job. Deciding to try lower Manhattan's financial district, he concentrated on the tall buildings. As he later explained his first triumph on Wall Street, "Looking for an indoor job, I walked into 43 Exchange Place, a nice-looking, tall building, at eight o'clock one morning and took the elevator to the twenty-third floor. Starting from the top, I stuck my head in every office and asked as politely as I could, 'Want a boy?' By six o'clock, I had worked my way down to the third floor and still had no job. Goldman Sachs was on that floor and it was closing up for the day. The cashier told me there was no work, but to come back. Next morning, I came back at eight o'clock and started right where I had left off."

Brazenly, Weinberg said he had been *asked* to come back. "The cashier, Mr. Morrissey, turned to the hall porter: 'Jarvis, do you need an assistant?' Jarvis was willing, so they hired me at $5 a week as assistant to Jarvis the janitor." His new job included the lowly task of cleaning out cuspidors.* Lowly, but a start.

Weinberg did not stay long at the starting line. Told to take an eight-foot

* Until his death at seventy-seven in 1969, Weinberg kept in his office the brass spittoon he allegedly polished for Jarvis in his first job. He also kept a bag he bought as a naive young man at Niagara Falls from a smooth-talking con man who said, "You look like a great young man. Do you know that down at the bottom of those falls are diamonds and nobody's been able to get them, but I can, and I have some of them in this little bag here, and I'm willing to sell it to you." "Well, how much do you want for it?" "One buck," said the man. "I haven't got a dollar. I've only got fifty cents left." "Well, you're such a promising young man I'll sell it to you for fifty cents." Weinberg bought the bag for fifty cents and soon learned there was nothing in it but an ordinary pebble. He kept that pebble all his life as a reminder to never be a sucker again.

flagpole uptown on the trolley—"Ever try to carry a flagpole on a trolley car? It's one hell of a *job!*"—Weinberg arrived at Paul Sachs's door, where he was met not by a butler, but by Mr. Sachs himself, a son of Goldman Sachs's first junior partner. Demonstrating his lifelong knack for becoming friendly with men in high positions who could help him, Weinberg so impressed Sachs with his energy and brightness that Sachs invited the likable teenager to stay for dinner—with, of course, the servants. Weinberg soon became head of the mail room and prepared a complete plan for its reorganization that again brought him to the attention of Paul Sachs, who would become Weinberg's "rabbi" among the partners of his new employer.

Sachs decided to send Weinberg to Browne's Business College in Brooklyn for a course in penmanship and to learn something about the math of Wall Street.[2] Sachs paid the $50 tuition, advised Weinberg to clean up his rough language, told him how to advance within Goldman Sachs, and continued to watch over and watch out for him. "Until he took me in hand, I was an awful kid—tough and raw. Paul Sachs gave me another $25 to pay for a course at NYU. He didn't tell me what course to take. I had never heard of New York University, but I sought it out. Lots of courses didn't interest me. One course was called Investment Banking. I knew the firm was in the investment banking business, so I took that course. I think it did me a lot of good."

Weinberg took one other course to complete his education: "Some time later, they were considering promoting me to the foreign department. I went to Columbia University and took a course in foreign exchange." He also developed his office skills. "At that time, the firm used mimeographed sheets offering commercial paper. I became proficient at making copies and won the $100 prize as the fastest operator of National Business Equipment mimeograph machines at the New York Business Show in 1911."

Irreverent then as later, brash young Weinberg was clearly on the make: "I had expensive tastes and used to sit behind one of those big desks after the bosses went home and smoke fifty-cent cigars that belonged to one of the men I later became partners with." When too slow a series of promotions at the firm left him frustrated, Weinberg quit in 1917 to enlist as a seaman in the U.S. Navy. Nearsighted, short, and scrappy, he cajoled his recruiting officer into inducting him as an assistant cook, a rating for which he affected great pride in later years, even though he actually transferred after a few weeks to Naval Intelligence at Norfolk, Virginia.[3]

A friend[4] told of Weinberg's being the guest of honor at J. P. Morgan's luncheon table, where the following exchange occurred: "Mr. Weinberg, I presume you served in the last war?"

"Yes, sir, I was in the war—in the navy."

"What were you in the navy?"

"Cook, Second Class."

Morgan was delighted.

Though inconsequential by Wall Street standards, the firm that Sidney Weinberg joined in 1907—and later helped to rescue from a disaster, and eventually propelled almost to Wall Street's top tier—was already nearly four decades old when Weinberg arrived. The financial colossus got its start as the inconspicuous business of a single immigrant with no staff and almost no capital. Marcus Goldman, the son of a peasant cattle drover, was twenty-seven when he left the village of Burbrebae near Schweinfurt in Bavaria during the turmoil of Europe's conservative counterrevolutions of 1848. Having decided like millions of others to leave Europe, he had taught school for several years to save enough money to pay for his six-week crossing of the stormy Atlantic Ocean as part of the first major Jewish migration to America.

The Kuhns, the Lehmans, the Loebs, the Seligmans, and others—the families that called themselves "our crowd"—were already establishing the German Jewish banking community that became powerful as the United States industrialized. But with no connections to that crowd, Goldman began working as an itinerant merchant peddler in New Jersey. There he met and married Bertha Goldman, no relation, the eighteen-year-old daughter of a locksmith and jeweler from Darmstadt in northern Germany. They settled in Philadelphia and moved to New York in 1869.

Interest rates were high following the Civil War, and Goldman developed a small business in mercantile paper—similar to today's commercial paper—in amounts ranging upward from $2,500. Commercial banks had few if any branches and expected customers to come to them, so this left an opportunity for entrepreneurs like Goldman to get to know the merchants, evaluate their creditworthiness, and act as an intermediary between small borrowers and insti-

tutional lenders. Goldman conducted most of his business among the wholesale jewelers on Maiden Lane in lower Manhattan and in the nearby "swamp" area where leather merchants congregated on John Street. Both groups were doing their business with minimal capital, so money lending or "note shaving" was a profitable opportunity for someone as diligent as Goldman. He either bought the merchants' promissory paper at a price discounted at 8 percent to 9 percent per annum or worked on a consignment fee of half of 1 percent, which could produce a much higher return if turnover was rapid.

"It was a small business done in a small way, but with accuracy and exactitude."[5] Collecting the paper he purchased during the morning inside the interior band of his high silk hat, Goldman would take a horse-drawn cab up Broadway to the crossing of Chambers and John streets to visit the commercial banks where he hoped to resell the paper at a small profit. Over a century and a half of persistent entrepreneurship, his tiny proprietorship would evolve and grow into the world's leading securities organization, but in 1870, forty-nine-year-old Marcus Goldman was still an outsider at the lower end of the financial food chain. By the end of that year, however, he had developed enough business to employ a part-time bookkeeper and an office boy. Dressed in a Prince Albert frock coat and tall silk hat, he presented himself rather grandly as "Marcus Goldman, Banker and Broker."

In 1882, thirteen years into his career as a sole proprietor, Goldman's annual profits, which were not taxed, approximated fifty thousand dollars. Perhaps beginning to feel flush, he took thirty-one-year-old Samuel Sachs—the husband of his youngest daughter, Louisa Goldman—as his junior partner and renamed the firm M. Goldman and Sachs.

Marcus and Bertha Goldman enjoyed a particularly warm and close friendship with Sam's parents, Joseph and Sophia Sachs.[6] The Sachses' eldest son, Julius, had married the Goldmans' daughter Rosa in a match approved by both mothers. The two mothers agreed that another Sachs-Goldman marriage would be desirable, and Sam Sachs, who had begun work at fifteen as a bookkeeper, soon married Louisa Goldman.

Marcus Goldman advanced Sam Sachs fifteen thousand dollars so he could liquidate his small dry goods business in an orderly way and make his capital commitment to the partnership. The loan was to be repaid over three years in three

promissory notes of five thousand dollars each. By the time Sam and Louisa's third son was born, Sam had repaid Marcus two of the three notes, and Marcus, in his old-fashioned German script, wrote formally to his son-in-law to say that, in recognition of Sam's energy and ability as a partner, and in honor of little Walter's arrival, he was forgiving Sam the final payment. Thus, Walter Sachs was able to say many years later, "It appeared that on the very first day of my entrance into this world I concluded my first business deal for Goldman Sachs."[7]

Louisa Goldman Sachs, a sentimental sort, always kept her father's letter, along with the canceled note, in the little strongbox where she also kept, tied in faded bows, her little boys' silky blond ringlets and, dated and labeled, all their baby teeth.

The name of the firm became Goldman, Sachs & Co. in 1888. During the firm's first fifty years, all partners were members of a few intermarrying families, and its business affairs were always conducted by consensus. By the 1890s Goldman Sachs was already the nation's largest dealer in commercial paper. Sales doubled from $31 million in 1890 to $67 million in 1894; two years later the firm joined the New York Stock Exchange. To expand beyond New York City, Henry Goldman began making regular trips to such business centers as Chicago, St. Louis, St. Paul, and Kansas City[8] and to financial centers including Providence, Hartford, Boston, and Philadelphia.

In 1897 Sam Sachs, hoping to expand the business and bearing a letter of introduction from England's leading coffee merchant, Herman Sielcken, went to London and called at 20 Fenchurch Street on Kleinwort, Sons & Co. The Kleinworts, whose business had originated in Cuba in 1792, had transferred their operations to London in 1830 to engage in merchant banking, and seventy years later were important merchant bankers there, accepting checks and other so-called bills of exchange from around the world and, with their well-established creditworthiness, enjoying the best rates in the city. To Herman and Alexander Kleinwort, who were looking for a more aggressive American correspondent than the one they had at the time,[9] Sam Sachs explained Goldman Sachs's business in New York and the attractive possibilities for both foreign exchange and arbitrage between the markets in New York and London.

Although Sachs's proposition was clearly interesting, the Kleinworts, given their sterling reputation, were understandably cautious about doing business

with a firm they did not know. They inquired through August Belmont, the leading Jewish banker in New York City and N. M. Rothschild's New York agent, about the acumen, integrity, and zeal of the firm. Hearing no evil, Kleinwort, Sons & Co. accepted Goldman Sachs's proposal for a joint undertaking, and it ran successfully for many years without a written contract.

The business friendship was not always as easily matched by a social friendship. The Kleinworts soon began a custom of entertaining the Sachses at their country home, but were amused by the unsophisticated Americans and learned to be careful about which of their wealthy and cultured English friends they entertained at home while the Sachses were visiting. Walter Sachs recalled reaching out during a visit when he was fifteen to shake hands and saying, "How do you do, sir?"—to the Kleinworts' butler. As a young trainee, Walter Sachs would again blunder, passing on to Alexander Kleinwort that he had heard a concern expressed in the City about the amount of Goldman Sachs–Kleinwort paper on the market. The great man listened in granite silence. Only weeks later was Sachs advised privately of his transgression: In a breach of business etiquette, he had nearly implied the slight possibility of the impossible—that anyone would ever doubt or question Mr. Kleinwort's impeccable credit standing.

Correspondent relationships were opened with banks on the Continent. Goldman Sachs limited activities to self-liquidating transactions to avoid risking capital, and profits in the foreign department rose to five hundred thousand dollars in 1906.[10] Profits were largely made through arbitraging the money rates in New York against those in London, where they were substantially lower even after the joint operation's commission of 0.5 percent for ninety-day paper. With its credit established in Europe's financial markets, Goldman Sachs extended the money-market activities, at least in small amounts, to South America and into the Far East.

Marcus Goldman remained a partner until his death in 1909. Sam and Harry Sachs continued to build the firm's most important business: commercial paper. Harry Sachs later admonished his son: "Never neglect this specialty." Meanwhile, Henry Goldman, who was as boldly expansionist as Sam Sachs was meticulous and conservative, sought to develop a domestic securities business by selling railroad bonds to savings banks in New York and New England.

In the mid-1890s, the firm had occupied two rooms on the second floor at

9 Pine Street,* with a staff of nearly twenty working from 8:30 a.m. to 5 p.m. each day of a six-day week. It moved in 1897 to 31 Nassau Street. To build the commercial-paper business, Goldman Sachs opened its first branch office in Chicago in 1900, and a one-man office was soon operating in Boston. Thanks mainly to the rapidly expanding commercial-paper business, capital reached one million dollars in 1904, when the firm moved again to the more spacious quarters on Exchange Place.

Goldman Sachs was prospering, and its partners, led by Henry Goldman, had a new ambition: to expand into investment banking.

Goldman Sachs was unable to break into what was the major part of the securities business in the early twentieth century—underwriting the new bond and stock issues of the rapidly expanding, cash-hungry railroads. J.P. Morgan, Kuhn Loeb, and Speyer & Company operated an effective underwriting oligopoly, and these dominant investment banking firms warned Henry Goldman that they would do whatever it took to prevent his firm's getting any part of this large and lucrative business. Goldman was not intimidated; he was angry and keen to fight his way in, but he couldn't find an opening. His only choice was to retreat and look for other opportunities. That proved fortunate: If the oligopolists had opened the door a crack, Goldman Sachs would have struggled for years to build up a share of a business that had already peaked and was entering a long, long decline—eventually leading to multiple bankruptcies.

The attempted expansion into railroad bonds led to what was long remembered as "that unfortunate Alton deal"[11] in which the firm agreed to take ten million dollars of a bond issue by a Midwest railroad. Expecting to earn a 0.5 percent syndication fee, the firm instead suffered a considerable loss when interest rates suddenly rose before Goldman Sachs and the other members of the underwriting syndicate had sold their allocations to investors.

As so often in Goldman Sachs's history, specific gains and losses led to strategic entrepreneurial decisions. Locked out of underwriting the major railroads, Henry Goldman turned to the then unsavory business of "industrial" financing.

* Having moved from 30 Pine Street. In 1928, at least partly for sentimental reasons, the firm built a twenty-one-story building at 30 Pine.

Most industrial companies were still rather small proprietorships; only a few of the larger enterprises were looking for more capital than their owners and commercial banks could provide. Goldman Sachs began near the bottom with manufacturers of cigars. The firm owed at least part of the opportunity in financing cigar manufacturers, and later retailers, to religion. Two leading financiers—J. P. Morgan and George F. Baker of what is now Citigroup—would not deal with "Jewish companies" but left these companies for "Jewish firms" like Goldman Sachs.

After the turn of the century, the partners of the family firm, led by Henry Goldman, were increasingly committed to growth and expansion. In 1906 an opportunity came in the form of a company recently established by the merger of three cigar-making companies into United Cigar (later renamed General Cigar).[12] Goldman Sachs had dealt in the constituent companies' commercial paper for several years as they financed inventories, and United's chief executive, Jake Wertheim, was a friend of Henry Goldman's.[13] Wertheim and Goldman were both keen to do business, but the public securities markets, both debt and equity, had always been carefully based on the balance sheets and the capital assets of the corporations being financed—which is why railroads were such important clients. To expand, United Cigar needed long-term capital. Its business economics were like a "mercantile" or trading organization's—good earnings, but little in capital assets. In discussions with United's half dozen shareholders, Henry Goldman showed his creativity in finance: He developed the pathbreaking concept that mercantile companies, such as wholesalers and retailers—having meager assets to serve as collateral for mortgage loans, the traditional foundation for any public financing of corporations—deserved and could obtain a market value for their business franchise with consumers: their earning power.

Fortunately, a friendship led simultaneously to a timely expansion of resources. Henry Goldman introduced his pal Philip Lehman and the firm of Lehman Brothers, then an Alabama cotton and coffee merchant, into the discussions with United Cigar. Philip Lehman, one of five ambitious brothers, was able and competitive. "At anything he did, Philip had to win," said a member of his family.[14] Philip Lehman was determined to see Lehman Brothers venture into the New York City business of underwriting securities and often discussed the opportunities with Henry Goldman. Sam Sachs's summer place in Elberon, New

Jersey, was back to back with Lehman's, so it was easy to discuss business and make deals over the shared back fence.

The wealthy Lehmans were looking for new opportunities to invest for growth, and with their substantial capital they could be valuable partners in underwriting securities. The process of underwriting and distributing securities—buying them from the issuing corporations and reselling them to investors—lacked the established industry structure and the swift, well-organized procedures that would later develop. Selling the securities of an unfamiliar company could take a long time—three months was not at all unusual—so the underwriter's reputation and capital were of great importance in supporting the sale. In a rapidly expanding firm-to-firm partnership, the Goldmans provided the clients and the Lehmans provided the capital. Their sharing arrangement would continue until 1926.

The sale of United Cigar's common shares, "of necessity a prolonged affair,"[15] eventually succeeded. The investment bankers agreed to purchase forty-five thousand shares of the company's preferred stock plus thirty thousand shares of common stock for a total of $4.5 million. After several months of continuous selling efforts, the securities were sold to investors for $5.6 million, a 24 percent markup. In addition, Goldman Sachs kept 7,500 shares as part of its compensation, adding another three hundred thousand dollars to the firm's profits. More important, this innovative financing—based on earnings instead of assets—opened up new opportunities for Goldman Sachs. A successful debt underwriting followed, for Worthington Pump.

Another major financing—and the start of a very important relationship—developed from taking up a conventional family responsibility. Before the turn of the century, Samuel Sachs's sister, Emelia Hammerslough,[16] and her husband had reluctantly taken in a boarder from Germany because he was a distant relative, despite their not caring much for him; he seemed crude and uncultured. The boarder was Julius Rosenwald, who soon went west and linked up with Richard Sears, becoming the one-third owner of Sears Roebuck by merging his firm, Rosenwald & Weil, with Sears's mail-order operation. Together they would build the mail-order business that eventually made Sears Roebuck a major American company, but back in 1897, with net worth less than $250,000, they first needed working capital to finance inventories of merchandise purchased in New York City.

Apparently Rosenwald never knew how restrained his welcome at the Sachs home had been, but he did know that Emelia's brother Sam's firm could raise money and was looking for business. Rosenwald, as Sears's treasurer, turned naturally to Goldman Sachs to sell Sears Roebuck's commercial paper. Goldman Sachs arranged a seventy-five-million-dollar commercial-paper financing and was soon linked to an explosively growing retailing client with voracious needs for financing.

Less than ten years later, after substantial growth and with great expectations, Sears and Rosenwald decided they needed five million dollars in long-term capital to build a major mail-order plant in Chicago. Rosenwald turned again to Sam Sachs's firm, hoping it could arrange a loan, but Henry Goldman countered with a bigger and better proposition: a public stock offering for ten million dollars to be underwritten jointly by Lehman Brothers and Goldman Sachs.

Since there had never before been a public flotation of securities for a mail-order company, there was no way to know in advance how investors might respond. The stock issue was clearly daring. Once again the entrepreneurial innovator, Henry Goldman proposed using the United Cigar "formula": Preferred stock would be supported by hard net assets, while the earning power of Sears Roebuck's customer acceptance—its goodwill franchise—would be the basis for a simultaneous issue of common stock. The Sears Roebuck underwriting, with many shares placed in Europe through Kleinwort, was eventually a substantial success for investors, but completion took an agonizing nine months—three *times* the ninety days needed to complete the United Cigar underwriting.

By 1910 Goldman Sachs had three senior and three junior partners. Sears's stock had already doubled—and went on to double again. To watch out for their investors' interests and because, in those days, the bankers were better known to investors than the companies they underwrote, Henry Goldman and Philip Lehman joined the boards of directors of both Sears Roebuck and United Cigar. This watchdog role led later to Walter Sachs's succeeding Henry Goldman as a Sears Roebuck director—and to his being succeeded by Sidney Weinberg in what had become known in-house as a firm tradition.

Goldman Sachs and Lehman Brothers not only found a fast-growing client in Sears Roebuck, they jointly launched a substantial business in financing retailers and up-and-coming industrial companies. Lehman Brothers and Goldman Sachs

jointly underwrote the initial public offerings of May Department Stores, Underwood Typewriter, Studebaker, B.F. Goodrich, Brown Shoe, Cluett Peabody, Continental Can, Jewel Tea, S.H. Kress, and F.W. Woolworth. In 1909, with Sears Roebuck's market value up over 250 percent, Goldman Sachs organized a nine-million-dollar syndicate to buy out Richard Sears's personal ownership.

Walter Sachs, fresh out of Harvard College, where he was elected to the *Crimson* with Franklin D. Roosevelt, joined the firm in 1907—the same year Sidney Weinberg became an assistant janitor. Sachs started as a commercial paper salesman, covering accounts in Hartford and Philadelphia. A few years later he was in Chicago, opening an account with J. Ogden Armour at Armour & Co. Because Goldman Sachs could offer access to the lower-cost London money market through its Kleinwort connection, the initial Armour account was large: five hundred thousand dollars.*

Henry Goldman and Philip Lehman developed an unusual collaborative arrangement: Lehman Brothers and Goldman Sachs would each continue with its own business specialty—commodities for Lehman Brothers and commercial paper for Goldman Sachs—while the two friends' firms conducted a joint venture in securities underwriting, splitting profits fifty-fifty. The capital required was eventually too much for the two Americans firms, so they organized a three-handed syndicate with Kleinwort &Sons, which had much more capital.[17]

Goldman Sachs's business with F.W. Woolworth & Co. illustrated Henry Goldman's drive. After being refused by another underwriter who found it "unfitting" to be identified as the underwriter of the common stock of a mere five-and-dime store chain, Frank Woolworth approached Goldman Sachs. Dynamic and imaginative, Woolworth had expanded his company by acquiring other companies and now wanted to continue expanding by branching. An aggressive financing plan was developed that still caused some awe in recollection. Walter Sachs observed many years later: "Our firm was bolder and more imaginative [than others]; and bolder still was the capitalization. To justify this capitalization required a degree of optimism almost beyond the dictates of conservatism."[18]

* Half a century later, Goldman Sachs would successfully reverse the transatlantic flow of funds, doing substantial business with major British companies because it could then raise working capital via commercial paper at cheaper rates in America than the rates charged on loans by the British banks—and, still benefiting from Kleinwort's stature, could place substantial portions of stock and bond underwritings with investors in Europe.

Sachs was not exaggerating. Woolworth's sales were sixty million dollars and its net assets fifteen million dollars. Preferred stock of fifteen million dollars was issued against 100 percent of the assets, and common stock of fifty million dollars was issued against goodwill based on projections that sales would rise rapidly and lift earnings to $5.4 million—with expectations for more growth generously added in.

Fortunately, investors were enthusiastic. Woolworth's preferred and common shares both went quickly to a premium over the issuing price. Offered at fifty-five dollars, the common stock went to eighty dollars on the first day of trading. The preferred stock was eventually retired in 1923 at $125 a share.

With successes like Sears and Woolworth, Goldman Sachs advanced rapidly from just a Jewish outsider that struggled to complete its underwritings to a firm increasingly recognized as innovative, effective, and highly profitable to itself and to investors. On April 24, 1913, a year after the successful Woolworth offering, completion of the truly monumental Woolworth building in lower Manhattan—to this day one of the most handsome skyscrapers—was celebrated at a dinner. Frank Woolworth was flanked at the banquet table by Cass Gilbert, his architect, and Sam Sachs, his banker. Woolworth introduced Sachs and Gilbert, saying, "These are the two men who made this building possible."

Until his retirement from Goldman Sachs, Arthur Sachs was a director of Woolworth, but to the firm's surprise, Woolworth did not elect a successor director from the firm. For forty years Goldman Sachs did no business with Woolworth. Still, Walter Sachs and after him Stanley Miller continued to solicit Woolworth's business. Finally, in the sixties, this led to Goldman Sachs's issuing Woolworth's commercial paper and arranging the purchase of Kinney Shoe Co. from Brown Shoe. These transactions caused Walter Sachs to observe: "I know of no situation which exemplifies better the importance of nursing an old relationship."[19] Others might question the value of forty years of solicitations for just one transaction—particularly a transaction that might have been accomplished without the considerable cumulative cost of the forty years of solicitations—but during Sachs's years of leadership, client service was particularly important because new clients were hard to come by. Still, Goldman Sachs and Lehman Brothers gained a reputation as underwriters of good companies—particularly in retailing—whose stocks performed well. Partners began to say proudly these companies bore the two firms' "hallmark."

Around the time of the Woolworth offering, Goldman Sachs took on its first full-time new-business solicitor: Colonel Ned Arden Flood, a "colorful individual, elegant in appearance, smooth in manner. Flood dressed in the height of fashion, spats and all, and invariably carried a cane."[20] Never an employee of the firm, Flood received a percentage of the profits on deals completed through his introductions. He did so well at bringing new accounts to the firm—including Studebaker and Cluett Peabody—that he retired after half a dozen years.[21] After Flood, soliciting new business was left to younger partners and the managers of the firm's branch offices. Surely it was neither a bold nor an imaginative effort. In that era—and among the leading Wall Street firms for another half century—corporations were not solicited by competitors. It simply was not done.

Those were the days," Walter Sachs later observed, "when the course of business seemed to move uninterruptedly and serenely forward."[22] But the serene family world of Goldman Sachs—two of Henry Goldman's sisters were married to Sachs brothers, and all partners in the firm were members of the two families—was disrupted by an argument over foreign affairs at a dinner at the Hotel Astor. It divided the families and broke up the firm. And this estrangement led to splitting up the joint-account arrangement that had been so successful between Goldman Sachs and Lehman Brothers.

In August 1914 Germany declared war on Russia and a day later on France and England. When Walter Sachs returned from England shortly after the outbreak of war, expecting his partners to be strongly pro-Allies—as he had assured the Kleinworts he and all his partners would surely be—he was dismayed to find Henry Goldman proudly and intensely expressing views highly sympathetic to Germany and making pro-German speeches. When his partners and sisters begged Goldman to modify or at least conceal his feelings, he refused. His public utterances became more frequent and startling. Henry Goldman admired the Prussianism that others deplored, and quoted Nietzsche to anyone who would listen.

The rift between Goldman and Sachs came to a head in 1915 when J.P. Morgan offered for public subscription a five-hundred-million-dollar Anglo-French loan. Almost all the leading houses on Wall Street were participating, but Henry

Goldman objected, so the firm could not join in. As Walter Sachs later explained, "The firm had an age-old rule that participation in any business could only be accepted if all the partners were unanimous in their desire to accept." Chagrined, the two Sachs brothers went to J. Pierpont Morgan's office, where each man subscribed personally for $125,000 of the loan.

Even America's 1917 entry into the war did not stop Henry Goldman's "utterances and tirades."[23] Nor did Howard Sachs's service overseas with the Twenty-Sixth Division, nor Paul Sachs's service in the field with the Red Cross, nor the Liberty Bond sales by other members of the firm. Nor did the Kleinworts' warning that Goldman Sachs would be blacklisted in the City of London, nor the Bank of England's forbidding Kleinwort to do any foreign exchange business with Goldman Sachs. The split within the firm rapidly worsened. Finally Henry Goldman realized he was out of step with his partners and after thirty-five years with the firm resigned from Goldman Sachs the day the firm began selling Liberty Bonds for the United States government. Goldman kept his office at the firm for a while, but "in the heated atmosphere of wartime, his very presence in the office created difficulties,"[24] so he moved uptown. Henry Goldman's departure left the firm severely shorthanded, because he had been key to all its lucrative industrial financings.

In leaving, Henry Goldman withdrew his substantial capital, which created an enormous financial problem for the firm and left its underwriting business without his dynamic, thrusting leadership.* The rupture also left Goldman Sachs under the pall of being considered a "German firm," which hurt business. Henry Goldman and Samuel Sachs would never speak again.[25] Their personal hostilities continued into the next generation, and to this day there are hardly any Goldmans who are on speaking terms with any Sachses.

After the Great War, Sidney Weinberg returned to Goldman Sachs, but his old job was gone and he was told if he wanted a job, he'd have to create one.

* Goldman left the firm a very rich man, with successful investments in Sears Roebuck and May Department Stores. In the early 1930s he traveled to his beloved Germany with the idea of settling there permanently as a demonstration of his national loyalty. He collected paintings by Rubens, Van Dyck, and Rembrandt, bought a Stradivarius for twelve-year-old Yehudi Menuhin, and gave Albert Einstein a yacht, which was confiscated by the Nazis. With Hitler rising to power, Goldman was seized and searched and was subjected to "many other humiliations," according to his family. He returned to New York in 1936, defeated and disillusioned.

He did—as a bond trader. In 1920 he married Helen Livingston, a lovely, cultured amateur pianist and the daughter of a dress manufacturer. He soon became a recognized authority within the firm on pricing, making recommendations based on his sense of the market. Weinberg also built up the over-the-counter stock-trading business. In April 1925 he bought a seat on the New York Stock Exchange for $104,000.[26] Proudly, Weinberg stressed that the money came from his own earnings: "None of it was from trading. I never traded. I'm an investment banker. I don't shoot craps. If I had been a speculator and taken advantage of what I know, I would have made five times as much money."

He became a partner of Goldman Sachs in 1927—only the second from outside the two founding families. "The people I worked with were always boosting me, and I was made a partner ahead of many people who were senior to me. They told me this was due to my personality, ability to work hard, and good health—plus integrity and character." He became the principal assistant to senior partner Waddill Catchings. As assistant treasurer of Goldman Sachs Trading Corporation, Weinberg developed his knowledge and understanding of each of Trading's various investments. In the ensuing crisis, this knowledge would catapult him into much larger responsibilities and authority within the firm.

2

DISASTER

GOLDMAN SACHS TRADING CORPORATION

While Henry Goldman and Philip Lehman's friendship brought their firms together in a long series of transactions—they comanaged 114 underwritings for fifty-six issuers—the two firms continued to be rivals that never fully trusted each other. Goldman Sachs partners believed that since they brought in a majority of the business, the original fifty-fifty agreement should be modified. Lehman partners thought Goldman Sachs was being greedy.

Partly in hopes of overcoming this problem, partners of Lehman Brothers and Goldman Sachs developed a routine in the 1920s of having lunch together each day at Delmonico's, an ornate Wall Street restaurant that specialized in rich German food. One day, only halfway through the meal, one of the Goldman Sachs partners jumped up from the table, exclaiming with alarm: "I forgot to lock the safe!"

"No need to worry," laconically responded a Lehman man, glancing around at his partners. "We're all here."

With Henry Goldman's departure, the close relationship between Goldman Sachs and Lehman Brothers, which had originated with and developed through

and depended upon the friendship between Philip Lehman and Henry Goldman, was destined to change. More and more differences arose. Arguments were increasingly frequent, particularly on the division of profits. Why, the Lehmans demanded, did Goldman Sachs take all the credit, with its name showing at the top of the advertisements, for ventures for which Lehman had supplied the money? Goldman Sachs, in turn, asked why the Lehmans expected half the profits on deals originated and managed by Goldman Sachs. The arguments frequently degenerated into name-calling. As one banker has said, "They were both too ambitious to stay married."

But there was more to it than that. In the long run, the split actually benefited both firms—Lehman Brothers most of all. It forced the Lehmans to take off their coats, roll up their sleeves, and go out and get into investment banking on their own, without depending on the crutch of Goldman Sachs. "Lehman Brothers always had a lot of money, but that's different from being aggressive to get business," said a Goldman Sachs partner many years later. "After the dispute, they became real go-getters." At the same time, the split challenged Goldman Sachs to build up its own capital.

During the later 1920s, a series of conferences was held to redefine the business relationship. The "change in the generations" had included Waddill Catchings's coming to power at Goldman Sachs and Robert "Bobby" Lehman, Paul Mazur, and John Hancock at Lehman Brothers. Sidney Weinberg was among those impatient with the Lehman relationship and wanted to end it. A formal memorandum of separation was prepared that listed sixty corporations that the two firms had jointly underwritten. Each of the sixty was allocated to the firm with the primary interest: Goldman Sachs got forty-one, Lehman Brothers got nineteen. Each firm agreed not to solicit the other firm's clients.[1]

The Lehmans continued Philip's policy of underwriting issues that seemed too undignified for other investment bankers to handle. Among these were early stock offerings in airlines, electronics, motion pictures, and liquor companies, all of which helped Lehman Brothers become what *Fortune* would call "one of the biggest profit makers—many believe the biggest—in the business." The Lehmans liked to describe themselves as merchants of money, intermediaries between men who wanted to produce goods and men looking for something to do with their surplus funds.[2]

Replacing the capital that Lehman Brothers had supplied turned out to be a challenge caused by Henry Goldman's departure that Goldman Sachs could handle well. But replacing Henry Goldman was a challenge that the firm would not handle well—although the dire results took years to unfold.

Goldman's departure left the firm without an entrepreneurial leader in underwriting, the main business of the leading firms in Wall Street and the standard by which industry stature was and still is measured. Despite its success in the retailing industries, Goldman Sachs was still relatively unimportant. The Sachs family was now clearly in control, but no employee of the firm was capable of providing the bold, effective leadership Goldman Sachs would clearly need to recover its prewar momentum in investment banking.

The search for a successor to Goldman led the partners in 1918 to invite Waddill Catchings to join the firm and head up underwriting. Catchings, who grew up in Mississippi, seemed just the man. A close friend of Arthur Sachs's at Harvard, he went on to Harvard Law School and joined Goldman Sachs's future law firm, Sullivan & Cromwell. There he attracted the attention of James Wallace, president of the Central Trust Company, who invited Catchings on successive occasions to head reorganized companies: Millikan Brothers, Central Foundry, and Sloss Sheffield Steel & Iron. This gave Catchings substantial industrial experience. During the war years, he was part of the organization set up by J.P. Morgan & Co. under Edward R. Stettinius to purchase war supplies for the Allies, so in the final year of the war Catchings was able to become quite familiar with Goldman Sachs, its clients, and its activities. His training and experience seemed to suit him ideally for his major role at the firm. On top of all that, Catchings was one of the most talented, charming, handsome, well-educated, and upwardly mobile people in Wall Street.

Yet Catchings would in just ten years very nearly destroy the firm, proving once again that articulate optimists encouraged by early successes and armed with financial leverage can become hugely destructive.

"Waddill Catchings was very tall, quite handsome, and had great charisma," said Albert Gordon, the long-serving leader of Kidder Peabody, who began his career at Goldman Sachs. "More important, he not only was a lawyer, a partner

of Sullivan & Cromwell, but had had real experience in industrial management. He also had great charm and a generous way with employees. For example, he had scheduled the two of us to go together to Pittsburgh to call on an important prospective client corporation, but when he heard of my plans to go duck hunting that same weekend, he simply called the CEO and explained that that tentative date would be inconvenient and suggested an alternate date. That's the way he was."[3] Proudly self-confident, sure of his standing, he was easing into arrogance.

Catchings wrote a series of books with an easy, engaging prose style that expounded optimistically on the promising economic prospects for America. In one visionary and best-selling volume, cheerfully titled *The Road to Plenty*,[4] he exuberantly explained: "If business is to be kept zooming, production must be kept at high speed whatever the circumstances." Naively, he believed that the business cycle no longer threatened and that America's economic prospects were truly limitless. Convinced that his Harvard professors had been far too theoretical about long-run economics while real people cared much more about short-run results, Catchings saw himself as just the person to take the middle way and integrate up-to-date theory and real-world practice. He intended to establish himself as a national thought leader and was gaining the public attention he sought.

Meanwhile, confidence was running high among the partners of Goldman Sachs, and with Catchings's dynamic leadership in underwriting, the firm was once again clearly moving ahead and entering an active period of industrial financing. Goldman Sachs's first underwriting after the war was an issue for Endicott Johnson, the shoe maker, in 1919. The postwar boom in business, "which grew with astounding rapidity" through the twenties, led to an era of mergers in which the firm played an increasingly important part.[5]

With his successes, Catchings became increasingly self-confident and insisted on a larger and larger ownership share in the firm. By 1929 he held the largest single percentage in the partnership and was clearly the leader of Goldman Sachs.

However, Philip Lehman, the leader of Lehman Brothers, was not favorably impressed. He felt Catchings lacked balance and was too aggressive and optimistic. But Lehman's doubts didn't faze Catchings's partners. Neither did the cautions of Catchings's Harvard classmate Arthur Sachs. The partners of Goldman

Sachs, determined to make up for the loss of Henry Goldman, had been looking for a real go-getter, and Catchings was the man of the hour.[6]

The exciting "New Era" of economic growth accelerating through the 1920s brought increasing public recognition of America's stature in the world, exciting new technologies, and a booming stock market with wider and wider participation by individual investors. Before investing in stocks became widely accessible, individual investors' principal investment opportunities had been confined primarily to railroad bonds and mortgages on single-family homes. Catchings got more and more interested in the trading side of the firm's business. He organized several successful pooled trading accounts, installed a stock ticker in his office, and encouraged expansion in foreign exchange. The nation's giddy overconfidence was best represented by a wonderfully optimistic 1928 article in a popular magazine, written by the chief financial officer of General Motors Corporation, John J. Raskob. With the encouraging title "Everybody Ought to Be Rich," it presented a "simple plan of moderate, prudent" borrowing on margin to buy more and more fully into the steadily rising stock market. (Eventually, however, Raskob himself sold all but three thousand of his 150,000 shares of GM.)

In this heady environment, Catchings's charismatic presentation of his optimistic views and his penchant for bold action would lead the firm into a major public commitment and a massive public failure. With enthusiasm, Catchings advocated creating a modern "corporation of corporations"—a holding company or investment trust similar to those being established by other securities firms. In his vision, a truly dynamic business organization would move out of markets or products with declining profitability and move into markets and products that were new and dynamic. The one great objective for investor-owners was profits—maximum profits on their invested capital—with products or markets merely the means to achieve that end. So the truly modern business leader would run a pure investment trust—and concentrate on redeploying capital to maximize profits.

Organized as holding companies, the investment trusts were promoted as companies whose business was investing in, controlling, and managing other companies. Often, but not always, these holding companies were concentrated in a single business, particularly insurance or banking (such as A. P. Giannini's Transamerica, which was an outgrowth of his original Bank of Italy, later named

Bank of America) or utilities (such as the empire constructed by Samuel Insull). The benefits, in management, innovation, and financing, of corporate consolidation were being demonstrated over and over again by the increased profitability of such merger-created corporations as General Motors, General Electric, General Foods, and International Harvester.

Catchings saw no reason to confine his futuristic vision to just one industry. Why not create companies that would use these exciting modern techniques of finance and management *and* be free to go into any industry where opportunity was particularly great and promising—where experts in modern management and finance could make the greatest gains for investors!

Investment trusts were designed to capitalize on the continuing growth opportunities for American business, which many assumed were inevitable. And not unlike the conglomerates of the 1960s, they specialized in "financial engineering" as they concentrated on maximizing profits to shareholders. Often using borrowed money and increasingly elaborate "senior" financing—such as preferred stock, convertible debt, convertible preferred stock, or debt with warrants attached to buy equity—the trusts raised capital to buy a controlling interest in operating companies. They gained control of other corporations that, in turn, controlled still other corporations as subsidiaries. The layers of corporations controlling corporations that controlled still other corporations and the opportunities for financial leverage seemed nearly endless. The remarkable extent of corporate pyramiding by investment trusts was illustrated by one retailer, Metropolitan Chain Stores, whose dividends went through eight tiers of holding companies; the cash dividends paid out to common-stock investors were what little remained after paying the required dividends and interest expenses of all the layers of senior securities.[7] The idea of creating investment trusts seemed to open new horizons for financial creativity to capitalize on the New Era in American industry.

Seeing the remarkable profitability of other firms' ventures with investment trusts, the partners of Goldman Sachs got more and more enthusiastic. As Walter Sachs later ruefully noted, "All would have been well had the firm confined its activities strictly to the type of business which had been done over the years." Al Gordon recalled, "Catchings got quite concerned about the booming speculation on margin in the late 1920s and for a while was almost bearish. Then, with most unfortunate timing, Catchings became convinced that he could see and project all

the great growth that was ahead for this country. He became quite bullish at the worst possible time . . . in the spring of 1929."

As plans developed, the scale of the proposed investment trust was rapidly expanded. From a moderate twenty-five-million-dollar initial plan, the proposed size of the trust was doubled to fifty million dollars, and then doubled again to one hundred million dollars (about $1.2 billion in today's dollars). A salient indicator of the ascending prominence of the "trust concept" within the firm was the name it was given: Goldman Sachs Trading Corporation. As originators, partners of the firm bought 10 percent of the original offering, and that ten million dollars represented nearly half the firm's total capital. The rest of the offering, even though the trust had not yet begun operations, was heavily oversubscribed by the investing public, and the firm made a quick profit of over three million dollars on its initial stake, lifting expectations still higher. In addition to its stock ownership, Goldman Sachs would be paid 20 percent of the trust's net income for its management.[8] Immediately after the initial public offering, the price of shares in Goldman Sachs Trading leaped up—in just two months, the stock jumped from its $104 offering price to $226 per share, twice its book value in shares and cash.

Flush with success and eager to expand, Catchings arranged a merger with another investment trust, Financial & Industrial Corporation, which controlled Manufacturers Trust Company and a group of insurance companies. This doubled the assets of Goldman Sachs Trading to $244 million just three months after the original issue.

Walter Sachs described the growth of Goldman Sachs Trading as meteoric. The trust went rapidly on to control companies with total assets over $1.5 billion. As Sachs put it, "Rising markets in investment trust shares during 1929, to which the shares of Goldman Sachs Trading were no exception, led to grandiose ideas involving further bank acquisitions."[9] Goldman Sachs Trading gained dominant ownership positions in banks in New York, Philadelphia, Chicago, Los Angeles, and San Francisco, as well as in insurance and industrial companies.[10]

With serene confidence in continuing success, Catchings and Goldman Sachs were caught up in the elation of the time and went boldly on to add further leverage—at the worst possible time. Despite its high price, Goldman Sachs Trading repurchased fifty-seven million dollars' worth of its own shares. Joining forces with Harrison Williams, who was expanding his utilities empire, Goldman Sachs

Trading in the summer of 1929 launched two new subsidiary trusts bearing the picturesque names Shenandoah and Blue Ridge and through them invested in such holding companies as Central States Electric, North American Company, and American Cities Power & Light. In addition to fifty million dollars of preferred stock, Shenandoah sold one million shares of common stock to the public at $17.80. Four million shares were taken at only $12.50 by the promoters: Goldman Sachs Trading Corporation and Central States Electric Company.[11] Both hands were in the cookie jar, but euphoric investors didn't care. Shenandoah shares, seven times oversubscribed, closed the first day of trading at thirty-six dollars. Shenandoah was both oversubscribed and overleveraged with $42.5 million of convertible preferred stock providing over one-third of its total capital. (Like debt, preferred stock is senior to common stock, and its dividends, like bond interest, must be paid before common dividends.) One month later, Blue Ridge was launched. In leverage, it went even further: fifty-eight million dollars of preferred stock or 44 percent of $131 million in total capital. Together these preferred issues had annual dividend commitments of nearly six million dollars. Goldman Sachs Trading owned 40 percent of Shenandoah, and the partners of Goldman Sachs must have felt euphoria worthy of the first man to invent a perpetual motion machine.

Partners of Goldman Sachs put considerable pressure on associates in the firm to invest in the new investment trusts at double the amount each had taken in Goldman Sachs Trading. When a young associate declined the "invitation" being made to all employees to subscribe to the Shenandoah issue, Sidney Weinberg, by then Catchings's number two at Goldman Sachs Trading, sternly scolded the recalcitrant: "This won't help you here."[12]

Goldman Sachs Trading Corporation and its two new subsidiaries greatly expanded Goldman Sachs's reach. With total capital of less than twenty-five million dollars, the firm effectively controlled five hundred million dollars in investments—approximately six billion dollars in today's dollars. This was wonderfully convenient for an active, deal-minded Wall Street firm. Goldman Sachs Trading controlled banks and insurance companies that the firm could encourage to buy the newly issued corporate securities that Goldman Sachs was underwriting, while the controlled corporations generated investment banking business for the firm. All this was in addition to the substantial profits from originating the three investment trusts and any gains on the shares held by the firm.

But as Walter Sachs later observed, "The entire structure had become top-heavy and too extensive for easy and intelligent management." Goldman Sachs Trading's portfolio was far too concentrated: If any of its major holdings cut or stopped paying dividends, the trust would become a house of cards. And that is what happened when American Trust Company of San Francisco—then nearly 50 percent of Goldman Sachs Trading's total portfolio—stopped paying dividends in July 1929. North American, a utility holding company controlled by Shenandoah and Blue Ridge, never paid a dividend.

In early 1929, Goldman Sachs Trading had bought thirty thousand shares of Guardian Group shares at $130, versus a market price of $120. Trading soon made a good profit. But Guardian wanted to be independent, so its directors asked Sidney Weinberg to sell the shares back. Correctly expecting the share price to keep rising, Weinberg indignantly refused. But by October 1929, when the market price had fallen from a high of three hundred dollars to $220, another approach by Guardian got an agreement from Weinberg, who was trying to raise cash, to sell twenty-five thousand shares at $184. Weinberg got the better deal: When Guardian attempted to resell those shares, it could unload only seven thousand. In November, to save embarrassment, Guardian directors, including Edsel Ford—one of the company's original sponsors, who had put up $1.2 million—bought the balance of the shares at $184 even though the market value had by then dropped to just $120.[13]

Walter and Arthur Sachs were traveling in Europe during the summer of 1929. In Italy they learned of the deals Catchings was doing on his own, and Walter Sachs got worried. On his return to New York, he went straight to Catchings's apartment in the Plaza Hotel to urge greater caution. But Catchings, still caught up in the bull-market euphoria, was unmoved. "The trouble with you, Walter," he said, "is that you've no imagination."[14]

The Dow Jones Industrial Average had begun 1929 at exactly 300, fluctuated over the next five months between 300 and 320, and then soared in both price and trading volume. It peaked at 381 on September 3: thirty times 1929 earnings per share, over four times book value, and yielding only 2.5 percent in dividends—astounding numbers in those days. Euphoria was easy to find—National City

Bank of New York stock traded at 120 times earnings, and several companies, including International Nickel, sold at ten times book value. New common stock issues jumped from an average annual volume of five hundred million dollars to ten times as much in 1929—$5.1 billion, dominated by the investment trusts.

By October 23, the Dow had fallen back down almost to its January level of 305. The 20 percent decline in less than two months provoked widespread margin calls, and selling seemed sure to accelerate. On Thursday, October 24, the New York Stock Exchange required all 1,100 members be on the floor for the 10 a.m. opening.[15] Prices fell quickly, and in just half an hour the ticker tape was sixteen minutes late. By one o'clock the tape was ninety-two minutes late. The 3:30 closing prices were not reported until 7:35 that evening. Trading volume was a record 12,894,650 shares—three times the normal volume. Then margin calls and European selling, combined with urgent selling by brokers whose short-term loans were being called, ignited heavy selling on the day still called Black Friday, as 16.4 million shares traded—another record—and major stocks dropped 20 percent to 30 percent. (Prices temporarily turned around on November 14 and rose 25 percent over just five days—and then added another 6 percent. The Dow closed the year at 248.)

With the October stock market crash, Goldman Sachs Trading Corporation, which had seemed so sure to be a great success, quickly turned into an astounding failure. Trading's shares took their first big plunge from $326—on their way to just $1.75, or less than 2 percent of their original value and less than 1 percent of their market high. While all the investment trusts suffered, Goldman Sachs Trading—because it was so large and so highly leveraged and because Catchings had optimistically made overly concentrated investments—became one of the largest, swiftest, and most complete investment disasters of the twentieth century. And since the investing public saw no real difference between Goldman Sachs and Goldman Sachs Trading Corporation, the harm done to the firm and its reputation was comparably horrific.

In the crucial period, as the crash gathered momentum, Waddill Catchings was not at Goldman Sachs: He had left New York for the far West, partly to see to Goldman Sachs Trading's western investments firsthand, and partly to divorce

his wife. In early 1930, as the stock market appeared to improve, Catchings called from California to tell Weinberg, who was working closely with him, of the "splendid" opportunities he saw for further investment on the Pacific Coast. At the time, Goldman Sachs Trading had debts and forward commitments of twenty million dollars. Stubbornly bullish, Catchings proposed issuing fifty million dollars of two-year convertible notes to fund the existing debt and provide funds for bold action: "With the remaining $30 million, Taylor out here can make a world of money."*

Sidney Weinberg and Walter Sachs agreed that such a note issue would be folly and decisively rejected Catchings's proposal. They were thinking differently now about Catchings. Walter Sachs spoke to his brother Arthur the next day, saying apologetically, "You have been right about Catchings and I have been wrong. I am afraid that he will never learn." Walter Sachs then went to Chicago to meet Catchings for several hours at the University Club. "I told him in no uncertain terms that in the future he could not carry on without the complete approval of the entire partnership." Sachs[16] was too late.

Necessarily, a program of quiet liquidations to pay off debts was begun, even with the difficulties of a falling market and the illiquidity of most of Goldman Sachs Trading's investments. Catchings came back to New York City, where, at Weinberg's initiative, he was obliged by the other partners to resign as president of Goldman Sachs Trading Corporation in May, to quit as a director of companies in which it was invested, and to withdraw from the Goldman Sachs partnership at the end of 1930.[17] In one last hurrah, Catchings organized a stock market pool of speculators to invest in Chrysler. Between October 1929 and July 1930 it lost $1.6 million.[18]

Under Sidney Weinberg's direction, Goldman Sachs Trading Corporation was steadily wound down and eventually taken over by Floyd Odlum's Atlas Corporation, which bought shares of various trusts at major discounts from their net asset values. Atlas acquired eighteen trusts by late 1932, increasing its per-share book value even as others were plunging—and trading on the stock market at a premium over book value while others sold at a discount. The financial cost to Goldman Sachs was punishing. In an enormous double whammy, the firm not

* Frank Taylor, who had been affiliated with Tucker, Hunter, Dulin & Co., a Pacific Coast investment house that had become a subsidiary of Goldman Sachs Trading.

only lost the chance to make the great fortune it had so recently and confidently expected, but it also suffered huge losses, taking its accumulated capital down to the level it had passed thirty long years before and eliminating the fruits of all the labors of an entire generation.[19] The venture cost Goldman Sachs, which never sold a share of its own original stake in Goldman Sachs Trading Corporation, more than twelve million dollars. Recognizing the destructive impact of these losses on their younger partners, the Sachses announced that their family would cover partners' losses. As the Depression settled in, employees were asked what minimum salary they needed to live on—and were paid just that sum and no more.[20]

For Walter Sachs, now serving as president of Goldman Sachs Trading Corporation, it must have been painful to go before one after another group of irate stockholders and appear in court to defend against shareholder suits.* Catchings got a termination payout of $250,000, and his capital account deficit was absorbed by the other partners. He moved to California, wrote another book—*Do Economists Understand Business?*—and produced various radio programs. Walter Sachs observed of Catchings: "Most men can stand adversity; very few men can stand success. He was not one of them. He . . . had had no money. He suddenly thought himself to be a rich man. He *was* a rich man on paper. In that very year—it all happened in twelve months—he just went haywire. We weren't smart enough, perhaps—or perhaps we were too greedy, too—but we didn't stop it in time."[21]

By 1931 the losses of Goldman Sachs Trading exceeded by far the losses of other investment trusts.[22] Of the $172.5 million lost by fourteen leading trusts, Goldman Sachs Trading accounted for $121.4 million, or 70 percent. In distant second place on this dishonor roll was Lehman Corporation, which lost just under $8 million.

With 70 percent of its assets tied up in Shenandoah and American Trust Company, both paying no dividends, Goldman Sachs Trading's revenues plunged from five million dollars in 1930 to just five hundred thousand dollars in 1932. It couldn't pay six million dollars of dividends on the preferred stock, nor the one million dollars in debt interest.

For the proud Sachs family, the failure of Goldman Sachs Trading Corporation became a very public humiliation. In 1932, Eddie Cantor, the popular

* Sidney Weinberg took his son Jim to court in Foley Square on the day when Judge Milton Pollack threw out the last lawsuit linked to Goldman Sachs Trading—in 1968.

comedian and one of forty-two thousand individual investors in Goldman Sachs Trading Corporation, sued Goldman Sachs for one hundred million dollars while regularly including in his vaudeville routine bitter jokes about the firm. One: "They told me to buy the stock for my old age . . . and it worked *perfectly*. . . . Within six months, I felt like a *very* old man!"

The Sachs family's stress and anguish were exacerbated when the trust's third-largest investment—Manufacturers Trust Company, a major lender to the Jewish garment industry—cut its dividend and a run on the bank began. The best solution for the bank was to join the New York Clearing House, whose members guaranteed each other's deposits. But the price of admission was high: separation from Goldman Sachs Trading and the installation of a non-Jew as CEO.[23] The crude message clearly reflected anti-Jewish prejudice, which Goldman Sachs would experience for many years.

For the Sachses, the hardest part was the harm done to their family firm's reputation, to which they had devoted so much time, effort, and attention. In the last years of his father's life, when Walter Sachs called on the man who had seen the firm grow over fifty years from tiny beginnings, "He was interested in only one aspect: how the name was regarded." Sam Sachs would die in 1934, at eighty-four.

Goldman Sachs Trading canceled its management contract with Goldman Sachs near the market bottom in April 1933 and changed its name to Pacific Eastern Corporation. That September, Floyd Odlum bought an additional 501,000 shares, gaining over 50 percent control of a mixed bag of small stocks that had not participated fully in the market recovery.[24]

Because he knew the companies previously served by Waddill Catchings, Weinberg was selected as a director for, among others, Sears Roebuck, Continental Can, National Dairy, B.F. Goodrich, and General Foods. At the same time, Weinberg led the painful process of reconstructing the firm's position on the Street.

It could have been worse. Goldman Sachs nearly lost the man who was destined to be its decisive leader. A decade after Henry Goldman had resigned because he supported the Kaiser, Sidney Weinberg went to him. Weinberg explained that he did not think the Sachses were particularly bright and said, "I want to work for you, because you've got the brains." Henry Goldman declined, saying: "My career is ending. You stay with Goldman Sachs."

3

THE LONG ROAD BACK

Goldman Sachs was fighting for its life all through the Depression and World War II and was profitable in only half of the sixteen years from the 1929 crash to the end of the war. Most partners owed the firm money because their partnership income was less than the moderate "draws" that their families needed to get along.[1] There was little need for Wall Street services, particularly services from a midsize Jewish firm with few distinctive capabilities and a prominent negative reputation from the failure of Trading.[2] In the early thirties, the firm neither led nor co-led any underwritings, and in 1935 it did only three debt placements that totaled less than fifteen million dollars. This period was later described euphemistically by Walter Sachs as a time of "defensive action" as the partners worked to unravel the many problems caused by Goldman Sachs Trading Corporation and "fought valiantly to retain the firm's corporate relations." Sachs always called it "Trading Corp."—apparently reluctant to use the firm's name when identifying the great failure.

The Sachs family was vital to the rescue of Goldman Sachs in an essential but unusual way: They stepped aside. Howard and Walter Sachs knew that, having become accustomed to genteel affluence, dignity, culture, and refined tastes, they

were not the right people for the gritty job that had to be done. They couldn't do it. So they took secondary roles for themselves and gave Weinberg the power to lead the firm, knowing he was smarter and tougher than they were and could do what had to be done. Arthur Sachs, living abroad with his French second wife, agreed with them; he retired and eventually withdrew his capital. Weinberg himself had no alternatives either, particularly when the Sachs family agreed to underwrite and forgive well over one million dollars of his share of the operating losses.

Jim Weinberg, Sidney's older son, gives the Sachs family great credit for sustaining the firm: "Over the twenty years from 1927 to 1947, Goldman Sachs made $7 million—and lost $14 million. The Sachs family were extraordinarily important to the firm for many, many years and in many ways, but surely the most important was their stamina and persistence over twenty long years of staying with the firm, covering the losses of others, and never compromising on any of the firm values they believed in."

Where the Sachses were genteel, cultured, and had refined tastes, Weinberg was smart, tenacious, and aggressive. "We had learned to live by the street code: you do everything right—and nothing wrong," explained Weinberg, who had scars on his back from knife fights as a newspaper boy. "We would never retreat for anything or from anybody." Al Gordon, later senior partner of Kidder Peabody, recalled an instance of Weinberg's aggressiveness in the 1920s that still rankled more than seventy years later. Goldman Sachs and Lehman Brothers were preparing to underwrite what was then an unusually large bond issue—fifty million dollars—for National Dairy Products. Gordon, having met Sumner Pike of Continental Insurance on behalf of Goldman Sachs, became convinced that the market was underestimating National Dairy's creditworthiness, so, on his own initiative and based on his own analysis, he urged Pike to invest in the National Dairy bonds. Appreciative, Pike insisted that the lucrative order for two million dollars of bonds go entirely to Goldman Sachs, even though a Lehman Brothers partner was on Continental's board of directors. Continental's order—the largest placed by any investor in that bond issue and the largest order Goldman Sachs had ever gotten—produced a seventy-thousand-dollar commission (over eight hundred thousand dollars in today's dollars). Gordon naturally thought the credit was rightfully all his, but Weinberg, as the partner in charge of distribution, took full credit for himself. It would not be their only confrontation.

"He was a trader and built the firm's over-the-counter business," recalls Gordon. "Salomon Brothers, Asiel, and Goldman Sachs were the recognized trading firms in the 1920s. Weinberg was very competitive and ran Goldman Sachs with an iron hand. He wanted me to work for him, but I shifted to commercial paper and the new business department. From time to time thereafter, he would try to get me to come back into his area, but I wouldn't go. He had much too dominating a way of operating."

Weinberg knew the markets and had a quick mind for numbers, people, and markets. To price a Sears bond issue, Stanley Miller, a persistent number cruncher, worked out an enormous spreadsheet with all the conceivable interest rates along one side and years to maturity along another side. He'd labored all night, pulling the long handle of one of the huge NCR adding machines to get each possible combination. As Miller was unrolling his masterpiece, Weinberg simply announced that the bonds would be issued at par with a 4⅜ percent coupon—and he was exactly right for the market.

Weinberg had an extraordinary capacity to appraise people, and on one occasion it saved him some real money.[3] Richard Whitney, then chairman of the NYSE but soon to be jailed for serious fraud,[4] had gotten in the habit of stopping stock exchange members to make surprising requests for large personal loans, often several hundred thousand dollars at a time and always without collateral. Widely recognized as the House of Morgan's broker and the brother of George Whitney, one of J.P. Morgan's senior partners, Whitney was tall, impeccably dressed, and imperious. In what might have seemed a great compliment (if he hadn't shown his disdain for Weinberg by calling him "Weinstein"), Whitney once asked Weinberg to lend him the relatively small sum of fifty thousand dollars. Weinberg said he'd think it over and, returning to his office, called Whitney to say he would not make the loan. Asked by a colleague why he hadn't refused Whitney right away, Weinberg said, almost sheepishly, "I wanted to be a little more gentlemanly."[5]

Weinberg could be strikingly generous, as E. J. Kahn Jr. noted in his 1956 *New Yorker* profile: "On learning that a former business rival of his had run into hard times, Weinberg called on the fellow and, after satisfying himself of the reality of his plight, summarily arranged to provide him with a hundred dollars a week for the rest of his life." As B.F. Goodrich's board of directors was meet-

ing in Akron in 1931, a run started on the local banks, threatening hardship for Goodrich and its thousands of employees. Weinberg offered to see what could be done and spent the next ten days examining the banks' books. Convinced that they could make it if they got enough help, he called New York and persuaded some bankers there to put up the money. The doors of Akron's banks stayed open, the funds of Goodrich and its employees remained intact, and Weinberg came back to New York, another little job out of the way."[6]

Goldman Sachs was in a period of acute "internal management transition" and anxiously hoping for a business recovery. As Ernest Loveman, then one of Goldman Sachs's five partners, cheerfully said, "We have to have a good future because we can't get any lower than we are now." From that "can't get any worse" base, Weinberg led in consolidating the firm's position on Wall Street in what *Fortune* described in 1937 as "one of the most remarkable investment banking comebacks of the decade."[7] The firm decided to expand, and as Walter Sachs described the results: "We carried on with a sharply expanding business for the ensuing twenty-five years,"[8] though profits remained elusive until the mid-1940s.

Weinberg increasingly clearly ran the firm, and it soon became known as Sidney Weinberg's firm. Even though Goldman Sachs was a family firm, he was tough on the Sachses. To make it clear to everyone that the Sachses were *not* in charge, he put a round table in the partners' dining room so no Sachs could ever sit at the head of the table. Weinberg moved up fast and was continuously aggressive. His percentage participation in the Goldman Sachs partnership began in 1927 at 9.5 percent, but grew to 30 percent by 1937. Sullivan & Cromwell rewrote the partnership agreement so that a small trust owned the rights to the name Goldman Sachs; when the other two trustees died, Weinberg personally controlled the name. Weinberg's stated secret of success: "Love of hard work, no fear of tackling anything—and liking every minute of it." He didn't mention intimidation, but others certainly would.

Troubled times can uncover opportunities as well as problems, and Goldman Sachs experienced both. When Weinberg went around to call on the senior people at other firms, several refused to see him because his firm was not important or because of the failure of Goldman Sachs Trading Corporation. Opportunities came in commercial paper where, as others struggled, the firm expanded through the acquisition in 1932 of its main rival, Hathaway & Company, which gave the

firm strength in the Midwest.[9] And a few years later, when Boston's Weil McKay & Company split in two, the McKay brothers brought their Southern textile accounts into the firm. With economic recovery, the market for commercial paper would expand substantially beyond commercial banks to include other kinds of financial institutions and industrial corporations. While "the business is done on a rather close margin of profit,"[10] the volume became so large that it could be relied on as a regular source of profit and, far more important for the firm's future, as an opening-wedge line of business with many corporations.

In 1935 a new crisis for Sidney Weinberg hit the front pages of the newspapers: McKesson & Robbins—on whose board Weinberg sat, supposedly looking out for investors' interests as an independent, "outside" professional director—was suddenly bankrupt, after several years of reporting substantial and apparently steady progress. The failure was no accident: It was part of a major accounting fraud. Originally a Bridgeport, Connecticut, manufacturer of pharmaceuticals, McKesson & Robbins was controlled by a man called F. Donald Coster, whom Weinberg had met on a vacation. Coster, cruising near Nantucket, where the Weinbergs rented a house each summer, invited Weinberg to come aboard his 134-foot yacht. As the Weinbergs rowed out, the yacht captain waved off their small, decrepit rowboat—until Coster came to their rescue.

Coster had conceived the idea of acquiring drug wholesalers across the country to create a nationwide drug manufacturing and distributing organization. Having persuaded accountants at Price Waterhouse to accept an inventory "verification"—done by Coster and other McKesson officials—which purported to show that the company had, supposedly in a large warehouse in Canada, a large inventory of crude drugs that it did not have,[11] the company reported hugely overstated "earnings."

McKesson's bankruptcy came as a stunning surprise, but it should have been no surprise at all. As it unfolded that Coster was an impostor whose real name was Philip Musica, that name triggered an old memory. A check of the credit files showed that Walter Sachs's father had, many years before, red-penciled the comment that Goldman Sachs should not do business with Musica, who had been accused of irregularities by U.S. Customs.[12] In addition, Walter Sachs had, several years before, refused "Coster's" request that Goldman Sachs sell several million dollars in notes to finance McKesson's continued expansion. A rueful Weinberg

said, "All I know is that the figures of the crude drug department showed that it was doing a splendid and profitable business." His self-appraisal: "I just wasn't very bright." During an emergency meeting of the McKesson directors, news came that Musica had committed suicide. Weinberg didn't miss a beat: "Let's fire him for his sins anyway!"[13]

Apparently Weinberg learned his lesson. According to George Doty, later a partner of Goldman Sachs, "Sidney could and would smell a rat a mile away. Sidney Weinberg's fondest word was *integrity*. He virtually worshipped that word, and what it meant for him"—honesty and putting customers' interests first. "Mistakes were quite forgivable, but dishonesty was unpardonable. He was a looming presence and Mr. Integrity. If ever a question of ethics came up, it would be described as a 'Sidney Weinberg question.' "

"The real culture of Goldman Sachs traces back to Sidney Weinberg," says Al Feld, who worked at the firm for more than fifty years. "Tough as nails, he held the firm on the straight and narrow path of very high ethics—and true fellowship throughout. Goldman Sachs was a total meritocracy. Mr. Weinberg tolerated none of the politics or infighting that hurt so many of the other firms. And the key to there being no political games was the omnipotence of Sidney Weinberg, who was tough and endowed with tremendous energy."

One use of that power was to keep payouts to partners low, forcing them to build up equity in the firm. "Sidney Weinberg set the policy on tough capital retention," says partner Peter Sacerdote. "It was good for the firm because it made everyone focus always on what was best for Goldman Sachs as a whole firm. And it was good for the individual partner because it kept you financially modest. You couldn't get into fancy spending habits because you didn't have the money to spend."

Hard as he worked at rebuilding Goldman Sachs, Weinberg was also seriously engaged in reforming Wall Street—and in national politics and as a director of many major corporations. When the New York Stock Exchange was reorganized in the early thirties, Weinberg played an important behind-the-scenes role as a member of an insurgent group, persuading Carl Conway of Continental Can and Thomas McInnerny of National Dairy to head the crucial

committee on reorganization, known popularly as the Conway Committee. Weinberg became a member of the NYSE Board of Governors. When he declined to run for a second two-year term in 1940, he successfully advocated the election of William McChesney Martin Jr. (later the longest-serving chairman of the Federal Reserve) as the first paid president of the New York Stock Exchange. After the Second World War, he orchestrated the election of Keith Funston, whom he had earlier recruited to the War Production Board.

Having tasted politics in 1932 by working for Franklin D. Roosevelt as a member of the Democratic Party's National Campaign Finance Committee, where he raised more money than any other member,[14] Weinberg launched a long series of relationships with occupants of the White House that would continue for more than thirty-five years. Almost everybody on Wall Street voted against FDR, and many distrusted him or literally hated him. For Weinberg this was an opportunity to go the other way and reach out to be helpful to the president, and he took it. In 1933 the president had him organizing the Business Advisory and Planning Council, through which corporate executives could present their views to the government with an assured hearing. And suddenly, there he was—a Jew from a Jewish firm of no great stature on Wall Street—extending as valuable an invitation as a business executive could have: to be one of the corporate executives who would meet with the top people in government and speak on behalf of the American business community.

The council became the bridge between business and government during the New Deal, helping coordinate business and government relations, clearing up misunderstandings, and restoring confidence. Weinberg not only decided who got invitations, he made sure he was the only investment banker in the group, making him the classic fox in the chicken coop. With an engaging personality and a great gift for gab, he was a star of the show and was soon known to everybody. He knew exactly how to capitalize on all these contacts. With his subsequent War Production Board service, he soon became the number one go-to man between corporate America and the U.S. government.

President Roosevelt paid Weinberg a singularly handsome tribute, considering the source, by conferring on him the nickname "The Politician." In recognition of his ability to handle touchy problems smoothly and effectively, FDR also offered him a number of federal appointments—including cabinet

positions—and nearly proposed him for the new Stock Market Board, the predecessor to the Securities and Exchange Commission.[15] As reported at the time, "What the brokers have feared is that it may be extremely difficult to get men of sufficient experience in business and finance to serve on the Commission because of the small $10,000 salary and the requirement that Commissioners have no other business interests. Among the possible nominees, including T. J. Watson of IBM and General Robert E. Wood of Sears Roebuck, Mr. Weinberg is regarded as having the most thorough knowledge of the stock market."[16] In 1938 he was informally offered the post of ambassador to the Soviet Union.[17] The Russians had already been sounded out and had accepted Weinberg, but when he realized that anti-Semitism was gathering momentum there, he graciously begged off, mischievously saying: "I don't speak Russian. Who the hell could I talk to over there?"[18] The president wrote Weinberg a letter of regret, which he kept on display in his office with the rest of what he fondly called "my mementos."

In 1939 Weinberg got another assignment: conducting an exhaustive study of investment banking for FDR, with particular attention to the wholesale and retail distribution of securities.[19] Again and again, Weinberg said that "government service is the highest form of citizenship,"[20] and as World War II began, he joined up full time. "I'll never take a job in government in peacetime, but I'll take any job in time of war."

Weinberg was active in forming the Industry Advisory Committee in 1941, initially as assistant director of purchases under Donald Nelson, a former executive vice president of Sears Roebuck who headed the War Production Board. Weinberg's main job for Nelson was to get the very best executive talent he could for the war effort. (Another task was arranging the presence of attractive young women—the Miss Indianas and Miss Ohios for whom Nelson had such an enormous appetite that the FBI worried that the Germans might figure it out and plant some of their female spies in Nelson's bedchamber.) Weinberg also became acquainted with young Henry Ford during this period, earned his trust, and established what would become a most important friendship.

He advanced to be chief of the Bureau of Clearances, where he was paid the classic wartime patriot's one dollar a year. On January 26, 1942, Weinberg was made assistant to the chairman of the War Production Board, where General Motors's Charles E. Wilson observed: "His wide and influential friendships were

invaluable in inducing outstanding men to come to Washington to work with us." That put it politely. Weinberg, as usual, put the matter far more directly. To get the numerous top-flight young executives he needed, Weinberg called on practically every giant corporation in America, met one-on-one with the CEO, and explained his mission clearly and forcefully: "Our nation is in grave danger. America needs an enormous number of talented executive leaders to organize a *massive* war production effort. The President has sent me here to get your help in identifying your very best young men. We need the smartest young stars you've got. And don't you even *think* of passing off older men or second-raters. I'm asking the same thing of every major company in the country, and I'll be watching *very* closely how well your men do compared to the best young men from all the other corporations. God forbid the people you pick are less than the best because God, President Roosevelt, and I would *never, ever* forgive you."

Affectionately called "the body snatcher" by FDR because his CEO meetings proved so very effective, Weinberg rapidly accumulated an extraordinary advantage for an investment banker: He got to know large numbers of America's best young executives and to see firsthand how effective each one really was, what work he was best at, and with whom he worked particularly well. After the war, hundreds of these same executives went back to run their companies, and many decided to make Sidney Weinberg their investment banker. Many more, when they became CEOs, were looking for suggestions as to who would be effective directors—and they usually wanted other CEOs. Weinberg knew more young CEOs than anyone else and was perceptive about which people would work well or not so well with each other person or group. He became a high-volume, high-level matchmaker who was discreet, got things done quietly and effectively, and was remarkably successful. More than anything else, the power and stature Weinberg accumulated during the war years—plus his remarkable one-to-one relationships with America's top executive talent and his encyclopedic knowledge of the skills and personalities of many top executives—boosted the stature of Sidney Weinberg.

Naturally appreciative, many of the men he placed in top-executive positions became clients of Goldman Sachs or, more precisely, clients of Sidney Weinberg, whose firm was Goldman Sachs. Numerous executives wanted Weinberg himself to be one of their directors, a role he performed particularly well. Over time,

his detailed knowledge of specific companies led to his being elected a director of such corporations as Sears Roebuck, Continental Can, National Diary, B.F. Goodrich, and General Foods. (In 1953 the Department of Justice sued to require Weinberg to stop serving on the boards of both B.F. Goodrich and Sears Roebuck because both were so prominent in automobile tires.) In preparing for board meetings, Weinberg had an assistant, Nat Bowen, study all the facts and figures and the minutes of all previous discussions—with everything relevant to each item on the agenda kept in a small, coded notebook for handy reference—and then thoroughly brief him just before each meeting. With such complete preparation, Weinberg easily distinguished himself as a director by asking unusually penetrating questions during meetings. Weinberg wanted to know everything and would travel to see individual plants so he could take the company apart to see how it ticked. He became recognized as one of the first professional "outside" directors, serving as the representative of the public shareholders. In a departure from the then current convention, Weinberg asserted that directors' responsibilities were to the shareholders of the company they were supposed to direct and so they must be privy to all significant corporate information. He wrote an article for the *Harvard Business Review* outlining a series of recommendations on boards of directors that were then considered novel, but have since been largely adopted. His reputation soared, and Weinberg's capabilities as a director are fairly credited with cementing Goldman Sachs's relationships with many major corporations—invaluable in the investment banking business.

Weinberg had an extraordinary capacity to inspire trust, and with his effervescent personality was unusually well liked by people of all stations in life. At a General Foods board of directors meeting, always a formal and dignified affair, a long presentation was being made that was overloaded with dull, detailed statistics. Number after number was read off. When the droning presenter finally paused for breath, Weinberg jumped up, waving his papers in mock triumph, to call out "Bingo!"[21]

Called "the boy wonder" in his early years, Weinberg was widely known in his later years as "Mr. Wall Street." His offhand explanation, "I'm just a Brooklyn boy from PS 13 and I know a lot of business people," was cited as an extraordinary understatement of the reason for his great success by *BusinessWeek*, which explained that his bluntness was accepted because he was always objective, had

no personal rancor, and "startles you with extra kindness."[22] Cocky and tart-tongued, Weinberg had an amazing ability to get along with anyone and relate to anybody.

Weinberg would not only tease corporate executives with a temerity almost unique in a man of his status, he would frequently twit the corporations themselves. Shortly after he was elected a director of General Electric, he was called upon by Philip D. Reed, GE's chairman of the board, to address a group of company officials at a banquet at the Waldorf-Astoria. In presenting Weinberg, Reed said that he was sure this new director would have some interesting and penetrating remarks to make about GE and that he hoped Mr. Weinberg felt, as he felt, that GE was the greatest outfit in the greatest industry in the greatest country in the world. Weinberg got to his feet. "I'll string along with your chairman about this being the greatest country," he began. "And I guess I'll even buy that part about the electrical industry. But as to GE's being the greatest business in the field, why, I'm damned if I'll commit myself until I've had a look-see."[23] Then he sat down to vigorous applause, provoked by both his brevity and his brashness.

In 1946 General Electric had mapped an expansion program of several hundred million dollars, but president Charles E. Wilson (known as Electric Charlie to differentiate him from GM's Engine Charlie) was not sure how his board would react. His worries vanished when director Weinberg supported the plans with hard facts and figures. Said Wilson: "Sidney had done his homework, and that was all I needed."[24]

Weinberg could be shatteringly frank, but his irreverent wit could deflate his listeners somehow without offending them. "Sidney is the only man I know who could ever say to me in the middle of a board meeting, as he did once, 'I don't think you're very bright,' and somehow give me the feeling that I'd been paid a compliment," said Charles Mortimer, chairman of General Foods. Such abrupt candor in formal board meetings was captivating. Weinberg knew he was different: "I've no family background and no blue blood. When I bleed, it's red as hell! That's the trouble with Wall Street. It's stuffy. There's so much tradition down here that people don't have a good time." Receiving an honorary degree from Trinity College, he cheerfully observed that he was the only Jew with an honorary degree from an Episcopal college and that for twenty-three years he had been a trustee of Presbyterian Hospital. After a long General Foods board of directors

meeting, Weinberg agreed to stay over at Charles Mortimer's home in the exclusive Greenwich compound of Belle Haven. At the guardhouse, the car window was lowered and a deep voice from the rear seat intoned, "Mor-ti-mer." After the car was waved on, a rasping voice piped up, "What would the guard have said if he'd heard: 'Wine-boig'!?"

When Scott Paper's CEO, a Philadelphia Main Liner, put on a lavish black-tie dinner to celebrate his own sixtieth birthday and rose to toast his guests, he introduced Weinberg as "my very great friend." The puckish reply from Weinberg, who was always looking for business, delighted the crowd: "If we're such very good friends, why aren't we your company's investment bankers?" Irreverence won the day again for Weinberg when the head of Lehman Brothers brought his father, Governor Herbert Lehman, who had been a revered financier, to impress a company's board of directors. Tipped in advance by telephone, Weinberg hurried to the meeting and quickly turned the situation to his own advantage: "I'm sorry, gentlemen, *my* father is dead. But I have an uncle over in Brooklyn who is a tailor and who *looks* like him, and if that would mean anything to you, I'd be glad to bring him over!" When the directors stopped laughing, Goldman Sachs got the mandate for the underwriting.

General Robert E. Wood, the very formal and commanding chief executive of Sears Roebuck—as well as an outspoken anti-Semite and America Firster—once called on the offices of Goldman Sachs. At any other firm, a visit by General Wood would have been a Very Important Occasion marked with pomp and circumstance, but not at Sidney Weinberg's Goldman Sachs. As soon as Weinberg saw him, he called out cheerfully, "C'mon in, General!" Far from offended, Wood loved Weinberg and his irreverent ways. On another occasion, Weinberg turned to Wood and deadpanned: "You're so old, you won't live long. So why don't you leave all your money . . . to *me?*"

"Mr. Weinberg had a remarkable talent for spotting superior companies that would succeed and grow over many years—companies like 3M and GE," says partner Bob Menschel. "He had great taste and selectivity. He felt particularly close to the Morgan bank and he always expected of you what J.P. Morgan wanted—a first-class business done in a first-class way. He was very clear that if you lower the standards you set for the clients you'd accept and work for, your best clients will know—and they will leave." Weinberg's comment on doing

business with second-tier companies as clients was typically blunt: "If you lie down with dogs, you'll wake up with fleas."

Throughout his career, Weinberg's irrepressible sense of humor centered on practical jokes. As a beginner at the firm, he had enjoyed placing tacks on seats where other low-level employees would sit down. On one occasion, he put an advertisement in the newspaper stating that a new Broadway musical would be produced by Sam Sachs and that chorus-line applicants should come to Sachs's Wall Street office for an interview. This produced a string of pretty young dancers that embarrassed the elderly Sachs—and delighted others in the office.

In the nation's capital, Weinberg's pranks expanded to an appropriately grander scale. Paul Cabot, a patrician, Harvard-educated Boston Brahmin, and Sidney Weinberg, the drop-out Jew from Brooklyn, had hit it off as soon as they met in the 1920s. Cabot was as shrewd and blunt as Weinberg and, like Weinberg, a dedicated practical joker. They soon developed a truly great friendship.

Cabot was both "to the manor born" and famous for his direct manner. Serving as a director of J.P. Morgan along with General Motors's great leader Alfred P. Sloan, Cabot once asked Sloan how things were coming along at GM. Mr. Sloan began carefully describing the smooth but complex workings of the corporation's committee system, when Cabot cut in: "What we all want to know is this: when are you going to make some real *dough?*" Cabot was managing partner of State Street Research & Management, treasurer of Harvard University, and the very successful overseer of Harvard's endowment who declared that each school or department must finance itself rather than relying on the central university, saying famously, "every tub on its own bottom." Despite the "impossibility" of controlling a university faculty, he made that dictum stick.

During the thirties, Weinberg arranged to put Cabot on the boards of several major corporations, including Ford, B.F. Goodrich, National Dairy, and Continental Can, so when Weinberg urged him to come down to Washington as a wartime dollar-a-year man, Cabot was ready.

Weinberg decided to teach Cabot a lesson to remember by putting him in charge of a raucous bunch of scrap dealers, expecting he would soon have Cabot in full retreat, humbly asking for help. Not so. Cabot quickly took firm control

of the scrap dealers. They worked so well together that at the end of the war, the dealers gave Cabot a solid gold tray with their signatures on it. Cabot knew that he had gotten that particular job because it suited Weinberg's sense of humor to put his friend, the Boston blue blood, in with a crude and rough bunch—another practical joke, but nothing like his next one.

The Hopkins Institute, notorious as the largest of the many busy brothels operating in the nation's capital during the early war years, was finally raided and closed down by the District of Columbia police. A few weeks later, learning that Mr. and Mrs. Cabot would soon move their home from Boston to Washington, where they planned to stay for the duration, Weinberg suddenly had a great idea: With the nation at war, telephone service was, of course, tightly restricted, so if and when a telephone number was finally assigned to a customer, it was virtually impossible to get that number changed to another listing. This reality would be Weinberg's fulcrum, and the reputation of the Hopkins Institute would be his Archimedes' lever.

Printing up a stack of handsome four-by-six cards proudly announcing the "Grand Reopening" of the Hopkins Institute in response to strong public demand, Weinberg hired several smartly dressed young men to go down to Union Station and hand out the happy announcements to soldiers, sailors, or civilian travelers—anyone they thought might be a good prospect for the Institute's fabled services. Hundreds of cards were given out, all asking interested patrons to call a special number for directions to the Institute's secret new address—and all giving the Cabots' newly assigned telephone number. The calls began coming into the Cabots' home about four in the afternoon, increased steadily to a peak near midnight, and then gradually declined into the early morning. The calls from insistent, often inebriated, "customers" came in night after night—for weeks and weeks.

With this beginning, the personal war between the two jokesters was on. It would last long after the shooting war was over. Weinberg and Cabot, both armed with clever imaginations, were constantly looking for ways to pull pranks on each other. After many weeks in sweltering Washington, Cabot somehow got tickets to fly to Boston for a weekend with his family. Weinberg, affecting great urgency, said the director of the Office of War Production, William S. Knudsen, had called an emergency meeting to reorganize the whole war production

operation. Knowing they could never be rebooked, Weinberg told Cabot he'd better cancel his tickets. Fortunately, a pal had tipped Cabot that it was all a joke, so Cabot kept his tickets but told Weinberg he had given them up. Panicking, Weinberg called airline after airline, trying to get tickets—*any* tickets. No luck at all. Desperate, Weinberg decided to pretend he was Knudsen and called Cabot, who had never met Knudsen, to say the meeting was called off. Weinberg hoped that maybe Cabot could get himself reinstated with the airlines. Cabot, of course, still had the treasured tickets in his pocket and was delighted to see Weinberg squirm. When the call came in, Cabot told his secretary to say he was too busy. Cabot's secretary said, "Mr. Knudsen insists," so Cabot picked up the phone, certain that it was Weinberg. In what had to be Weinberg pretending a Swedish accent, Cabot was requested to come around to Knudsen's office. Certain he had all the cards, Cabot snapped: "For God's sakes, go piss up a wall!" Unfortunately, Knudsen himself had happened to call moments before Weinberg got through. Suddenly realizing it really *was* Director Knudsen, Cabot dashed to his office to apologize. Luckily, Knudsen knew of Weinberg's jokes, so they had a good laugh together—and Cabot flew home to Boston for the weekend.

"He had a fantastic nose for who was honest and who was not quite so good," said Cabot of his friend. "Plus he had that great sense of humor."[25] The peak of Weinberg's irreverence during World War II may have been achieved when Admiral Darlan, the senior Vichy French naval officer and a politically powerful, haughty, and ambitious man known to have Nazi sympathies, was at the White House being courted with attentive protocol by the Allies for political reasons. When it was time to leave, Weinberg reached into his pocket as he came to the front door, pulled out a quarter, and handed it to the resplendently uniformed admiral, saying, "Here, boy, get me a cab."

Cabot introduced Weinberg to his patrician friends and they got along famously, often sailing on summer cruises in the cold waters off Maine. Despite his navy service, Weinberg knew nothing about sailing and never learned how to swim. On one occasion, obliged by his companions to jump into the cold water—because all hands were required to wash at least once each day—Weinberg prudently tied one end of a long rope to the mast and the other around his waist before he climbed carefully down the boat's ladder into the sea. Cabot, quickly

untying the line from the mast, joyfully tossed it into the water where Weinberg, in a bulky life preserver, struggled to stay afloat.

Cabot and Weinberg both loved dirty jokes, which they delighted in telling each other in their regular telephone calls. In their later years, both were losing their hearing, and Cabot's proper Bostonian secretary was so offended when overhearing Cabot's end of those scatological calls that she insisted Cabot close the door when Weinberg's calls came in. To accommodate her request, but knowing such offending calls came in quite often, Cabot found a clever solution: a foot pedal under his desk that would automatically close the door.

Cabot had occasion to learn that Weinberg, while widely respected and very well liked, was not free from other people's prejudice. One morning the acting president of Manhattan's exclusive club, the Brook, went to the dining room table where Cabot was eating his breakfast to inform him that it had been "inappropriate to do what he had done the night before." Cabot had dined with two guests; one was Sidney Weinberg. A man with no time for fools, Cabot sensed what was up, but decided to play innocent: "Did we speak in too-loud voices?"

"Oh, no, it wasn't that. It was the *individuals* at your table."

"What's your exact meaning?"

"You know we don't accept Jews at the Brook."

"Well, I've read the by-laws and there's nothing on the subject there." Cabot's voice changed to a firmer tone: "If that's the way this club is to be run, you can stick your club you know where. You will have my resignation this very morning."

At other times, prejudice was shown more innocently if just as obviously. Once Morgan Stanley's senior partner, Perry Hall, called Weinberg to tell him some wonderful news: "We've just made our first Jewish partner!" "Oh, Perry," retorted Weinberg without a pause, "that's *nothing*. We've had them here for *years*!"

After the war, Weinberg resigned from government service, explaining cheerfully: "There was less and less real work for me to do. In the winter, I was reading important papers until eight p.m. Last spring, I'd be finished by

three. When I was done by ten a.m., I knew it was time to resign in Washington and return to New York."

But he stayed active as a Democratic fund-raiser. Weinberg did detour from the New and Fair Deals in 1940 to back Wendell Willkie, because he believed two terms was a proper limit for presidents, and in 1952 to play a key role in the election campaign via Businessmen for Eisenhower. As many other major figures did when Weinberg's name came up, Ike said: "He's a close personal friend of mine." Weinberg's fund-raising technique—mostly personal solicitation with his rasping Brooklyn voice—was abrupt and effective. According to his friend John Hay "Jock" Whitney, the financier and newspaper and radio proprietor, "Sidney is the best money-getter I've ever seen. He'll go to one of his innumerable board meetings—General Foods, General Electric, or General Whatnot—and make no bones about telling everybody there what he wants. Then he'll say, 'Come on boys: where is it?—and up it comes." Weinberg went on to successfully recommend to Eisenhower the following appointments: George Humphrey, who became treasury secretary; Charles Wilson of General Motors, who was made secretary of defense; and Robert Stevens, who was appointed secretary of the army. Later on, Weinberg also played a key role in organizing the Communications Satellite Corporation (Comsat) for John F. Kennedy and then served on the Committee for Johnson-Humphrey. In 1964 he helped form a Johnson for President group and later recommended John Connor and Henry H. Fowler to the president; Connor became secretary of commerce and Fowler secretary of the Treasury.

During Hubert Humphrey's 1968 campaign against Richard Nixon, L. Jay Tenenbaum, a Goldman Sachs partner, got a rare call from Weinberg, who asked: "L. Jay, what are the odds on the [stock exchange] floor in the Humphrey-Nixon election?" Tenenbaum said he would find out and called Bunny Lasker, a floor specialist, who said the odds were seven to five for Nixon. "Don't cuff it," said Tenenbaum: "Sidney Weinberg wants to know." Lasker replied bluntly: "I offer $70,000 to Sidney Weinberg's $50,000!" Weinberg couldn't believe it: "Doesn't he know that George Ball has just come out for Humphrey?" Tenenbaum couldn't resist making up a quick reply: "Lasker says he knows Humphrey has Ball—and when he has *two* balls, he'll have a shot at the White House." Immediately,

Tenenbaum called Lasker to say, "Protect me on this, Bunny," but Lasker was laughing and saying, "I've gotta tell RN!"

"With his strong Brooklyn accent," recalls John Whitehead, Goldman Sachs's cohead from 1976 to 1984, "Sidney couldn't possibly masquerade as a Harvard man, so he made fun of the Harvard aura." He got pawnshops all over Brooklyn to sell him any Phi Beta Kappa keys that came in, kept them on a wire in his desk drawer, and, if he had a stuffed shirt going on and on for too long about something, would pull the wire full of PBK keys out of his drawer and say admiringly, "Gee, you're so awfully smart, you should have one of these." He observed, "One scientist accused me of shaking the bedrock of Phi Beta Kappa until I reminded him that *I* wasn't the one who had hocked his key." Weinberg helped organize a "counter Phi Beta Kappa" called Kappa Beta Phi, had keys made up, and proudly wore one on his watch chain. The group inducted new members at annual ceremonies featuring racy skits and nude women.

Weinberg's engagingly outrageous chutzpah prevailed on the day the firm was sued for one hundred million dollars by Eddie Cantor, the Broadway entertainer and major stockholder in Goldman Sachs Trading Corporation. The suit got front-page coverage in the *New York Times* on the day Weinberg and all the other big shots on Wall Street took the evening train to Washington for the annual meeting of the Investment Bankers Association. With such a public embarrassment, other bankers might have gone into hiding. Not Sidney Weinberg. He worked his way through every car on the train, making a joke out of the disaster by facetiously urging each of the other firms to join in a general syndication of the lawsuit.

Weinberg never forgot his Brooklyn background and its lessons in thrift. He rode the subway, cheerfully reminding others that he was saving five dollars every week: "You can learn a lot more looking around at the people and the ads on the subway than you can by watching the back of a chauffeur's head in a limousine." Savings came in other ways too. The heir to a large retailing fortune once spent a night in Scarsdale with the Weinbergs and retired early. After Weinberg and his wife, whose only servant was a cook, had emptied the ashtrays and picked up the glasses, they noticed that their guest had put his suit and shoes outside his bedroom door. Amused, Weinberg took the suit and shoes down to the kitchen,

cleaned the shoes, brushed the suit, and put them back. The following day, as the guest was leaving, he handed Weinberg a five-dollar bill and asked him to pass it along to the butler who had taken such excellent care of his things. Weinberg thanked him gravely and pocketed the money.

As much as he always exuded self-confidence, in some ways Weinberg was uncertain about himself. He knew he had little education and would write out a letter he wanted to send to a client—always with a very wide nub on his pen and always on a yellow pad of paper—and then say to one of his Harvard-trained associates, "Please read this. Is it okay?" As partner Jim Marcus recalls, "You might offer a suggestion or two—for which he'd always be appreciative—but it really wasn't easy to find corrections." Marcus adds, "Sidney was fun, and he had a big temper that usually erupted only because he was so frustrated when he couldn't get something done that he wanted to do."

One device that was apparently beyond Weinberg, quick study that he otherwise was, was the slide rule. John Whitehead recalls, "Sidney would call me into his office and ask me to close the door so we could be alone. Then he'd open the desk drawer where he had a very large, fancy slide rule someone had given to him and say, 'Now, John, just show me once again how this thing works.' So I'd go around behind where he was sitting, reach around his shoulders to the slide rule, and explain, 'You put the one here over the two here and then slide the plastic with the vertical line on it over this two and read below the line here, where it says four.' You could sense his frustration swelling as he looked down at all the numbers and saw complexity and felt confusion. And then he would burst out with, 'Damn it all, I *know* that two times two is four! What use is this!' And he'd slam the drawer shut for another year or so. We *never* got any farther."

Loyalty was a central value to Weinberg. He ate, drove, wore, and used the products produced by "his" companies—cheese had to be Kraft, coffee had to be Maxwell House, cars were Fords, etc.—and when a young executive wanted to leave General Foods for a career at Goldman Sachs, it first had to be approved by one of General Foods's directors, Sidney Weinberg. "He was," John Whitehead recalls, "very protective—indeed possessive—about his clients. The only time I remember his becoming really angry at me was when Henry Ford, finding that

Sidney was out of the office, switched to me to leave a message. When I passed the message on to Sidney, he made it clear that he did not want me ever again talking to Henry. I could talk to anyone else at Ford, but conversations with Henry were to be his alone. I was upset at the time, and the edict disappeared as time passed, but I noted that, as with so many famous people, there was still with him a basic underlying insecurity."

Weinberg was deeply upset when the Department of Justice, "unmindful of the great service that the leading banking houses had made in time of peace and war to the country's economy,"[26] initiated an antitrust suit in 1949 against seventeen leading banking houses and the Investment Bankers Association for colluding to fix prices. Weinberg was convinced that his beloved firm was seriously threatened by the government's action, and he was determined to fight. Still, it was better to be included than, as almost happened, to be left out.[27] Weinberg was distressed that the firm was far down the list of the industry's hallowed pecking order: Goldman Sachs ranked only seventeenth of the seventeen. Weinberg knew that rival investment banking firms were sure to bring that sign of insignificance to the attention of the corporate executives that Weinberg was striving to win over as clients.

When the investment banks won the lawsuit in October 1953, Goldman Sachs received a compliment in Judge Harold Medina's final decision, which ran to four hundred printed pages: "Goldman Sachs pursued throughout the entire period, from the turn of the century down to the date of the filing of the complaint, a competitive policy which was in every sense of the term aggressive. Goldman Sachs even transcended the bounds of reasonable competitive effort in its endeavor to get every piece of business it could possibly secure, within the limits of its personnel and its resources." Despite this complimentary finding, the lawsuit cost the firm dearly: $7.5 million in legal expenses. But it was worth it to be included.

While the firm was, just barely, a member of the club, it clearly had a long, long way to go. Weinberg had no intention of remaining just a member of the club: He was determined to be important. "All the prestige clients of Goldman Sachs were not *firm* clients, they were the *personal* clients of Sidney Weinberg," says Al Feld, "and those core clients were crucial. For example, what got the firm into other firms' syndicates was our ability to trade positions in *their* syndicates for positions in *our* syndicates—which were really Mr. Weinberg's syndicates.

Mr. Weinberg's business was *his* business, and he brooked no interference. He was rough and knew how to be tough with others. He once gave an ultimatum that no one else could have given to the Sears Roebuck board of directors. He was not pleased with the way Lehman Brothers had been conducting itself and put the matter bluntly: 'Either they go or I go!' Lehman Brothers went."

During his era—from 1930 to 1969—Weinberg exercised control over Goldman Sachs by force of will and personality; by his standing within the firm; by his stature in the outside world, particularly in Washington; because he was by far the largest-percentage partner; and because he alone decided who would become a partner and once every two years he alone decided the percentage participations of all the other partners. (One year, partner Stanley Miller looked at the list and couldn't find his name. It wasn't there. So Weinberg gave Miller a piece of his own participation.) A further reason for Weinberg's dominance was that he was a director of so many corporations[28]—over time, serving on forty boards of major corporations or their subsidiaries and bringing vast business to the firm. "Sidney Weinberg was so clearly Mr. Goldman Sachs," recalls partner Ray Young, "that it was not surprising that when a bellhop was delivering a telegram addressed simply to 'Goldman Sachs at the Waldorf-Astoria,' he took it right to Weinberg's table because, after all, he was Mr. Goldman Sachs."[29]

"Mr. Weinberg felt very strongly about making no noise in the press," recalls Bob Menschel. "He did not want to create our own competition and was very strict about never talking about what we were doing. 'If you think it's to help the firm's business,' he'd say, 'you're just kidding yourself. The people who really want to know what you can do will figure it out. If it's for your own ego, go ahead. But remember: The press that praises you when you're up is the same press that kicks you when you're down.' " Weinberg's appraisal was not just an opinion. As Menschel recalls, "One indiscretion and you'd get a real reaming. Two and out you'd go. Fired."

Weinberg developed a reputation as a whiz at reconciling groups with different, even contradictory objectives. Recalls Al Gordon, "Sidney Weinberg was remarkably effective at bringing people together—very different people from very different backgrounds—so they would talk and cooperate." Weinberg became famous for his "evangelical talks," persuading people to do what they would otherwise be unwilling even to consider. In discussions of complicated

problems, he could almost always cut to the core, come up with *the* common-sense decision, and promptly act on it.

One exercise in "evangelism" enabled Owens-Corning Fiberglas Corporation to bring off what was at the time described as "one of the most successful public stock offerings in corporation history."[30] Corning and Owens-Illinois, as the principal shareholders, together owned 84.5 percent of OCF but were prohibited under an antitrust ruling from putting any more money into OCF and didn't want to sell any shares. The shares were not listed because the NYSE was insisting that the public had to hold at least 50 percent of the shares for any stock to be listed. As problem solver, Sidney Weinberg had a particular personal advantage: He knew all three corporate CEOs and Keith Funston, the president of the NYSE, so he was able to negotiate a solution acceptable to all four parties. The exchange reduced its public ownership requirement to 20 percent, and the two parent companies sold enough shares to meet this revised minimum required for listing.

Another time, when a group meeting with him were wringing their hands over a series of minor settlement problems with Morgan Guaranty Trust, he picked up the phone and told his secretary to get Henry Clay Alexander, then mighty Morgan's CEO. The two organizations had business relationships, but Mr. Alexander was considered far too senior to be bothered with such minor matters as trading settlements.

"You *can't* call Mr. Alexander about a small matter like this!" protested Weinberg's associate.

"Why not?" replied Weinberg. "If your friends won't tell you when you're making a mistake, who will?" The settlement problems were resolved.

Weinberg's personal habits were notably plain. His Scarsdale house was the same twelve-room frame structure he and Helen had moved into in 1923, three years after their marriage and four years before he became a partner of Goldman Sachs.[31] In the fifties Weinberg bought a piece of *The Pajama Game* at the urging of one of his friends, Floyd Odlum, president of the Atlas Corporation, and it was such a hit that he gave the impression of wishing he hadn't. Holding his latest check from the investment at arm's length, he observed ruefully to a visitor, "Money! Keeps coming in all the time and hardly means anything at all." As he explained, he was too busy to make as much for himself as he could have.[32] He

wasn't kidding. At his death, Weinberg's personal fortune would amount to little more than five million dollars.

Sidney Weinberg was—and clearly knew he was—far more important as an individual than Goldman Sachs was as a firm, and that was just fine with him. "Sidney Weinberg—Mr. Weinberg, as we all called him—had a tremendous, commanding personality and was an amazing producer of business," recalls Al Feld. "Many of the corporate executives he served so effectively came to feel they needed Sidney Weinberg to achieve their most important corporate and personal objectives, and that's why he and Goldman Sachs got their investment banking business. Otherwise, how could anyone explain why Henry Ford II, who could have picked anyone and any firm, selected Sidney Weinberg and Goldman Sachs to mastermind what was to be the underwriting of the century?"

4

FORD

THE LARGEST IPO

Goldman Sachs's most important transaction and the firm's relationship with its most important client for many years originated in a very personal way. The young CEO of the largest privately owned business in the world had a special friendship with Goldman Sachs's senior partner. That relationship was improbable: They were different in age, religion, wealth, social standing, and personal values. But they had both been in Washington during the war, and one of them, Sidney Weinberg, knew everyone from political and military leaders to showgirls, and he knew how to make connections.

The Ford Motor Company was built as an increasingly gigantic proprietorship by Henry Ford, a notorious anti-Semite who would never have been willing to rely on a Jewish financier. After Henry Ford's death, his son Edsel became CEO—but when Edsel died six months later, the title passed to his thirty-five-year-old son, Henry Ford II.

Young Henry's principal distinction to that date may have been getting dismissed from Yale not only for having his term papers written by a commercial agency, but also for being so casual about academic standards as to have carelessly left the agency's invoice inside a paper's cover. At Yale, Ford bought suits

of clothes a dozen at a time, had them delivered to his dormitory room, and, when told the closet was already full, said: "Just take out as many as you put in—and do whatever you want with them." Arguably, the best thing young Ford did before becoming CEO was to make friends at the War Production Board with a man who was twenty-five years older and really knew his way around: Sidney Weinberg.

When young Henry suddenly became CEO, the Ford Motor Company was in serious trouble—converting from wartime truck and tank production to making passenger cars; breaking the power of a thug named Harry Bennett, who effectively controlled the River Rouge factory operations with goons carrying guns until he was forced out with the help of the former head of the FBI in Detroit; and establishing a management team that was up to the enormous postwar tasks and responsibilities of reorganizing a sprawling, mismanaged proprietorship into an effective corporate giant. Ford addressed the third challenge in part by hiring in Tex Thornton's Air Force Whiz Kids—including Robert McNamara, who later became Ford's president and then JFK's secretary of defense. In addition, Ford got invaluable help from FDR's "body snatcher," Sidney Weinberg, who helped recruit—with large incentive pay packages—Ernie Breech, the former chairman of Bendix, as president; Bill Gussett as general counsel; Ted Yntema as chief financial officer; and a cluster of young executives who would make Ford Motor Company a leader in corporate financial management—and Sidney Weinberg a real influence at Ford.

One day John Whitehead, who was then working as an assistant to Weinberg, asked: "Do you think Ford will ever go public?"

"No," said Weinberg, "but taking Ford public would certainly be a great coup." Little did either know that their brief exchange would soon lead to one of the most important transactions on Wall Street.

Ford was a *very* private company, and everything financial was kept secret. But Whitehead began to think that there must be some financial information somewhere, and he started searching for it. Sure enough, the Commonwealth of Massachusetts had a law requiring any company doing business there to register—and file a balance sheet at the state Department of Commerce so people could get basic information about any company with which they might do

business. Since Ford did business in the Commonwealth and could get no exception to the rule, Ford had to file.

Whitehead took the train to Boston, searched the files, and located Ford's single-page filing. It was the Ford Motor Company's balance sheet. Weinberg and Whitehead took a long look. Ford was not just big. It was *huge* in assets and had few liabilities. Indeed, it was the largest privately owned company in the world. However, as Weinberg and Whitehead would later find out when the Ford family—not the corporation—gave them a look at the financials, large as it was, Ford Motor Company was not profitable.

The Ford family had been shocked to learn that old Mr. Ford had decided just before his death to save on estate taxes by creating the Ford Foundation, funded with 88 percent of Ford Motor Company's common stock. With 2 percent owned by Ford directors, officers, and employees, only 10 percent would pass on to family members—but this 10 percent would hold 100 percent of the voting rights, so the family still had complete control.

The Ford Foundation finance committee—chaired by yet another of Weinberg's many close friends, Charles E. Wilson, chairman of General Electric—was in an untenable situation: Ford stock paid no dividends, so the foundation could not make grants. Equally important, the trustees sensibly believed that prudence required them to diversify the foundation's endowment, so they were determined to sell a large block of Ford stock in a public offering and have Ford listed on the New York Stock Exchange. The exchange, however, required all listed stocks to have voting rights and pay dividends—which the family opposed. Family members were all on the Ford payroll at handsome salaries, so they had no need for even more income through dividends. In addition to these strong differences, the Internal Revenue Service would have to agree to make a special private ruling that the benefits—presumably paid in additional shares—that the family would receive in exchange for giving up absolute voting control would not be subject to taxation. Otherwise the family would never agree. As both sides would soon learn, there was one more potential conflict: Both the foundation and the family intended to retain the same expert adviser—Sidney Weinberg.

Weinberg may have been the smallest important man on Wall Street physically, but it did not matter: He was at the height of his personal powers and stature.

Goldman Sachs may have been a small, second-tier firm with little experience in managing underwriting syndicates, but it did not matter: It was Sidney Weinberg's firm. The issue was whether Weinberg would represent the Ford Foundation or the Ford family.

The foundation's finance committee had thought it wise to retain an expert adviser for an operation that was so large and complex. Over the years, Charles E. Wilson had become acquainted with practically all the shrewdest money men in the country, and there was no question in his mind about which one of them he wanted as the foundation's adviser: "I want Sidney Weinberg." When Wilson told young Henry Ford, who was also the chairman of the foundation, that he planned to enlist Weinberg as his adviser, Ford promptly blocked that idea: "You can't have him. Sidney is financial adviser to the family." The family got Weinberg, and the foundation got three other advisers.

As E. J. Kahn observed in his *New Yorker* profile of Weinberg:

> That both of the principal parties involved in the nation's most impressive stock offering wanted the services of the same individual was no surprise to people familiar with the individual—Sidney James Weinberg, a 65-year-old oracle whose counsel has long been one of the financial community's most avidly sought commodities. As the senior partner of the venerable and powerful investment banking firm of Goldman, Sachs & Co.; as a director, over the years, of more big corporations than any other American; and as an adviser to whom not only the country's industrialists but its presidents listen attentively, Weinberg, though largely unknown to the man in any street but Wall, is among the nation's most influential citizens . . . as a power behind the throne.[1]

Ford offered Weinberg the job on October 1, 1953. Weinberg immediately accepted without knowing how much of his time or how long it would take to complete. As things turned out, it took about half his working time for two straight years. "The big problem was to get all hands to agree on how much stock the Fords should get for transferring a part of their voting rights to the shares the foundation wanted to sell. Although others naturally had a hand in the proceed-

ings, the immense chore of reorganizing the Ford Motor Company's entire financial setup was left pretty much up to him."[2]

Over the next two years, Weinberg and Whitehead, with help from Shearman & Sterling, developed fifty-six different and very complex reorganization plans—all in absolute secrecy. To ensure strict security, Weinberg dictated no letters, notes, or memoranda on the subject. Anything he absolutely needed in writing was written out in longhand—using a promotional pen received from National Dairy showing "Sealtest" in bold letters—and Ford was never discussed by name: It was always "X."

To avoid attracting attention, meetings were held in various inconspicuous locations or at the magnificent home of Edsel Ford's formidable widow, now remarried to Ernest Kanzler, a Ford executive who had headed the War Production Board in World War II. Mrs. Kanzler chaired the meetings with her children Henry, Benson, Bill, and Josephine attending. The meetings were strictly private. To avoid public recognition of the frequency of Weinberg's visits, travel was usually by private plane. When Henry Ford went to Europe for a holiday, Weinberg gave him a code sheet for deciphering cables. The company was "Agnes"; Henry Ford was "Alice"; his brothers were "Ann" and "Audrey"; the family's lawyer was "Meg"; the foundation was "Grace"; and Weinberg was "Edith." Whitehead and Ford's messages read a lot like *Little Women*, though both enjoyed playing with double entendres in how the names were used.

In 1955 Weinberg and Whitehead were given something remarkable to look at—an *absolute* secret. It was a full-scale annual report for Ford Motor Company with color pictures, full text, and all the financials, including detailed footnotes.[3] This was all for practice and to make sure the detailed data required by the SEC could be collected and reported accurately and quickly after years of closely guarded secrecy. In anticipation of possibly going public, every aspect of that mock annual report was designed to equal the annual report of archrival General Motors. Only one copy was ever taken outside the Ford headquarters building—the copy entrusted to Sidney Weinberg.

On the way to one of those rigorously clandestine family meetings, Weinberg nearly ruined everything. Landing fifteen minutes earlier than expected one morning at the general aviation terminal at Detroit's airport, Weinberg and

Whitehead had to wait for the limousine sent to fetch them to headquarters, so they paused at a newsstand to buy a local newspaper. Weinberg put down the zippered leather portfolio in which he carried Ford's supersensitive private documents, including the corporation's full and audited financial statements, while he reached into his pocket for the coins to pay for the newspaper, never pausing in his item-by-item review with Whitehead of what must be accomplished during the day ahead as they went into the café for a cup of coffee. When the limousine driver sent to meet them came to the table, apologizing for their having to wait, Weinberg, anxious to be punctual, quickly paid the bill and got into the car, all the while continuing the item-by-item review with Whitehead as they drove to their meeting at Ford headquarters in Dearborn. Suddenly, Weinberg stopped talking. He looked horrified and turned immediately to Whitehead and almost shouted: "John! *John!!* Where in hell did you put my portfolio?"

Weinberg knew Whitehead didn't have it: He knew he had lost those papers himself. "But," recalls Whitehead, "it was in his nature to be aggressive like that. That was Sidney." Weinberg, of course, insisted that the car turn around and drive all the way back to the airport where the two men jumped out and ran to the café and the newsstand, desperately hoping to find that essential portfolio. If anyone found that envelope and opened it and Ford's sensitive financials got disclosed, all their work over the past two years—all Weinberg's work over the past *forty* years—would be threatened. Fortunately, there it was, right where Weinberg had left it. Seeing the two men so out of breath, the news vendor observed laconically: "If you fellas hasn't come soon for those papers, I'd've tossed 'em away."

Almost losing those precious documents was a close call, but the secret that Ford and Weinberg were up to something was kept until Weinberg met with Henry Ford and several other members of the family at Palm Beach in March 1955. After working all one day, Weinberg and Ford decided to relax at a large charity ball, where their cover was pierced by a society columnist who noticed the pair when Ford guided Weinberg to the table of the Duke and Duchess of Windsor. As Weinberg later observed, "How could you keep anything confidential under *those* conditions?"

The Ford offering was certain to be the defining underwriting of the postwar era in Wall Street. Every investment banker wanted a major role. Weinberg shrewdly positioned himself to control participation in the syndicate even though

the foundation was the actual seller and well-respected Blyth & Co. the nominal lead underwriter.[4]

Most important, Weinberg carefully arranged everything so that he would personally be understood to be making all the key selections of the specific firms to be given the lucrative and prestigious positions as the principal underwriters. He had wanted fewer underwriters, but Ford wanted more, so in a compromise Weinberg determined that seven was the appropriate number of lead underwriters—an elite group including, of course, Goldman Sachs.* Nearly one hundred other firms filled out the enormous syndicate. While some of the leading firms might have argued that seven lead underwriters were really too many, they knew all too well that if they ever complained, Weinberg, being Weinberg, would make certain that their firm—whichever firm it might be—would be taken out of the lucrative underwriting altogether.

Every major underwriter soon understood that Sidney Weinberg intended to achieve two simultaneous objectives: first, to put together the strongest possible syndicate so the Ford family and the Ford Foundation would get the best possible price, and second, to ensure a major advance in the stature of Goldman Sachs among underwriters. As he chose each of the lead underwriters for one of the coveted, lucrative slots, Weinberg made sure its leaders knew where this opportunity came from and understood what reciprocal business would be expected in the years to come.

After one of the many grueling days, followed by an evening of difficult negotiations, it was finally time to leave Ford headquarters. As it happened, Henry Ford and Sidney Weinberg were both headed to New York City's LaGuardia Airport, so Ford offered Weinberg and Whitehead a ride in his private plane. "Should I order a car to meet you, Mr. Ford?" asked the pilot. Ford asked, "Going to Manhattan, Sidney?" Weinberg was going to the Sherry-Netherland, while Ford was going to the Regency. Their hotels were close, so they could share a cab. Trying to be helpful, Whitehead offered, "I have a car at the airport. I'll be going through Manhattan on my way to New Jersey and can easily drop you both

* John Whitehead kept a photo of the then heads of all seven lead underwriters—with himself substituting for Weinberg. He also kept the full-page "tombstone" newspaper advertisement for the Ford offering, which included the names of all the many firms in the syndicate. Over the next several decades, as firms failed, merged, or changed names, Whitehead carefully drew a red line through their names on a clear plastic sheet he would pull down over the ad, until only a few firms' names were left. One of the few was Goldman Sachs.

off." As Whitehead drove his car up to the Butler Aviation private-plane building, Ford gasped, "My God! You can't ask *me* to ride in a goddamn *Chevy!* What will people say?"

"John," exclaimed Weinberg, "what have you *done*? This is worse than awful. This is the end of the world!"

Then Ford turned on Weinberg. "Sidney, don't you pay your people enough so they can afford a really *good* car?"

It was too late to change plans: They would have to make the best of it. Embarrassed and determined not to get caught, Ford instructed Whitehead, "If you have shades on this car, pull 'em down!" and tugged his coat collar up as he slid down, hoping to hide from view. When they got to Manhattan, Ford told Whitehead, "Let me out on the corner two blocks away from my hotel and I'll walk to the front door—and send a bellboy back to get the bags."

Nevertheless, the story was soon passed around Detroit that Henry Ford had been riding around New York City in a Chevrolet.

The Ford offering in January 1956 was a personal and professional triumph for Weinberg and a business triumph for Goldman Sachs. Weinberg's final plan rewarded the Ford family with a huge increase in shareholdings—tax free. At the time, Ford's was the largest IPO ever: 10.2 million shares at $64.50 per share for nearly seven hundred million dollars (over five billion in today's dollars). The offering dwarfed all previous underwritings and attracted five hundred thousand individual investors. The *New York Times* carried the story with Sidney Weinberg's photograph—on the front page, above the fold.

When Henry Ford had asked Weinberg at the outset what his fee would be, Weinberg had declined to get specific; he offered to work for a dollar a year until everything was over and then let the family decide what his efforts were really worth. Far more than the actual fee, Weinberg always said he appreciated an affectionate, handwritten letter he received from Ford, which says, along with other flattering things, "Without you, it could not have been accomplished." Weinberg had the letter framed and hung in his office, where he would proudly direct visitors' attention to it, saying: "That's the big payoff as far as I'm concerned." He was speaking more literally than his guests knew. The fee finally paid was estimated at the time to be as high as a million dollars. The actual fee was nowhere near that amount: For two years' work and a dazzling success, the

indispensable man was paid only $250,000. Deeply disappointed, Sidney Weinberg never mentioned the amount.

In fact, the fee was not really important in the overall picture. Weinberg soon became a director of the Ford Motor Company—and took his pal Paul Cabot onto the board with him—and for nearly half a century Ford would be Goldman Sachs's most prestigious investment banking client. Even more important, Sidney Weinberg used the Ford Motor Company underwriting to leapfrog his firm's standing on Wall Street into the top tier of underwriters, strongly positioned as a major firm that others had to treat well. The continuing stream of Ford financings expected over the following decades could be shared and traded with others to keep Goldman Sachs in that top tier.

Though a major success for Weinberg and his firm, the Ford underwriting was a dud for many investors. Offered at $64.50, the shares jumped to seventy dollars by the end of the first day's trading, a clear, clean underwriting triumph. But then, over several months, the price drifted down into the forties. The problems, both the initial sharp price rise and the subsequent fall, were due to Ford's insistence on allocating over 10 percent of the shares to Ford dealers. In the initial excitement around the IPO, many dealers rushed to buy still more shares. Later, remembering that they had huge bank debts to finance their inventories of cars, most dealers felt obliged to sell—and as the price fell, other dealers rushed to sell their shares too. Believing it was always in an issuer's long-term interests for investors to make a profit, Weinberg insisted, when Ford subsequently borrowed one hundred million dollars in bonds, that the yield be set slightly *above* the market, saying that Ford could not afford to have another poor performer in the aftermarket.

Not long after the record Ford equity underwriting, Weinberg did a record bond underwriting—a $350 million issue for Sears Roebuck. It was then the largest public debt offering ever made. The issue was floated in a bond market that was so soft that professionals at other firms had doubted it could sell at all, but the issue was a success. Right after the Sears bonds came a three-hundred-million-dollar bond issue for General Electric, comanaged with Morgan Stanley. Goldman Sachs was moving up in the ranks and was arguably now one of Wall Street's Top Ten.

Ford was for many years certainly the firm's most important client in

prestige, but not in business volume. After the IPO, Ford did no long-term financing because young Henry Ford relied entirely on Sidney Weinberg for financial advice and Weinberg was sure that interest rates would decline, so he flatly opposed using any new long-term debt. Any borrowing would have to be done with commercial paper. Unfortunately, Weinberg was wrong about interest rates. His control of Ford finance so angered Ed Lundy, Ford's brilliant CFO, that when Weinberg died, most Ford executives wanted to get rid of Goldman Sachs. Gus Levy, John Whitehead, and Don Gant, the partner covering the Ford account for many years under Weinberg, were warned that they would have to compete for any future business, and that they would begin that competition several yards behind the starting line. While Gant was successful at rebuilding the relationship, Ford was so successful in the fifties and sixties that financing, and the services of Goldman Sachs, were seldom needed.

Underwriting wasn't the only area in which Sidney Weinberg set the pace for Goldman Sachs. He was also an active innovator in giving merger advice. As John Whitehead recalls with admiration: "The first time Goldman Sachs charged a fee for M&A advice was, to all of us in the firm at the time, stunning. Naturally, it was Sidney Weinberg who brought in the business. Through his remarkable network he knew both Jerry Lambert and William Warner, and that enabled him to bring them together in a merger as Warner Lambert Pharmaceuticals. The fee was quite impressive. In those days, most investment bankers got paid only for underwriting stocks and bonds, and didn't charge *anything* for advisory work on mergers and acquisitions. But for this particular merger, Sidney Weinberg did indeed charge a fee: one million dollars!"

Weinberg's million-dollar fee was a harbinger of the high mergers-and-acquisitions fees and the profusion of Wall Street–initiated mergers that lay ahead. But Weinberg was not a champion of corporate mergers. When two Midwest retailers, Hudson and Dayton, wanted to merge in 1969, Goldman Sachs worked on the merger in a most unusual way. Weinberg and partner Bob Horton represented Hudson, while John Whitehead represented Dayton. At one point Weinberg asked, "Why does Dayton want to grow so fast? What good will that do them?" Whitehead just rolled his eyes. M&A was about to become a major part of Wall Street's business and a strategic catapult for Goldman Sachs. Weinberg was clearly from a different era.

5

TRANSITION YEARS

The Ford offering, spectacular personal triumph that it was for Sidney Weinberg, might have turned out to be an isolated event with little long-term impact on Goldman Sachs's competitive position. That was not acceptable to Weinberg. Always looking for openings and quick to see how openings could be exploited, he was determined to see his firm move up in the ranks of investment banking.

In addition to his business-attracting personal stature and notoriety, Weinberg's main business contribution was crucial: He was a director of over two dozen major corporations where he could make sure Goldman Sachs got the business. As the lead underwriter for those companies, Goldman Sachs could then swap participations in the syndicates it organized for lucrative participations in the syndicates of the other leading underwriters.

Weinberg's successes were always the result of his direct action on specific subjects with specific individuals, almost always corporate CEOs. "The structure of the firm was determined by *clients*," explains John Whitehead. "Since Sidney Weinberg controlled most of the clients, he controlled the firm." John Weinberg recalled: "He was very definitely *the* senior partner. And, boy, was he the boss! I

can hear him now saying at a partners' meeting, 'I've listened and heard all you've said. I've considered it very carefully. I will tell you now that democracy has gone far enough.' And then he'd announce his final decision."

Like all the great Wall Street leaders of his era, Weinberg had no interest in internal operations. He and his peers were no more concerned with organizational management than the members of great social clubs are with housekeeping. Weinberg would advise his son John: "Don't waste your time on internal operations of the organization. If they have important problems, they'll bring them to you." As John recalled, "He didn't enjoy management of the firm; he liked investment banking. So he had other people manage the firm."

One exception Weinberg made was recruiting. He looked for outstanding talent on two levels. At the top, hoping to find a leader who could carry on his own work of building up Goldman Sachs in investment banking, and certainly not able to believe that anyone then at the firm could fill his shoes, he recruited Charles Saltzman and Stanley Miller as potential successors. Miller had experience in Wall Street and was well connected in New York City and with business leaders across the country. Saltzman, also well connected socially, had been a Rhodes Scholar, a general in the army, and assistant secretary of defense under George Marshall. However talented, neither man was ever accepted as Goldman Sachs's leader by the other partners. That was probably just as well, since it left an opening that would eventually be memorably filled by Gus Levy, who spearheaded the growth of Goldman Sachs's trading business in the forties, fifties, and sixties.

At the entry level, Weinberg took a special interest in recruiting MBAs from Harvard, particularly to be associates in investment banking. That's how John Whitehead came to join Goldman Sachs in 1947.

Whitehead, born in Evanston, Illinois, on April 2, 1922, grew up in Montclair, New Jersey, where his father had worked as a New Jersey Telephone lineman before transferring into personnel. After high school, John went to Haverford College, where he took a course with Edmund Stennis. Stennis had left his wealthy, cultured family in Germany because of Hitler; when he landed in Haverford, Pennsylvania, the president of the college invited him to teach. He and young Whitehead developed a special bond. As Whitehead recalls, "Stennis certainly opened my eyes to Europe and a wider world and was an important factor in my confidence that Goldman Sachs must expand internationally." Whitehead

worked his way through Haverford; served three years in the navy during World War II attached to an attack transport that participated in the invasions of Normandy, southern France, Iwo Jima, and Okinawa;[1] and then earned an MBA (with distinction) at Harvard Business School. The navy had earlier assigned him to the business school as a wartime instructor, so Whitehead had the unique experience of resigning from the faculty to become a student at the school.

After graduating in 1947, Whitehead joined Goldman Sachs as one of just three hundred employees for what he expected would be only a transitional position in a family firm: "I thought of working on Wall Street as a form of postgraduate training and as a way to get a broad exposure to American business and learn from seeing many companies before eventually taking up a career in corporate management." Declining an offer from DuPont's finance department, Whitehead accepted the only investment banking job offer he got and the only offer made that year by Goldman Sachs.[2] "Candidly, I'd heard almost nothing about the firm." The salary was $3,600 a year.

In the late 1950s, Goldman Sachs was Sidney Weinberg's firm and John Whitehead was Sidney Weinberg's man. "Working for and under Sidney Weinberg," explains Whitehead, "I had the day-to-day responsibility for the Ford equity offering. I was selected as a good assistant: young, quiet, and not yet a partner. Then not long after the Ford equity issue, I found myself working on General Electric's three-hundred-million-dollar bond offering. At the time, it was the largest industrial *bond* offering in history. Those were exciting days."

Whitehead's first impression of Goldman Sachs's office at 30 Pine Street was disappointment. "Goldman, Sachs & Co." was in large gold letters by the entrance of the narrow twelve-story building that was squeezed between a much higher office tower and a tavern. But the building was not owned by Goldman Sachs. It was owned by the N and L Realty Company. The *N* was for "Nellie Sachs" and the *L* for "Louisa Goldman Sachs," the deceased mothers of the two Sachs senior partners, Howard and Walter. While the dark mahogany partners' offices on the seventeenth floor were suitably impressive, Whitehead was assigned to a metal desk squeezed with six others into a converted squash court incongruously located on the twentieth floor. While most of the other occupants

were college graduates, none had been to business school. The squash court, ventilated by a small "porthole" window that could only be opened with a long pole, got cold in winter and hot in summer. "Regardless of the temperature," recalls Whitehead, "we were expected to keep our suit jackets on year-round." Suits were woolen: That was the Goldman Sachs way.

"I complied for most of that first year, but when I started to roast in midsummer, I thought I might branch out sartorially, and I bought myself a lightweight seersucker suit that I thought very handsome. The next morning, I felt quite snappy as I passed through the Goldman Sachs entrance and down the hall to the elevator and stepped aboard the car to ascend to my sweltering squash court office. But before the doors could close, Walter Sachs entered just behind me. The son of the cofounder, he was one of the great eminences at the firm. Short, stocky, with a distinguished white beard, he inspired a certain awe, if not dread, and I started to feel miserable as he surveyed me in my seersucker suit that morning. Walter Sachs was the sort of person that other people remembered, but he did not always remember them. Although we'd been introduced a few times in the previous months, the great man clearly had no idea who I was. 'Young man,' he addressed me anonymously in a withering tone. 'Do you work at Goldman Sachs?'

" 'Yes sir, I do,' I replied proudly. He scowled, and his visage turned black.

" 'In that case, I would recommend that you go home right now and change out of your pajamas.' "

Despite this sartorial gaffe, Whitehead made early progress in his career. Unusually foresighted and more than willing to work unrelentingly to achieve his objectives, Whitehead was soon rising within the firm and even more rapidly in the esteem of Sidney Weinberg.

After several years at Goldman Sachs, however, Whitehead began to worry about his progress and his prospects for a major career if he stayed there. In 1954 Goldman Sachs sold only one underwriting deal in the entire year. Business was so very slow that partner Myles Cruickshank installed a wastepaper basket in one corner of the squash court so the young investment bankers could compete at *something*—tossing coins into that basket—to keep their interest up. Then things began to improve.

Still, it seemed to Whitehead that the firm was too dependent on just one man, a man clearly at or past the peak of his career and getting older. Even though

Sidney Weinberg may have been the best business getter on Wall Street, Whitehead worried: "Sidney brought in business, and our group of bright young men handled it, but I didn't think that an investment banking firm could grow and succeed with its source of revenues so concentrated in one single person."

While Whitehead worried about his future at Goldman Sachs, he received, from time to time over the years, offers to join other firms. Early in 1956, J.H. Whitney & Co. offered him a partnership in an exciting new enterprise in venture capital for which Jock Whitney put up 100 percent of the capital and agreed to split all the profits fifty-fifty with the staff. "Goldman Sachs had no employee-review process at that time, so if you were young and hopeful, you couldn't help wondering about your standing. I'd been at Goldman Sachs for eight years and no one had even *mentioned* my being a partner, so I was seriously interested in J.H. Whitney's approach."

When Whitehead went to tell Weinberg that, much as he loved working for him at Goldman Sachs, he had received a very special offer to become a partner at J.H. Whitney, Weinberg replied in quite absolute terms that this was not to be: "Oh, no, John, you cannot and will not do that. You are needed here—at Goldman Sachs." Weinberg promptly reached for the telephone, called Mr. Whitney, and spoke directly: "Jock, your firm has made an offer to John Whitehead. Now, Jock, we need John. He's doing important work for Goldman Sachs—and for me. You really must not take him: We need him here. He's one of our best young men and valuable to me. I cannot spare him, so I ask you now to withdraw your offer, Jock." Whitney deferred to Weinberg, and that was the end of that. At year-end, Whitehead made partner at Goldman Sachs.

To build up capital in the firm, Weinberg had established a capital-retention policy that kept everyone focused on what was best for the firm—Goldman Sachs retained most of each partner's yearly earned income. As a result, anyone who became a partner in Goldman Sachs usually experienced a drop in spendable income.

L. Jay Tenenbaum had become a partner in 1959, with his initial participation set at 1.5 percent. He was soon the firm's number two salesman, behind only one colleague, Jerry McNamara, and on his way to becoming one of the leading

partners of Goldman Sachs. But thanks to the strict capital-retention policy, Tenenbaum's spendable income was just forty thousand dollars—no princely sum for a successful man with family expenses and a need to "keep up" in New York City. Indeed, Tenenbaum was borrowing spending money from his father so he and his family could get along. Tenenbaum's situation was comparable to the other hardworking and ambitious younger partners: For most of them, finances were tight at home and aspirations were high at work, where the key factor in total compensation was their share of participation in the firm's success. So when participations were reviewed every two years, the personal stakes were high.

By 1962, apart from his sales prowess Tenenbaum was increasingly important in the firm's very profitable arbitrage business. Weinberg spoke gravely to his young partner: "L. Jay, you have had two good years. You and the four other members of your class of partners have made a fine contribution to the firm. I've decided to recognize that fine contribution by raising all of you in percentage participation. I'm increasing your percentages from one point five percent to two percent!" Clearly expecting an expression of jubilation and gratitude, Weinberg leaned back in his chair and said to Tenenbaum, "Now, young man, how do you feel about *that*?"

After a split second's silence, the reply came quickly and directly: "Mr. Weinberg, we are *not* equals. Either I'm better than the others and do more for Goldman Sachs, or I'm not as good. But we're not in one 'class'; we are not equals."

Tenenbaum had just "put 'em up"—one on one—with the man who had the power to determine his destiny at Goldman Sachs. After a long pause during which neither man broke eye contact, Weinberg closed the discussion—but signaled recognition of the central point: "You keep your nose clean for the next two years and do a good job for Goldman Sachs, and then we'll see about that."

When Weinberg decided in 1968 that a young investment banker, Mike Cowles, should become a partner, he called him. When Cowles picked up the phone, Weinberg said, "Sidney Weinberg," but he pronounced it "Wineboig" and he had a mannerism of raising his tone on the last syllable, which made his self-announcement sound more like a question.

Cowles didn't have any reason to expect a call from Sidney Weinberg: Mr. Weinberg had never called or spoken to him before. So, quite understand-

ably, he thought it must be a call *for* Sidney Weinberg and hastened to explain in his courtly way that no, he was not Mr. Weinberg—to which his caller responded in exasperation, "I *know* you're not Sidney Wine-boig" and hung up in frustration.

Fortunately for Cowles, Weinberg called again: "Is this Michael Cowles?"

"Yes."

"I want you to be my partner."

By this time, Cowles, thinking the whole thing must be some sort of practical joke, was not going to bite. He had been with the firm for only seven years and knew it traditionally took ten years to make partner, so it took more than a few minutes to get everything sorted out. As Cowles later ruefully observed, "What a way to begin the most important phone call in your career!"

Cowles and John Jamison, who later earned a big fee for Goldman Sachs when Procter & Gamble acquired Clorox, were both "Weinberg's boys," so when room was made in the partnership for both of them, Gus Levy was able to get one of his "boys" in too: Robert Rubin.

Weinberg was particularly highly regarded for his ability to get things done in a uniquely quiet but effective way, sometimes concealing aggressiveness that stretched the limits of hardball. An investment banker who was there gave this example:

> After making a lot of money going public with his own company, a corporate raider noticed that Baldwin United was selling at a very cheap price. So he took a big position and was going to offer to buy the rest of the stock at a price well above the market. Since the founding family's stock was held in a trust at a bank, the raider knew the bank trustee would be under terrific pressure to accept such an offer and sell the stock.
>
> Takeover defense is something Goldman Sachs specialized in, so the firm was asked to help. Nobody was sure what to do, so Weinberg was asked for suggestions. At first, he was not sure either. A little later, he told a young banker to call a particular guy. A meeting was arranged at Gage & Tolner's restaurant in Brooklyn.

Weinberg's man, wearing a black suit, black shirt, and a black string tie, came to the table and sat down, saying, "The only reason I'm here is I owe Weinberg." After a brief explanation, the man in black said he would see what he could do. Nobody heard from him for a week, then two weeks. Finally he called to say, "We've got him. It'll cost a hundred dollars—fifty dollars for a photographer and fifty dollars for the bellboy. He's got a cutie holed up in a midtown hotel."

A week later, the man in black called on the corporate raider and respectfully said to him, "You believe in this free country and so do I. *Anybody* can buy *anything* in this wonderful free country." Then he started spreading the pictures from the hotel on the man's desk, and said, "You can buy *almost* anything. But don't do Baldwin or these could show up in the *New York Post*." Then he excused himself and left. Nothing happened to Baldwin United, and nothing was printed in the newspapers.

"Sidney Weinberg had great willingness to confront a tough issue straight on. You didn't have to watch his hands when he was dealing the cards," recalls George Doty. "He always took it to the edge in his negotiations. One example was when I'd prepared an estate plan for him. He said Coopers & Lybrand's fee was too high. I said it was the normal fee and that the work had been very well done. Looking right at me, eyeball to eyeball, he said, 'I'll pay whatever fee you say is right. But if you insist I pay that fee, I'll never again do business with you or your firm.' I quietly insisted; he quietly paid—and we never discussed the matter again, quietly doing our business together as we always had."

Weinberg always understood power. After he made Gus Levy managing partner in 1969, he moved his own office uptown to the Seagram Building to give Levy room to manage the firm. But he kept to himself the ultimate power to decide on partnership percentages, the single greatest power in any partnership.

The relationship between Levy and Weinberg was clearly defined by Weinberg at the annual partners' dinner at "21" Club in Midtown Manhattan. After dinner, Levy rose to speak on behalf of all the partners with appropriately

respectful humility: "Mr. Weinberg, even though your office is now uptown and we're downtown so we don't see you at the office anymore, we all want you to know that you are *always* in our thoughts and *always* in our hearts and we are so glad you are active and well and we just want you to know that never a day goes by without our thinking of you and how much we respect you. Wherever you are and wherever you go, Goldman Sachs is always with you—and you are always with Goldman Sachs."

Warm applause confirmed that Levy was speaking for all the partners. Weinberg stood to respond. "Those are very nice thoughts, Gus, and I'm glad you feel as you say you do." But then his manner changed from accommodating to commanding: "But don't you ever forget this, Gus. No matter where I am, *I* am the senior partner of Goldman Sachs and *I* run this firm!" With that, Weinberg sat down. The entire room was silent and the silence confirmed the obvious reality: Gus Levy still reported to Sidney Weinberg.

By the late 1960s, Sidney Weinberg had done his work. Weinberg told his wife, "If I die tomorrow, I don't want anyone to mourn for me because every day I lived was a little better than the day before." He had saved Goldman Sachs in the thirties, established its stature in the forties and fifties through his government service and corporate directorships, and carved in stone a series of core policies: capital retention, competitiveness, integrity, disdain for publicity or pretension, and toughness. But the business of Goldman Sachs had changed greatly and forever, and he had become an older man who had lost touch.

The hundredth anniversary year of Goldman Sachs was 1969. In anticipation, the annual partners' Christmas party in 1968 was moved from "21," where they traditionally went each year, to a larger place so wives could be invited for the first time. That was also the occasion for Weinberg to introduce an important new partner. Henry Fowler, the former secretary of the treasury who long ago had been an important staff member of the War Production Board, would serve as chairman of Goldman Sachs International.

After Weinberg finished his usual welcoming remarks, Trudye Fowler went up to the head of the table and asked if she could say a few words. Weinberg passed the mike to her and she began, "A year ago, we were the guests of the president and Mrs. Johnson at the White House for a dinner for America's leading men and women—and that was quite a thrill. Tonight is an even greater thrill

and an even more important occasion because tonight the *wives* of the partners of Goldman Sachs are all included for the very first time. This is so wonderful and says so much about our firm." Turning with an admiring smile to Weinberg, she concluded, "So I say to you, Sidney Weinberg: congratulations!"

Weinberg took the microphone back to say, "Thank you, Trudye, for those truly touching words. I'm so touched. Tomorrow, I'll recommend to the management committee that inviting the wives be made a new tradition . . . and that the wives all be invited to come back for the Christmas dinner . . . on our two hundredth anniversary."

For decades Weinberg had held that directors should retire at seventy to make room for younger men, a view he would later brush aside with this assertion: "I'm not like those guys—some in wheelchairs—who fall asleep at meetings. I'm not like that!"[3] Weinberg continued as a Ford director until his death at seventy-seven in 1969.

6

GUS LEVY

Born and raised in New Orleans, Gustave Lehmann Levy never lost the soft Louisiana slur in his speech. He was the only son of Sigmund Levy, a crate manufacturer who died in 1923 when Gus was twelve, and Bella Lehmann Levy. As a teenager, Gus moved for a while to Paris with his mother and two sisters; he enrolled at the American School but said he spent most of his time "just bumming around." Back in Louisiana, he dropped out of Tulane University after a few months and went to New York City, where he got a room at the 92nd Street YMHA and a job as an assistant trader in arbitrage at Newborg & Company.[1] After work he sometimes went uptown to dance at the Casino in Central Park.

In 1933, on the recommendation of a friend, Gus Levy moved to Goldman Sachs at $1,500 a year—first trading in foreign bonds and then in arbitrage, where he was an understudy of Edgar Baruc, who wore celluloid collars and had a small, waxed mustache.[2] Baruc was a friend of the Sachs family but never became a partner because the Sachses didn't want the stigma of having as a partner of Goldman Sachs anyone who had once been with any firm that had failed. Because of his past link to a bankruptcy, Baruc technically reported to Levy. They worked together

as a team under Walter Sachs's supervision and, with a "wealth of ideas, added substantial profits to what would have been otherwise very lean years."[3]

Gus Levy was destined to become by the late sixties and early seventies the most powerful man on Wall Street: the chairman of the New York Stock Exchange, the head of Mount Sinai Hospital, a power in the Republican Party, the "best" director of numerous corporations, the center of action in New York City philanthropic fund-raising, the go-to man at the market center of conglomerate finance, and the unquestioned leader of Goldman Sachs. But power and stature were far ahead of Levy when he first joined Goldman Sachs, a firm still suffering the ignominy of Goldman Sachs Trading Corporation.

Levy liked to say he was "one of the few guys who didn't lose any money in the stock market crash—because I didn't have any money to lose." He moved out of the 92nd Street Y owing two dollars. (He later became a major contributor to its parent organization, the Federation of Jewish Philanthropies, saying, "They gave me friendship and confidence in myself when I needed it badly.") By the end of the thirties, Levy had already made his first million dollars. Despite a distinctive lisp that complicated the bayou drawl, he drew on his aptitude for math, extraordinary memory, ability to connect with many, many people, and capacity for long hours of highly concentrated hard work to become stronger and stronger within Goldman Sachs during the firm's rebuilding years.

With world war coming, Levy, six feet tall and slim, was determined to get into action right away, telling his wife, Janet, simply, "I'm goin' in."[4] Through a Wall Street friend, I. W. "Tubby" Burnham, a pilot in the Civil Air Patrol, Levy had become a mission observer with responsibility for navigation and communications in 1941. Entering the army as a private in 1942, he went to Officer Candidate School, saw action in France with the Eighth Air Corps, rose to the rank of major, and mustered out as a lieutenant colonel. After he rejoined the firm as a partner in 1945, Levy and Baruc expanded Goldman Sachs's arbitrage operations and "built one of the most active over-the-counter trading departments on Wall Street."[5]

Levy built his early career in arbitrage, analyzing and trading the complex securities created by the breakup of public utility holding companies and later the reorganization of various railroads. America's railroads, while temporarily enriched by the enormous volume of freight and passenger traffic required dur-

ing wartime, were expected to fall back into serious long-term difficulty in the widely anticipated postwar depression.

Under the 1937 Public Utility Holding Company Act, designed to permit the restructuring and then the reemergence of debt-ridden holding companies like Samuel Insull's collapsed utilities empire, holding companies were allowed to keep only those operating companies whose service territories were contiguous. The more distant properties had to be divested. Trading in the securities of the newly independent operating companies would be allowed on a "when and if issued" basis in anticipation of final SEC approval of each holding company's plan of reorganization. So as the holding companies were broken up, investors needed to evaluate each operating company separately to determine its most likely market valuation.

Both investors and utility companies needed shrewd risk arbitrageurs willing to commit significant capital to making markets in those "when issued" securities. Arbitrage involved accumulating long positions or selling short in relatively large amounts and often in illiquid securities. This market need represented Levy's opportunity. He had access to capital and, as a trader, he was in the business of buying whatever existing security was being exchanged for new securities and then trading the new securities on a when-issued basis—profiting from the spread and changes in the spread between the whole and the component parts. This arbitrage trading provided rigorous training in gathering disparate bits of information with which to estimate and anticipate the actions others *might* take in that soft gray area in which an expression of "no interest" could, if properly nurtured and stimulated at just the right time in just the right way, be converted into a buy or sell transaction—sometimes even a significant transaction.

Valuation uncertainties surrounding the newly issued, unseasoned utility and railroad securities—which were rife with legal and credit complexities—provided an ideal environment for an astute, disciplined arbitrage operation like Levy's. "Gus was very smart, and an innovator," said his contemporary, Al Feld. "He built a good business because he recognized the opportunity in all the when-issued paper that came out of the big railroad and public utility financings of the 1940s. And he built a reputation for making good markets—in size. And if he had to take a loss, he took it."

Levy took charge when Baruc died suddenly in 1953, and continued to develop a "remarkably efficient and hard-hitting organization."[6] Whenever operating

losses were incurred for two or three months in a row, the Sachses would call for a financial review, often engaging George E. Doty of Lybrand, Ross Brothers & Montgomery (later Coopers & Lybrand) to do the study. Recalls Doty, "Gus Levy had a small group of loyal and very closed-mouthed clerks working directly for him. They kept all the very complicated and long-lasting records that were needed in railroad arbitrage. Their rules of conduct were simple and clear: 'Don't *know* anything and don't *say* anything.' "

To build business volume and create demand, Levy was always going out on the telephone, offering the new securities to different institutions. In the course of talking up these offerings, Levy would say, "If you want to *sell* something to raise the money for this, I will take it off your hands," or, "If you don't want to buy MoPac [Missouri Pacific Railroad], is there something *else* you'd like to buy?" And that was the beginning of Goldman Sachs talking to institutional investors about *transaction* ideas rather than *investment* ideas. It was of course, a small beginning. The equity-trading desk consisted of only three people. Levy later said, "We didn't have any electronic quote machines, so it was essential to watch the tape and to know where the last sales were and what the markets were doing."

The increasing size of transactions, the need for capital commitments to make trades happen, the speed of decision required to seize fleeting market opportunities, and discretion bordering on secrecy were all required in arbitrage—and they were splendid preparation for the changes in the nature of the stockbrokerage business caused by the surging increase in institutional activity. These changes created a rapidly expanding opportunity for those who, like Gus Levy, were prepared and determined to exploit any opening.

In the mid-1950s the climate on Wall Street began to change. Men who had known firsthand the difficulties faced during the Depression were completing their careers and leaving the Street, taking their fears and worries of another Depression away with them. Younger people with new ideas and high ambitions were beginning to come into the business. Still, the early indications of change were small and easily overlooked. In 1956 the total revenues of Goldman Sachs's "institutional business" were only three hundred thousand dollars—a business small enough to go unnoticed by senior partners at well-established firms who were members of wealthy families with well-established patterns of life. Such personages, preferring to consider themselves *investment bankers*, saw the stock-

brokerage sales and trading operations as somewhat demeaning activities pursued only as necessary for securities distribution sufficient to maintain their position in underwriting syndicates. Yet for those who were hungry to get ahead, even small changes could be seen as harbingers of interesting possibilities for advancement.

Since most of the people working at Goldman Sachs had no family wealth, they knew they'd have to work hard to make it, and as outsiders they had little to lose by taking risks or being "different." Bob Menschel, a young NYSE floor specialist, played a key role in getting Goldman Sachs into institutional block trading by convincing Levy to dedicate some of his extraordinary energies toward this nascent business right from its beginning.[7] "In those days," recalls Menschel, "the floor was very quiet, so we were always looking for new ways to do more business, particularly in companies where we were the specialist." Increased market activity linked to a possible merger involving a company where Sidney Weinberg was a director gave Menschel a pretext to call on Mr. Weinberg. A year later, Menschel wrote to Weinberg recalling their earlier appointment and explaining that he'd noticed a change of some interest: Trades of one thousand and five thousand—sometimes even ten thousand—shares were being done by institutional investors. "I noted that this was something new and might develop into an important opportunity to do business with insurance companies and other institutions. Trades of five thousand or ten thousand shares were too large for the specialists, who were used to working on trades of one hundred or two hundred shares and did not have the capital to handle these larger trades."

Weinberg sent the letter along to Levy with a note saying, "Not sure I recall, but please see him." Levy, who was interested in any new market development, had coincidentally been courting the specialists, saying, "I'll participate with you in trades of five thousand and ten thousand shares." When they met, Levy was taken with Menschel, agreed something important might be developing, and arranged for all eight Goldman Sachs partners to interview him. Six months later, Menschel joined the firm. "My uncle was furious. He couldn't believe I'd give up the floor. Most of the partners at Goldman Sachs found it hard to believe themselves: Like most people on Wall Street, they generally aspired to own a [stock exchange] seat someday at the peak of their careers. But I was bored on the floor. You need to be a real poker player to thrive on the floor, and I'm not a poker player."

Levy's and Goldman Sachs's experience in arbitrage gave the firm a

different way of thinking about the time and risk aspects of market making. At other firms, the profit and loss on trading "principal" positions was calculated daily. Daily measuring made sense for the over-the-counter market-making business, which was all about separate, stand-alone transactions where there were no "relationships" that might link one trade with another. But what worked well in the retail trading business inevitably led to wrong decisions for the institutional trading business, which was all about relationships and the recurring transactions of regularly repeating customers. Additionally, the OTC dealer's focus was on protecting the firm's *owners'* capital from trading mistakes or losses by *employees*. At Goldman Sachs, the capital at risk was the partners' capital and partners were making the trades—the employees *were* the owners. They knew the accounts' traders well because they did business with them almost every day. To make profits for Goldman Sachs, their focus was not on protecting against taking a loss on each transaction, but on developing profitable relationships that would over time make money for the firm. They took a long-term, principal's view of trading as an ongoing business. By combining risk capital with superb service, trading could be made a continuing business. Rough and tumble, often painful, always competitive, and requiring special skills plus a willingness to take significant risks, block trading was transformed by Levy's Goldman Sachs and a few competitors into a relationship business that was like riding a bucking bronco but could be successfully managed at substantial profit with longer-term orientation.

The block-trading business grew in several ways. The number of block trades increased. The size of block trades increased, and the number of institutions active in buying and selling blocks of stock increased. As the volume multiplied, so did the profits and the competition. Levy was determined to dominate this remarkable, fast-growing new business because he understood that the best profits went to the market-leading firm, and he was determined that that leading firm just had to be Goldman Sachs. "Gus was always one hundred percent committed, and that commitment could unnerve people *or* it could bring out the best in each person," says Menschel. "He was so intent on doing *every* trade that he could get catatonic if he felt we'd missed one. Gus would be storming around, bemoaning our failures: 'We're losing out! We're not in the market anymore! We've lost it! We're not *competitive* anymore!' To build the business, we had to find ways to keep Gus calm—or at least at bay."

Menschel believed that "originating a trade is a lot like fly-fishing: Both take patience and quiet persistence to land the really big ones." He created a quantitative index of the total block-trading business and of the firm's percentage—in number of trades, in number of shares traded, and in different sizes of blocks—to prove to Levy each day that the firm was actually doing very well. (About this time, Levy began using a string of worry beads given to him by a friend in Greece.) Eventually, Bob Menschel and L. Jay Tenenbaum would both decide they had to quit the business because Levy's unrelenting driving was too much for them—it threatened to kill them both. But in the meantime, Levy's drive and leadership paid off handsomely: By the late sixties Levy's trading produced half of the firm's profits. And Levy, who at his peak owned ten percent of the firm, was becoming the recognized leader of Goldman Sachs.

Levy said he would never forget the day he first knew he was important: Sidney Weinberg had quietly asked if he would like to sit next to him at the partners' annual dinner. When it became time in 1969 for Weinberg to turn over operations to a successor, Levy *had* to be made managing partner of Goldman Sachs. As the major rainmaker who commanded great personal loyalty within the firm, he was the obvious choice* as the firm's leader for a simple, compelling reason: He was already leading. As John Weinberg put it, "If Gus asked me to do *anything*, I'd do it—anytime!"

However, while Sidney Weinberg accepted the investment banking business Levy brought in and respected Levy's profitability and his internal leadership, he took no pride in Levy's block-trading business nor in the "ragtag" conglomerate companies Levy and his trading prowess attracted to the firm as investment banking clients. Levy always wanted to find a way to do the deal, which was a concern for Sidney Weinberg, who worried about the companies and people Levy did business with—conglomerate wheeler-dealers like Jimmy Ling, Norton Simon, the Murchisons. But that's where the business was to be done, and Levy went for the business. As John Whitehead observed of Levy,

* Not to everyone. Stanley Miller was a long-term partner in investment banking who had been brought in by Sidney Weinberg to develop an international business and as a possible successor. In 1974, when stockbrokerage was losing money, Miller made his move to be the leader. It came to a head one day with Gus Levy in Miller's office. Voices got louder and louder until Levy, a former Golden Gloves boxer, grabbed Miller by the top of his tie, commented on his Episcopalianism, observed how self-centered his activities had been, and delivered in disgust the conclusion that Miller was being disloyal to Goldman Sachs. Levy had the solid support of most of his partners, so the conflict was soon over—as was Miller's career at the firm.

"He had only one central idea: More! Gus would take almost anybody as a client. Just as he avoided the paneled offices on the seventeenth floor in order to be in the trading room on the thirteenth floor, he reached for the *doers* rather than for *class*." While respecting Levy's prodigious business-building capabilities and extraordinary capacity for work, Weinberg could never fully trust someone with the instincts of a trader to be solely in command of the firm. Weinberg was hard on Levy, and Levy went to Weinberg's son John to complain, "I've gotta leave this firm!"

Just before Levy was made managing partner, Weinberg, anticipating his own retirement, organized a management committee and filled it with partners he knew were loyal to him to control and restrain Levy—to prevent him from converting Goldman Sachs from a banking firm into a trading firm, as Bear Stearns had become under a strong trader, Levy's close friend Sy Lewis.[8] As managing partner, Levy would have forty-nine percent of the votes, so, as George Doty explains, "To block Gus, you'd need one hundred percent opposition, but to get anything done, Gus would always need to win at least one supporting vote." During Levy's initial years as managing partner, Weinberg knew that members of the management committee would, as his personal surrogates, always seek his opinion on key decisions and then vote as he told them to vote. Even with this governor established, Weinberg still had reservations, so he continued on as senior partner and sole decision maker on partnership percentages.

Levy—always calling him Mr. Weinberg—accepted the form but not the function of the management committee. Meetings were held every week, but they were kept short, usually only fifteen minutes, and there was minimal discussion, no agenda, no minutes—and no chairs. The group met in Levy's office, standing, and Levy often took phone calls during meetings to show how little importance he really gave to the committee. As John Weinberg acknowledges, "Gus always resented Sidney's having created the need for him to get committee approval." And as John Whitehead observed, "Gus was always afraid he would fail to fill Sidney Weinberg's shoes."

"Sidney and Gus were different in many, many ways," recalls Doty. "For example, Sidney would listen quite solemnly and intently to all you might want to say, and then simply ignore you. Gus would not listen—interrupting all the time and arguing—but he'd take your advice and information to heart and would *use* it."

On decisions that came to him, Levy required very short memoranda stating the situation and the specific recommended action; known across the firm as Gus-O-Grams, they had to be so carefully thought out that they were usually only four or five lines long. Otherwise he believed you weren't ready to act. Extensive examination of the facts of the matter and wide consultation within the firm were certainly expected, but having been done, the complete homework did not need to be paraded in the action recommendation. And Levy always came back within twenty-four hours. "Getting time with Gus was always hard," recalls partner Peter Sacerdote, "but he always read your memo and he always got back to you in time." Levy returned internal phone calls the same day—and usually the same hour. And his calls were always *very* short.

Levy routinely cut off discussion as soon as he was ready to decide a matter, and he was nothing if not decisive. As John Whitehead puts it, "Gus was indefatigable and never wasted a minute. There was no idle chatter with Gus, ever." When he asked questions, Levy wanted answers that were short, direct, and specific. He abhorred ambivalence and uncertainty. When one of his colleagues offered tentatively, "We may be able to do something that may help," Levy cut him off: "*May* is just a month between April and June. It has no place here at Goldman Sachs."

"Sometimes, you could get your way with Gus just by taking longer to talk about something and taking up more time than he was willing to give to the decision you were discussing," recalls Doty. "[Partner] Walter Blaine, a very upright sort of guy, would take *forever* discussing something. Sometimes, Gus accepted Blaine's decision not because he agreed with his views, but because he felt he couldn't afford the time Blaine would take discussing details and ramifications all too fully before a better decision could be hammered out. Gus's conclusions were often far better than the reasons he would give you. He was very intuitive and fast in his thinking." As partner Ray Young recalled, "Gus had a very quick mind, particularly with numbers. His one wart was this: He rarely if ever would compliment people for what they had done." Nor did he waste time on pleasantries with spouses when, as he often did, he called at home—early or late.

Decisions that did not require Levy's authority were expected to be made by others. "Gus was a great delegator *if* he trusted you," observes a banking partner. "He could also get *totally* involved." Levy was both decisive and remarkable in his good judgment. "He was not the most brilliant guy in the world," a contemporary

once observed of him, "but then the average genius on Wall Street, when you meet him, usually turns out to be just a clever guy. People aren't stunned by his brilliance, but they feel sure that Gus will get things done."[9] Levy had an intuitive sense of what might be doable, an instinct for action, an understanding of the risks that would have to be taken, and the fortitude to take the risks required to get things accomplished. In a persistent search and striving for advantage, he was always negotiating.

"Gus was very resourceful in the way he engaged in person-to-person negotiations inside the firm as well as with those outside the firm," says Doty. "He'd be very careful to give me the impression that such-and-such had already been agreed upon by so-and-so and therefore his hands were tied, so he and the firm would just have to live with it. Several times, he really had me 'solved' that way. But if you refused to accept it, you'd find out that, amazingly enough, he would still be able to renegotiate the supposedly final settlement."

Levy "negotiated" others, but he certainly expected no one to negotiate him. That's why "Two in the red!" may have been the riskiest outcry in the history of Goldman Sachs. A not particularly competent salesman (who later sued the firm for age discrimination when he was finally let go) had two box seats for a 1972 NBA playoff game between the Knicks and the Celtics—one of the most in-demand games in the history of basketball. Henry Ford wanted to go. He called Gus Levy and said so. The salesman had the only pair of tickets around, so Levy asked him to do this favor for a great friend of the firm. The salesman refused, saying, "Gus, my word is my bond. I promised a *client*. Even for Henry Ford and you, Gus, I can't renege on a client commitment." However reluctantly, Levy accepted. A promise is a promise and a client is a client. But as the crowd poured into Madison Square Garden that night, the salesman could be seen waving two tickets high over his head—both in the coveted "red" section—from the top of the steps. "Hey! Two in the red! Buy these tickets! Buy 'em now! I've got what you want: two in the red!" It was lucky for the salesman that word never got back to Levy.

Levy missed very little and was able to do so many things because he had extraordinary self-discipline, planning each day's many activities and closely

monitoring actions taken. He kept a long yellow legal pad with a list of items he wanted to get done, usually one line for each item. He'd get up at five thirty, run on his treadmill, say his prayers, and be at work by seven each morning. Then he'd take up his long yellow pad and start calling. Levy was an extraordinarily *operational* presence. As the CEO of Monsanto recalled with wonder, "Gus would call in the morning and give me price quotes on various stocks—for no particular reason—and then say, 'Well, I thought you'd be interested,' and hang up." He made those calls by the dozen day after day. Always pleasant, his calls seldom went over thirty seconds. And when return calls came in, Levy picked up his own phone. So did everyone else. Levy wanted no secretaries in between customers and sales traders. That "separated" customers from sales traders and wasted valuable time. Intensity and speed were crucial to Levy.

"If he called me on a Monday about something," recalls Doty, "and I explained that it would take, say, three full weeks to get that thing done, he wouldn't wait the three weeks. He'd call again the next Monday, wanting to know if I'd gotten it done yet. So I'd explain again all the reasons it would take the three weeks we'd already agreed upon. But the heat was clearly on, and he just might needle me into getting it done faster—and *surely* not any later." One evening, Levy gave a competitor a ride uptown in his limo. He had more than a page of foolscap listing, one per line, the calls he had received that day but had not yet been able to return. Given the late hour, his passenger noted that it was too late to make the return calls. Levy's tense reply: "They'll *all* be called by midnight."

A salesman who worked out of the London office had a typical experience. "Having flown into New York from Europe the night before, I woke up early and couldn't get back to sleep because of the different time zones, so I decided to go on down to the office instead of just sitting around my hotel room killing time. It was ten before seven in the morning when I got on the elevator to go up to the office. Another man got on just behind me: Gus Levy. Two weeks later, I was back in New York again; couldn't sleep again; and decided again to go on down to the firm early. It was a quarter to seven. And there was Gus again. Let me tell you, that sort of thing sets real standards in a firm and builds wonderful loyalty." Levy kept two very productive secretaries—Inez Sollami and Betty Sanford—very busy, and they too came in by seven. As partner Jim Gorter recalls, "Gus Levy was a shirtsleeves, no-frills guy. In the office before seven

every morning. Worked like a dog! Gus set an example by his own dedication—and he expected *everyone* to do the same." Retired partners agree that the dual emphasis on individual performance and on teamwork at Goldman Sachs came from Gus Levy.

"The firmwide work ethic really set them apart," says a block-trading competitor.[10] "At most firms in the 1970s everybody was in by nine a.m. At many firms, people were in by eight thirty; and at some, by eight. At Goldman Sachs, *everyone* was in by seven in the morning—because they truly *wanted* to be in. It made them feel different; they believed they *were* different. Gus set the standard by being among the very first ones in every day."

As Levy himself put it, "We have real spirit. We love to do the business. We get a kick out of it, and it's fun. While none of us wants to deprive a guy of a family life and a home, we do demand a full day. We want to make Goldman Sachs a close second to his wife and family. A *very* close second."Recalls Fred Weintz, "Gus had awesome standing in the firm. He once joked about how committed he was, saying, 'Just stick a broom up my ass, and I'll sweep up, too!' "

Levy was notorious for being "everywhere at once"—often having two different dinner engagements scheduled on the same night, with at least one at "21." Citibank's Walter Wriston once explained: "About six o'clock each evening, there really are *two* Gus Levys, both in tuxedos and both going to dinners in Manhattan—and both in a hurry." Levy, like many Wall Streeters before and after him, was busy in other ways; as his lifelong friend Tubby Burnham of Burnham & Company summarized, "Gus liked girls." Levy was also active in both politics and charities and was a director of twenty-one corporations, including Braniff, Studebaker, May Department Stores, Worthington, Witco Chemicals, and Lanvin-Charles of the Ritz. As John Whitehead admiringly explained, "Every CEO [of a company Gus served as a director] used to say that Gus Levy was his best outside director. Well, it's easy to be the best outside director of one company, but to be regarded so highly by *all* the companies whose boards you're on is really quite remarkable. And yet that's what people said he was." Then he had a whole further life in the world of nonprofit organizations, particularly Mount Sinai Hospital, where he was the active president and chief executive officer for years—in addition to all his fund-raising and political activities. He was treasurer of Lincoln Center, trustee of the Museum of Modern Art and the

Kennedy Center, and commissioner of the Port Authority of New York and New Jersey, and three times was treasurer of the United Jewish Appeal.[11]

On the board of directors of Lanvin-Charles of the Ritz, Levy was not like the other directors and not at all like the urbane, sophisticated CEO, Richard Salomon. He cared not at all for decorum. For example, while the other directors sat around a table in the boardroom, Levy sat separately in a corner, following closely the directors' discussions while talking to one person after another on the phone. His language was notoriously coarse as he talked from the boardroom to people at the firm: "That bastard is always trying to screw us. Fuck the fucker! He can't fuckin' fuck us. Tell him to go fuck himself."

"Gus was a leader, but not a manager," says L. Jay Tenenbaum. "Gus never had plans. Everything was daily—or even shorter—and very transactional. He only dealt with the crises. And if Gus found a part of the business we weren't covering, that was a crisis. Gus hated not covering *everything*. I can hear him now, nearly screaming, he was so upset: 'L. Jay! We are falling short in *options*! We're behind in *options*!' And he would want me to jump right to it and build up an options business, saying, 'What am I *paying* you for?' If Gus wasn't complaining or disgusted or shouting at you, you could figure he thought you were okay. He was a very bad teacher. Never explained anything or how to do anything. Gus always *knew* he could have made the call, done the trade, or whatever better—a lot better—if he'd only done it himself."

"In trading, 'being there' really matters," explains an admiring competitor, "and Goldman Sachs was always 'there' for their accounts. They knew how to take their little losses—and did—so they were very much in the flow when the big payoff opportunities came along, so they could—and would—win big by doing the major trades. And they were not above finding their full share of those numerous opportunities to pick up a little extra profit by anticipating a trade, going short a few thousand shares before a big block came onto the market—all of which was part of being in the block-trading business in those days."

Levy's constant pressure on others—always matched by the pressures he put on himself—produced an efficient, internally cooperative organization of people who were intensely competitive externally, people who again and again earned extra business and extra profits. At TIAA-CREF, a major institutional investor, Rodger Murray was managing the stock portfolio. After careful study, he decided

in late December one year to restructure the portfolio and decided the best way to do that was to complete the restructuring before year-end. Goldman partner Gene Mercy recalls with a smile, "Rodger called me from his home where he was working on Christmas Eve to say, 'We have a major market operation that we need to get done—now. Other firms are already closed for Christmas, so we're turning to you to do a series of large trades in utilities.' We reviewed the stocks in their portfolio and agreed to trade them at the close. With the music of the Salvation Army Christmas players outside, Rodger gave the go-ahead, and we did fifteen percent of the total NYSE volume that day in one minute at the close of trading—at the old fixed rates, for $425,000 in commissions—just for always being there, even on Christmas Eve, to pick up the phone."

In another case, when the Navajo Indians won an enormous cash settlement with the federal government, it was reported on a Thursday. By Tuesday, Citibank executives were in Arizona, determined to be the first to speak to the tribal elders. They were understandably stunned to hear, "But we already have a financial adviser. Gus Levy came to see us on Saturday. Gus Levy is our investment banker."

In Memphis, to help partner Roy Zuckerberg build up the firm's individual-investor business, Levy was all Southern charm. Speaking to a group of local business leaders, he began, "Ah'm from aways down rivah," gently and colloquially separating himself from New York and up-North and Yankee while genially and modestly making the connection between Memphis and his own hometown, New Orleans. As they reviewed that session afterward, Zuckerberg gently, but somewhat critically, pointed out that Levy had not actually asked for the business. Levy appeared preoccupied and not really listening, but at a subsequent meeting a few months later, with two dozen business leaders and wealthy prospects in Los Angeles, Levy's first cards off the deck were blunt: "We've come all the way from New York City to Los Angeles because we want your business!" After dinner, Gus asked, "How'd I do?" and Zuckerberg suggested he might have been perhaps a bit too direct. Levy retorted, "But Roy, that's what you *told* me to do!"

An important part of Levy's remarkable ability to produce business was his extraordinary range of personal connections. A devout Catholic, George Doty went to Mass every morning before coming to work by 7:30, gave generously to the Church, and made Fordham University *his* charity organization. Levy saw Doty and asked: "George, do you know the cardinal?"

"Of course, Gus. Cardinal Spellman."

"But, do you *know* him. You ever met?"

"No, Gus. Never."

"Come with me Wednesday. I'm having lunch with the cardinal. I'll introduce you. He'll be glad to meet you."

Similarly, George Bennett was the Man in Boston: treasurer of Harvard, the country's biggest endowment; a dominating managing partner of State Street Research & Management, then one of Boston's largest and most prestigious institutional accounts; and a director of Ford, Hewlett-Packard, and other major corporations. Once or twice a year, Levy visited accounts in Boston, where State Street was a key client, and Bennett was the strong man, so Levy went there. They would hug each other—neither man was ever considered a hugger or huggable by his own associates—and go into Bennett's office, close the door, and talk "serious talk" about politics, Ford, Harvard, Florida Power, and people.

For Steve Kay, a thirtysomething salesman who focused on traders, nothing could be more helpful to his ability to do business than having—and everyone at State Street knowing that he had—a special relationship with managing partner Bennett. "Steve, come in here so George can get to know one of our very best, fast-rising young professionals." And, never pausing, Levy moved right into sharing the inside scuttlebutt that everyone treasured from their time with him because he always seemed to know *all* the important people.

Later Levy called Kay. As usual, he was direct and brief: "I'll cover Bennett. You get to know Smith." And that was all Steve Kay needed to hear to know what nobody at State Street would know for a year: Charlie Smith was going to be George Bennett's chosen successor as managing partner. This gave Kay plenty of time to get close with the affable Smith, who privately resented being ignored by most Wall Streeters. Kay would soon have their relationship firmly established—long before anyone else in Wall Street had the first clue about the power shift—and Goldman Sachs would continue being State Street's most important and most profitable stockbroker, getting nearly fifteen percent of its business while the runner-up broker would get less than ten percent, and much less profit, for working equally hard. The difference was close to one million dollars in revenue.

As more and more Wall Street firms organized "asset management" divisions to get into the fast-growing business of managing pension funds, Kay, as head of

the Boston office, came under heavy pressure from institutional accounts to stay out of the lucrative investment management business. "Don't compete with us; we're your *clients*—and investment management is *our* business!" Loomis, Sayles & Company was particularly concerned about competition from brokers and had a strict rule: If a broker stole one of its accounts or even one of its people, Loomis Sayles would do no business with that firm. But as an old-line, conservative Boston firm, Loomis Sayles didn't pay competitively, so its best young people kept getting bid away. After Goldman Sachs had taken a *second* person, Dick Holloway of Loomis Sayles called to remind Steve Kay about the Rule, and Kay called Levy, telling him of the loss of a large account. "I wanna see 'em," was all Levy said, and he hung up. This put Kay in a box: He couldn't say no to Levy, and why would Loomis Sayles agree to see anyone from Goldman Sachs after it had broken the Rule a *second* time?

Dutifully, Kay called Holloway to plead for a short visit.

"Gus Levy wants to see *us?*" Holloway exclaimed, adding that he would call back after checking with his CEO. In less than an hour Holloway was back on the phone: "We'd be *glad* to meet with Gus Levy. No, don't come to Boston. We'll come to New York. When would be most convenient?"

A luncheon at Goldman Sachs's office was arranged for the men from Loomis Sayles with Kay, Levy, and research director Bob Danforth. Levy was obviously preoccupied and didn't participate in the conversation. Then one of his secretaries, Inez Sollami, came in to say, "Governor Rockefeller wants to reschedule your meeting for two o'clock and wants to move it to the Roosevelt Hotel instead of Pocantico Hills. He asks that you come in by the freight elevator so you won't be spotted." (The New York City hospitals were going on strike, and Rockefeller was personally involved in the negotiations because he feared racial problems if the hospitals were closed.) Levy took two other calls—both from prominent corporate executives—and then briefly focused entirely on his two guests. "I know we hurt you, and I apologize for that. Now we'd like to *help* you. Steve, let's see what we can do here to get these good clients of ours some nice new business. I'll call Bob White at Ford and recommend their services as pension fund investment managers—and Jimmy Ling needs someone too." Then, apologizing for having to go so soon to meet Governor Rockefeller, Levy left. He probably never knew the names of his guests. But he knew his business. When they got back

to Boston, the men from Loomis Sayles made Goldman Sachs one of their most important brokers.

Since every mutual fund had to report its shareholdings quarterly, it was easy to figure out who was selling after two or three blocks had been executed. On one big series of trades, Steve Kay in Boston knew that MFS, a big mutual fund organization, was the seller and that it had an exclusive with Salomon Brothers. Inez called: "Mr. Kay, Mr. Levy would like to speak with you." Gus Levy never called to say, "Well done"—so Kay knew as he waited on the line that there could only be one reason for Levy's call: to chew him out. "You've missed three big trades so far today. Don't you Boston guys know your accounts any better?"

"Gus loved doing business," observes Lew Eisenberg, who headed institutional sales in the 1980s. Long before Levy called him by his real name, Eisenberg was known as "the kid from Hartford," not because he was born or raised there—he was from Chicago—but because that's where his initial group of institutional accounts were located. After a few years of covering the Hartford accounts, Eisenberg got up the courage to propose to Levy that they make a joint trip to Hartford to visit the financial vice president and the treasurer of the Travelers Insurance Company.

During the plane ride to Hartford, Levy hardly spoke two words to Eisenberg. Same on the return flight. Nearly a week later, Levy received a call from Travelers saying the client felt their meeting had gone well and Levy could tell Eisenberg that he would soon be the selling broker for the first block trade in history to be done at negotiated rates. The size of the block would be 250,000 shares, with a commission of seventy-five thousand dollars—unless, with the firm's usual hustle, that commission could be doubled by finding buyers for that block and doing a cross (handling both sides of the transaction) generating total commissions of $150,000. Levy clearly expected the trade to be a cross at $150,000.

Once inside Goldman Sachs's trading room, Levy focused entirely on doing business. He had tinted-glass partitions around his desk, which was in the center of the trading room. Through the glass he could see all and hear all, checking the status of every big position or every possible trade while seeing visitors—mostly insiders, and as many as ten an hour—and taking and making calls all

the time, often two or three calls at the same time. He had sliding windows in the glass partitions so he could open them quickly to bark instructions, as he frequently did. "Why do I do it? It drives me. I don't know why, frankly. It's responsibility—trying to do the best you can. It's not a question of getting ahead, because I can't get ahead much farther. Now I just try to be afloat."

Challenged to explain why he had a general reputation for toughness, Levy said he recognized that he got "such a kick out of making a transaction that I guess I get excited and I say things I don't really mean. Then my conscience gets the best of me and I apologize—despite the fact that that's the one thing I hate to do." Levy's self-appraisal was that he was too open and not tough enough: "I think people at Goldman Sachs know that my door is always open. I have certain opinions, but they are not built in concrete. I'm willing to listen to reason."

"Gus was remarkable," says John Weinberg. "He had a tremendous capacity to do a huge number of things and do them all very well." Levy left Goldman Sachs every day at three thirty so he could be at Mount Sinai to run the executive committee from four to six—and then would take a Goldman Sachs client to dinner, usually to "21." And Levy was always networking with powerful people—in philanthropy, finance, or politics. "Gus Levy and Nelson Rockefeller, as powers in the New York Republican Party, would go to a small room with [NYSE floor specialist] Bunny Lasker and others to swap stories—crude dirty jokes, political gossip, and personal insights into powerful people."

Levy lamented: "I guess I'd have to admit that it's very hard for me to say no. I'm a bad naysayer—except where a principle is involved. It's very hard for me to turn a guy down. I wish I was harder. Mr. Weinberg used to say that if I were a woman, I'd always be pregnant because I just can't say no." Levy repeatedly promised one or another of his friends to give the friend's son a job at Goldman Sachs, usually in sales, and sales manager Ray Young would call to protest, "Gus, this is *my* job and *my* department. If you don't stop stuffing dopes on me, I'll quit."

Levy affected a gruff exterior, but he was there to help anyone in the firm who had a real crisis. On any serious personal problem, he would never say no. When a plane was hijacked in Israel with the daughter of one of the firm's older messengers aboard, Levy called the messenger to come right up to Levy's cubicle on the trading floor. The poor guy was scared to death to go. When he arrived,

Levy said how concerned he was about the man's daughter and that he wanted to help in any way he could. This was, of course, very nice to say. But then Levy picked up the phone and said, "Get me Bill Rogers"—when William Rogers was secretary of state—and in minutes, he was put through to the secretary himself. Levy knew Rogers from his days as a New York lawyer and their shared interest in Republican politics, so he spoke directly, explained his reason for calling, said, "Keep me posted," and hung up. The lasting impact Levy's call made on the old runner—and others in the firm—is easy to imagine.

Levy was a voracious and persistent learner, always striving to do better and to be better in every way. "Don't tell me where we're good. We can't do much about that. Tell us where we're weak, where we can improve, because that's what we are determined to do." Goldman Sachs got better and better under his leadership, and Levy's personal stature rose steadily higher.

As Doty recalls, "With his amazing memory for people and numbers and situations, he had a phenomenal list of people he could call and say, 'I need you to help me, and it won't hurt you.' Then he'd explain what he wanted—and he'd get their help. He was out of the Wild West as a young man, a loose cannon calculating what he could do, what he could get away with. And he was 'too Jewish' for Sidney. But when he became chairman of the New York Stock Exchange and a prominent figure on the national scene, although we had many arguments within the firm, Gus became much more conscious of the importance of process and order."

"Gus was very proud of being the first Jew to be chairman of the Board of Governors of the New York Stock Exchange," said his friend Tubby Burnham. "He considered that position very important in his life. However, Gus was really not a great chairman because he couldn't separate his thinking from what was in his own firm's interests. He was always favoring Goldman Sachs. More important than his two years as chairman of the Big Board, Levy was truly the father of NASDAQ's national market system. I know because I was there. In 1976, when Rod Hills was chairman of the SEC, he called me as head of the Securities Industry Association and said, 'Tubby, we've gotta have a *national* system for the over-the-counter business. And you've gotta come up with a system—and quickly—or we at the SEC will have to impose a system on you.'

" 'How much time will we have to get this done?'

"'Six months. It's not much for a major thing like this, but that's all you can have.'

"'Thanks, pal. Thanks a *lot*.'

"And as soon as I hung up, I called Gus because he knew the OTC markets so well. He was in Bermuda. 'Gus, you've gotta chair this committee and work out a solution.' And I promised him he could have any people he wanted. Gus's committee came up with the system where every OTC dealer and every market—Pacific, Chicago Board, and all the rest—had to show their bids and asks through a central computer screen and had to be good for one thousand shares on either side. And that was the whole secret to our country's having the national over-the-counter system, or NASDAQ, that now handles more daily volume than the NYSE."

Levy respected toughness, particularly in competitors, and had remarkable inner capacities to rise to any occasion. One illustration is the way he handled a dramatic change that confronted the New York Stock Exchange, where he was an increasingly prominent power. As head of Donaldson Lufkin & Jenrette, Dan Lufkin arrived in 1970 at his first-ever meeting as a new member of the NYSE Board of Governors. The meeting was in the ornate amphitheater appropriate to the knights of capitalism who were gathering together. Lufkin carried two large, heavy boxes tied with sisal cord with wooden handles—just in from the printers.

Lufkin had met the night before to brief his friend and incoming NYSE chairman, Bunny Lasker, about DLJ's decision to break all tradition and go public—and to tell him that the preliminary prospectus or "red herring" would be filed with the SEC at noon the next day. As the Board of Governors meeting came to order at three thirty on the day of filing, Robert Haack, NYSE president, was handed a news item that had just come on the broad tape announcing that DLJ had filed for its initial public offering.

Lasker announced: "We have an important news report that concerns us all—DLJ has filed an IPO with the SEC. Fortunately, we have Mr. Lufkin here to explain." Lufkin then opened the boxes and asked that copies of the preliminary prospectus be passed out. Taking a deep breath to maintain composure, he began explaining the revolution that an "upstart" firm, not even fifteen years old, was provoking. Angry feelings were widespread. "You are Judas!" exclaimed Lazard Freres's Felix Rohatyn, saying the NYSE's only option was to expel DLJ immediately from membership.

That evening at the traditional transitional dinner for incoming and outgoing exchange governors held uptown at the Brook club, Lufkin—clearly and obviously being avoided by everyone—was standing alone at the bar nursing a beer when Levy, as outgoing chairman, arrived and went over to say: "I don't agree with you, and I don't like what you did today."

Lufkin started to counter with "I hope you will see things differently soon and . . ."

Levy cut in: "I haven't finished"—and continued admiringly, "But you have guts coming to this dinner after all that."

While deeply Jewish, Gus was an exemplar of Christian virtues," says George Doty. "He was always giving. And he taught me the joy of giving. He gave both in dollars and of himself and his time. If you asked his help with, say, a dinner, he would never pause or beg off. He'd open his appointment book right away, and if it was possible, he'd sign up then and there. Gus would work for *any* charity. That's how he got to know Cardinal Spellman: as a Jew working for Catholic charities."

"Gus Levy was the first one to ask 'How much?' *publicly* at appeals," recalled Tubby Burnham, who explained the way it happened. A meeting was held at Lehman Brothers where the senior leaders of the Jewish community on Wall Street—André Meyer, Joe Klingenstein, Bobby Lehman, and the others who had been the young Turks back in the twenties and thirties put the challenge on the table: How could the younger Jewish leaders organize *their* generation to give in significant size? "We didn't have their kind of money, so Gus, who was our natural leader, said it would be necessary to solicit many more people in order to match the personal giving of the older, wealthier leadership."

At the next annual dinner of the Federation of Jewish Philanthropies, Levy took the microphone and launched right into a new kind of public solicitation. Without ever pushing or demanding, but by publicly asking in a nice way that included calling out the donor's name, telling something about him and his family and his business and the good things he'd been doing at work and in philanthropy—really the person's life history—Levy would end with, "And last year, you gave fifteen hundred dollars to the Federation, and we're all wondering

what your gift will be *this* year?" And then in that moment of silence, the recipient of Levy's nice words would say, "I'll give . . . two thousand dollars." And Levy would reply warmly, "That's a very nice gift. Nice increase too. Thank you very much."

Levy would then turn his charm and the audience's attention to the next donor. Of course, he already knew each of his prospects and what they could give; he'd done his homework. He knew whom to ask first and who, like Charles Revson, needed to be a big shot and get featured with a lot of attention, and he knew exactly when to call on each of them. In that one evening, Gus Levy raised three times more money than had ever been raised before. And of course the calling out of names and stating specific amounts has gone on and on because it works so well. Now, it's a tradition—but it all began with Gus Levy.

"Gus was very extroverted, gregarious—and generous," recalls Peter Sacerdote. "One year, he gave one million dollars to the Federation and, in his speech, he said it was really not a big deal—that it had been more of a stretch when he gave one dollar that first year he was at the YMHA." More than money, Levy gave his time. He worked for hours every weekday for years as chairman of the executive committee to build Mount Sinai Hospital almost single-handedly.[12] Honored with an award for lifetime service, Levy took the mike to say simply and memorably: "I never expected this. I certainly don't deserve it—and I'll never forget it."

Levy was as notoriously intense in his private life as he was at Goldman Sachs and in philanthropy. His friend Burnham recalls: "Gus and I went all the way back to when he first got to New York. We talked at least once every day and played golf on weekends. Gus called me on Friday night from California: 'The grim reaper's got me, Tubs. My heart.'

" 'Did you see a doctor, Gus?'

" 'Naw. I'm not going to a doctor. I'll meet you on the first tee at eight tomorrow morning. I'm taking the red-eye in.'

"Next morning, just before eight, Gus comes up to the tee. 'Do you guys mind if I jog?' We all know Gus and what he has in mind. He'll hit his ball, run to it, wait for us to catch up, hit again—and jog off. We agree he can jog and we double the stakes. By the end of the ninth hole, Gus is down eight—and finally decides to play like the rest of us."

. . .

A strong record of past achievements and profit making had led to Gus Levy's being selected managing partner, but leadership authority and power in Goldman Sachs, as in all Wall Street firms, has to be earned over and over again every time the leader gets challenged—just as a male lion has to keep defending his pride of lionesses. Gus Levy knew and understood all this. What he did not know or anticipate was that his greatest threat would suddenly bolt out of the firm's oldest business—commercial paper—where Goldman Sachs, over the past hundred years, had made itself the leading dealer.

7

THE WRECK OF THE PENN CENTRAL

Without commercial paper, Goldman Sachs would have been unable to expand beyond the core of Sidney Weinberg's corporate clients—and even they would be at risk as competitors kept forcing the question: "Without Weinberg, why work with a second-tier firm that's only able to provide one specialized short-term financing service?"

In the early 1970s—before the boom in corporate bonds, before international bonds were anything more than rare oddities, before the invention of mortgage-backed and asset-backed bonds such as GNMAs, before high-yield bonds, before medium-term notes, floating-rate notes, and the myriad other aspects of today's enormous bond markets, and long before the derivatives and computer models that tie all these disparate instruments into one massive, complex debt capital market—commercial paper was far more important than a current observer might first imagine. And it was the strong basis, over the years, for the firm's expansion into money-market instruments and then on into bond dealing. Commercial paper was not only Goldman Sachs's oldest business, it was the only corporate product where the firm was the acknowledged market leader, and it became

the single, vital point of entry on which John Whitehead was striving to build an important and eventually highly profitable investment banking business.

During the fifties and sixties, use of commercial paper increased significantly. As interest rates rose and rose again, issuing commercial paper became increasingly attractive as an alternative to bank loans for more and more companies. And even if the commercial-paper alternative seemed not really the right way for a particular company to borrow right now, it was surely worth considering for the future, so discussing its advantages with the man from Goldman Sachs was easy to justify. Commercial paper also made considerable progress as a way for many corporations to temporarily invest surplus cash. Interest in buying commercial paper as a short-term, money-good investment increased substantially because the Federal Reserve's Regulation Q limited the interest rate that banks could pay to attract time deposits; commercial paper offered higher rates. The "unique selling proposition" of commercial paper—unsecured short-term borrowings that were cheaper and more flexible than bank loans—was attractive, very attractive. So doors opened and conversations began at more and more companies. Without commercial paper, Whitehead's ambitious strategy in investment banking would never have succeeded, but with commercial paper, it was almost certain to succeed—or so it seemed.

For Gus Levy, early 1970 promised a great year. His institutional block-trading business was so successful that even without a retail-customer business, Goldman Sachs ranked third in NYSE commissions and was much more profitable than any other stockbrokerage firm, earning at a record rate of 40 percent on the forty-five partners' fifty million dollars in capital. Confidence was spreading throughout the firm, including confidence in the leadership of Gus Levy and in the direction he was taking the firm.

The securities business was changing, and change creates opportunity, particularly for aggressive innovators. The era was replete with business opportunities and challenges, and Levy was flat-out committed to capturing every profitable business opportunity for his firm. Maintaining intensity of commitment was essential to the firm's continued progress and would have been a great challenge for any leader, particularly anyone coming after someone as dominating and effective as Sidney Weinberg. Levy believed he was up to the challenge but

knew that leaders are only as effective as their followers' confidence and commitment make them. Committed to attack and expansion, he had no spare capacities or resources for defense or to deal with new troubles. Levy certainly wasn't looking for any new trouble, but new trouble found Levy.

He got hit by the largest railroad company in America: Penn Central.

On June 21, 1970, Penn Central Transportation Company—the eighth-largest corporation in the nation and the largest owner of real estate—petitioned for reorganization under Section 77 of the Federal Bankruptcy Act, and at 5:45 p.m. U.S. District Court Judge C. William Kraft signed the petition. It was the largest bankruptcy in history.

Although its assets and book value were immense, Penn Central's stock price had plunged to ten dollars—down 88 percent from a high of $86.50 two years before. Between April 21, the day before it announced a $62.7 million loss for the first quarter (versus a much smaller $12.8 million loss in the same quarter a year earlier), and May 8, maturities and payments on its commercial paper exceeded sales by $41.3 million, leaving a balance outstanding of $77.1 million. Six weeks later, with Penn Central in bankruptcy, the market value of its commercial paper plunged, imposing large losses on clients of the issuing dealer for Penn Central's commercial paper, Goldman Sachs.*

Penn Central was Gus Levy's personal client, and the loss it threatened to impose on Goldman Sachs was not only larger than any prior loss, it was larger than Goldman Sachs.

The trouble was quickly contagious. Nearly three hundred other Goldman Sachs commercial-paper issuers faced a rush by investors to redeem their paper that meant the clients suddenly had to borrow from their banks to buy back their own commercial paper.[1] The Federal Reserve had to take swift and substantial action to ensure liquidity in the U.S. banking system. Standard & Poor's cut Penn Central's bond rating from BBB to Bb. According to Standard & Poor's Guide, a BBB security is "borderline between definitely sound obligations and those where the speculative element begins to predominate." The Bb securities have "only minor investment characteristics."

* Penn Central was not the first commercial-paper issuer to default. In late 1968, Mill Factors, another Goldman Sachs client, had defaulted on $6.7 million of commercial paper, and two holders—Alexander & Baldwin and Worcester County National Bank—sued Goldman Sachs. The firm paid out fifty thousand dollars.

Clients who had bought Penn Central commercial paper through Goldman Sachs could be expected to sue. Eventually over forty investors did sue, seeking recovery: Their claims totaled over eighty-seven million dollars. With partners' capital of just fifty-three million dollars, Goldman Sachs didn't *have* eighty-seven million dollars.[2] Penn Central–related lawsuits could wipe out all the firm's capital and more.

Losing the partners' money—or even a significant fraction of it—was devastating to contemplate. Beyond the money, it could cost Levy in loss of authority and strength of leadership. Partners close to Sidney Weinberg, who had worried about Levy's being too much of a trader with "ragtag" friends, could have withdrawn or reduced their crucial support.

Levy and others had assumed that gigantic Penn Central could always raise capital—if necessary, by selling off some of its enormous real estate assets—and had trusted Penn Central's chief financial officer, David Bevan. But Bevan had lied to Levy and to his fellow employees at Penn Central and to all his friends. In the exhausting series of misadventures since the merger that had produced Penn Central, Bevan had been scrambling to create liquidity for the asset-rich money-loser and had come to believe he had a "higher responsibility" to do anything and everything to save his company—at least until some of its real estate could be converted into liquid assets. Bevan was in over his head, struggling to keep up. As John Whitehead later recounted: "David Bevan was a nice enough guy, but as Penn Central's problems got worse, he was way out of his depth. He didn't know what to do and decided his responsibilities were to his company and the people he knew personally, so he deliberately lied to Penn Central employees and to his friends—including Gus Levy. He was entirely wrong, of course, but that's what he was thinking."

Bevan's struggles and poor judgment led to serious mistakes. Just ten days before the bankruptcy announcement, Penn Central appointed a new CFO[3] because Bevan faced criminal charges. Bevan had tried to force a bond underwriter's law firm to remove a lawyer who was working on a Penn Central bond issue and who "was particularly diligent in demanding full and unvarnished disclosure." This led to investigations that revealed various misfeasances: self-dealing by Penn Central executives, lavish expenses charged to subsidiaries, and insider trading. The offenses were not limited to Bevan. The SEC report charged that "the board repeatedly failed to act despite direct and clear warnings."[4]

Bevan's personal failings were a particularly explicit symptom of the malaise within Penn Central, which was a merger only in legal terms. In the largest railroad combination in history, the New York Central and the Pennsylvania Railroad had combined into one massive transportation and property complex with 20,530 miles of track. But after a century of archrivalry, the intensive competition between "Central" and "Pennsy" never stopped. Disputes, often quite serious disputes, continued between the "green hats" and the "red hats"—the premerger colors on the two lines' boxcars. Worse, the president (Stuart Saunders from Pennsylvania) and the chairman (Alfred Perlman from New York Central) bickered even at board meetings and fought over key appointments until, two years after the merger, Perlman finally gave up and agreed to step aside as chairman so a new president[5] could be brought in from AT&T's Western Electric unit. Instead of increasing operating efficiency, the merger increased chaos: Freight cars got lost; switch yards got jammed up; every day twenty to eighty trains got delayed because there were no engines to pull them; the computer systems were as incompatible as the people; and freight customers and passengers complained bitterly. As operating losses mounted, the dividend was cut and the stock price crumbled.

Amid these crises, Penn Central management cited numerous optimistic numbers: a 6 percent freight-rate increase authorized by the Interstate Commerce Commission would add eighty million dollars; a change in interline freight-car rentals would add sixteen million dollars; merger savings were running at thirty-four million dollars, twice what had been expected; thirty million dollars in extra costs of integrating the two lines were nearly over, and the Connecticut commuter lines that had lost over twenty-two million dollars annually would soon be taken over by the state, which would pay eleven million dollars for rolling stock and four million dollars in annual rents. In addition, executives observed, if it ever needed to raise money Penn Central could sell off pieces of its three billion dollars of nonrail assets—largely New York City properties like Madison Square Garden and Midtown apartment buildings.

Penn Central had ample assets but too little cash. And as its troubles got worse, its lack of financial flexibility got worse even faster. As recently as the summer of 1968, Penn Central had made public a plan for a new mortgage-bond issue that would consolidate more than fifty different debt issues of the Pennsylvania and New York Central railroads. This umbrella issue was sure to exceed one billion

dollars and was to be backed with the combined railroads' real estate holdings, including prize parcels of land in Manhattan. Penn Central also planned to raise one hundred million dollars of commercial paper as part of this massive restructuring and began using Goldman Sachs as its commercial-paper issuing dealer.

However, there were ominous signs. One ICC commissioner even spoke of a possible bankruptcy, saying, "The most discouraging thing is that the company is way ahead of its savings goals, yet the deficit is getting worse. If the Penn Central goes into receivership, anything can happen."[6] Others scoffed at the notion of bankruptcy for the nation's largest railroad. "They have assets up to their ears," said a federal official at the time. "The question is how fast they can liquidate assets into quick cash. Hell, they are the largest real estate holding company in the country."

Among a long series of negative events, these were major: In a crucial change following objections from Congressman Wright Patman, the Defense Department decided not to guarantee a two-hundred-million-dollar borrowing. (Goldman Sachs had been told of this confidentially in February.) After this setback, the company[7] was unable to float a bond issue of one hundred million dollars even at a high interest rate of 11.5 percent. In the preliminary prospectus for that aborted issue, the company revealed that it was having difficulty rolling over its outstanding commercial paper as it came due in the twenty days from April 21 (the day before the railroad announced the big first-quarter operating loss) through the day the prospectus went to press on May 8. In what might have been seen as a desperate tactic, the company borrowed fifty-nine million dollars in Swiss francs—with just a one-year maturity—at a high average interest rate of 10.1 percent before reporting a loss of $56.3 million for 1969 and another loss of $62.7 million for the first quarter of 1970.[8]

After the merger, both real estate and railroading had needed cash: In early 1968, the Penn Central was using up cash at the rate of seven hundred thousand dollars a day.[9] Less than two years later, in June 1970, Penn Central was bankrupt.

With so many variables—some positive and some negative—securities underwriters and rating services would have been expected to insist on

rigorous due diligence. But instead of conducting an up-to-date and independent evaluation of Penn Central and its finances, Allan Rogers of National Credit Office, a subsidiary of Dun & Bradstreet that acted as a rating agency for commercial paper, simply called Goldman Sachs and spoke with partner Jack Vogel on February 5, 1970, to get the firm's current opinion. Vogel gave assurance that, despite the disappointing earnings, with the railroad's massive real estate assets Goldman Sachs was definitely continuing to offer Penn Central's commercial paper. This kept NCO from lowering its "prime" rating. But Vogel had not given NCO the full story, particularly the actions taken to protect Goldman Sachs.[10]

On the day it heard of the big first-quarter loss, Goldman Sachs had insisted Penn Central buy back from the firm's inventory ten million dollars of its commercial paper.[11] And to avoid the risk of carrying Penn Central paper in inventory as issuing dealer, Goldman Sachs converted the offering to a "tap issue." (Taking no market risk whatever, Goldman Sachs would no longer buy commercial paper from Penn Central nor hold twenty million dollars of Penn Central paper in inventory for resale, but would instead have Penn Central issue commercial paper only when a specific buyer of the paper had identified itself to the firm.) These self-protective actions were not reported or explained to NCO nor to any customer of Goldman Sachs.

Bankruptcy for giant Penn Central had been truly inconceivable. Startled by the crisis of a major issuer's bankruptcy, the commercial-paper market panicked and demand plunged. Dealers were forced to buy back recently issued paper; nearly three billion dollars of commercial paper was cashed in and $1.7 billion in Fed funds was borrowed from the Federal Reserve banks in a single week in July. Interest rates spiked higher, and liquidity dried up as corporations all across America scrambled to borrow from their commercial banks to pay off commercial paper. The Federal Reserve had to take direct action to ensure the liquidity of the nation's banking system.

After Penn Central went bankrupt, information on the corporation's finances may have been interesting but wasn't important to commercial-paper investors: They had large losses on what was supposed to have been a safe investment. What they wanted to know was obvious: What was Goldman Sachs going to do now? Would Goldman Sachs make good the customer losses? Were any of the firm's three hundred other issuers also at risk of bankruptcy?

With eighty-seven million dollars in Penn Central's paper issued and outstanding—and now defaulted—the firm itself was clearly threatened. How large would its losses be? Since all the capital in the firm was the personal wealth of individual partners, losses were not "corporate," they were *personal*, and the pain of loss could be sharp and feelings bitter and divisive. Could Goldman Sachs absorb the pain?

Knowing from his experience in block trading how important it was to move quickly to make some kind of an offer—no matter how low or how unlikely to be accepted—to keep the market alive, Levy sent John Weinberg to meet with clients in the Southeast and make them an offer: fifty cents on the dollar. Weinberg had been a partner for fifteen years, was Sidney Weinberg's son, was great with people and a member of the management committee—but none of that mattered. No one was willing to negotiate, and everyone was angry. The mission was a failure. The issues and the recovery of losses would be resolved in the courts of law.

On November 17, 1970, four investors—led by Anchor Corporation and its mutual fund Fundamental Investors, which had bought twenty million dollars of the paper in four five-million-dollar pieces between November 28 and December 8, 1969—sued Goldman Sachs for a total of twenty-three million dollars in a joint action with Younker Brothers of Des Moines, Iowa, C.R. Anthony Company of Oklahoma City, and Welch's Foods, the grape juice producer, which had lost, respectively, five hundred thousand dollars, $1.5 million, and one million dollars.

The plaintiffs asserted that the firm had made "promises and representations as to the future [of Penn Central] which were beyond reasonable expectation and unwarranted by existing circumstances" and "representations or statements which were false."[12] The companies were at least somewhat pressured into suing by fears that if they didn't sue, they would get sued themselves for not protecting their own shareholders' interests. The plaintiffs alleged, among other things, that Goldman Sachs didn't give them numerous material facts it should have known about the quality of Penn Central commercial paper; the paper was and is "worthless or worth substantially less" than they had paid for it; Goldman Sachs didn't adequately investigate or regularly review the financial condition of Penn Central to evaluate the investment quality of its paper; when Goldman Sachs participated in the fall of 1969 in a Penn Central application to the Interstate Commerce

Commission for approval of the company's issuance of commercial paper, the ICC had "expressed serious concern over the heavy dependence of Penn Central upon short-term financing"; Goldman Sachs was the "confidential financial adviser" to Penn Central and "otherwise had obligations and loyalties to Penn Central which conflicted with its obligations, loyalties and duties to plaintiffs"; and Goldman Sachs was guilty of stating a long list of material untruths in its sales of Penn Central paper. Among these were alleged statements that Penn Central paper was "prime quality"; that Goldman Sachs had made an "adequate investigation of, and kept under continuous current review, the financial condition of Penn Central"; and that Goldman Sachs would, "at the request of plaintiffs, repurchase said commercial paper."

In rebuttal, Robert G. Wilson, the partner in charge of commercial paper, said in a prepared statement, "There is absolutely no merit to the claims which have been made against Goldman Sachs." Wilson stated that "during the entire period in which we were selling Penn Central Transportation Company commercial paper (which ended in mid-May), we were confident that the transportation company was creditworthy. The financial statements of the company showed a net worth in excess of $1.8 billion at December 31, 1969. . . . There also was ample evidence to justify our belief that the transportation company had access to credit at least sufficient to cover its current obligations and repay commercial paper as it became due."

John Haire of Fundamental Investors, as by far the largest claimant, took the lead in private settlement negotiations with Goldman Sachs. A major mutual fund organization and a major securities dealer would have many ways to do creative business together and would have ample reason to put a confrontation behind them, and Haire and Levy worked out a settlement in April 1972 for $5.25 million in cash and the balance in certificates of participation in any future settlement. But the farmers in the Welch's cooperative had had a bad harvest in 1970 and felt they needed 100 percent restitution, while the two Midwestern organizations saw the case as a matter of dishonest dealing and felt morally right in insisting on full recovery.

If all losses were settled at 20 percent to 25 percent of the face amount, Levy's firm would lose nearly twenty million dollars—a massive blow, but one Goldman Sachs could survive. In all, forty-six lawsuits were filed. In May 1972, eight

suits[13] involving $13.3 million in Penn Central commercial paper were resolved for 20 percent of the face amount with the plaintiffs executing stipulations of dismissal. This left holders of fifty million dollars face amount yet to reach resolution. Meanwhile, the federal government continued its investigations. Once the federal findings of fact were completed, private civil suits for financial recoveries would follow. All these recoveries would have to be paid by Goldman Sachs.

The SEC staff investigation of the Penn Central collapse concluded in August 1972, with a public report of eight hundred pages based on testimony of two hundred witnesses representing 150 financial institutions. The SEC staff report said that up to May 15, 1970, Goldman Sachs had continued to offer the railroad's commercial paper to its customers even when the firm had received warnings that the Penn Central's problems were "critical" and that Penn Central, when unable to obtain further financing in this country, had turned to foreign creditors as a last resort. "During this time, Goldman Sachs became aware of information which cast doubt on the safety of this commercial paper. Most of the nonpublic information . . . wasn't disclosed to customers. The information they did disseminate was out of date." The report went on to say that Goldman Sachs had reduced and was eliminating the Penn Central commercial paper held in inventory and that Penn Central paper was meeting strong resistance from buyers.

Levy testified he had been assured by his own partners that Penn Central's three billion dollars in assets was more than sufficient to raise the capital needed to meet all its obligations. Levy also testified that he was so certain of the Penn Central's future that he held on to stock worth nine million dollars in a trust he managed for Walter Annenberg, America's ambassador to the Court of St. James's.

Sale of Penn Central commercial paper was aided greatly, the SEC staff said, by the receipt of a "prime" rating from the National Credit Office. NCO rated Penn Central commercial paper prime—its highest commercial-paper rating—until June 1, just three weeks before the bankruptcy announcement. On June 1, NCO "reserved" Penn Central's rating—meaning the company's situation was too ambiguous to give a rating—and told subscribers it had learned Penn Central was "rearranging its financing." The SEC staff said that the prime rating was given without adequate inquiry into Penn Central's financial condition and at a time when the facts didn't support such a rating.

According to the SEC staff, Penn Central sought to inflate earnings artificially and to cover up losses of the merged railroad to disguise its critical financial condition in 1968 and 1969. Among the SEC's other charges: Penn Central directors approved the payment of one hundred million dollars in dividends to convey a rosy picture of railroad operations at a time when the carrier actually was losing more than $150 million a year and borrowing millions of dollars just to remain liquid. In furtherance of a scheme to "improperly increase the reported earnings" of Penn Central and its parent company, the commission report said, Saunders and Bevan failed to include charges to the corporation arising out of its ownership of the Lehigh Valley Railroad Company, the New York, New Haven & Hartford Railroad Company, and the Executive Aviation Corporation. The Penn Central complex was facing continuing cash drains, the SEC report said, that created "an increasing need to conceal the true conditions" of the operation, intensifying the search for accounting methods that would inflate Penn Central's reported earnings.

The SEC report continued: "Goldman Sachs gained possession of material adverse information, some from public sources and some from nonpublic sources, indicating a continuing deterioration of the financial condition of the transportation company. Goldman Sachs did not communicate this information to its commercial-paper customers, nor did it undertake a thorough investigation. "If Goldman Sachs had heeded these warnings and undertaken a re-evaluation of the company, it would have learned that its condition was substantially worse than had been publicly reported."

In his cover letter for the staff report, SEC chairman William Casey described the company's actions as "an elaborate and ingenious series of steps . . . concocted to create or accelerate income, frequently by rearranging holdings and disposing of assets and to avoid or defer transactions which would require reporting of loss." The SEC staff said, "Saunders established the policy and looked to other members of top management team to implement it."

In May 1974 the SEC filed civil suits in both Philadelphia and New York, charging that Stuart Saunders lied about profits in 1968 and 1969 and covered up losses; that David Bevan not only misrepresented operations, but also personally profited from illegal insider trading in selling fifteen thousand shares at prices between fifty and sixty-eight dollars to pay off a $650,000 loan that had allowed him to exercise his options; that Bevan had misappropriated four million dollars

in corporate funds; and that Peat, Marwick, Mitchell & Company had filed false financial statements for the railroad.[14]

The Securities and Exchange Commission censured Goldman Sachs, saying the firm had violated the law by not informing customers about the continuing financial deterioration of the railroad. The SEC enjoined the firm from further violations, and Goldman Sachs, while denying any wrongdoing, agreed to a consent order[15] barring it from making any misleading or fraudulent statements while selling commercial paper in the future and agreed to set up additional procedures to protect buyers of commercial paper.[16]

Within hours of the entry of the SEC consent decree, a long-distance controversy erupted between counsel for Goldman Sachs and the SEC as to the exact nature of the charges to which Goldman Sachs had agreed. Michael M. Maney, who handled the consent agreement as outside counsel for Goldman Sachs, said that while the action was brought under the antifraud provisions of the Securities Act, the firm was charged only with negligence in failing to inform itself and its customers of the actual state of financial affairs of Penn Central. Counsel for the commission insisted, on the other hand, that the intent of the complaint was, indeed, to charge fraud under a section of the Securities Act entitled Fraudulent Interstate Transactions.

In a statement for Goldman Sachs, Robert G. Kleckner Jr., the firm's in-house counsel, said, "The decision to consent to the SEC injunction was made as a matter of business judgment. We did not violate any law or regulations, and we believe we acted honorably and responsibly in selling the commercial paper of Penn Central Transportation Company." Then, apparently to deflect accusations that accepting the consent agreement implied that Goldman Sachs had done anything that was not normal industry practice, Kleckner continued: "We support the policies and procedures for commercial-paper transactions embodied in the injunction. It is our understanding that the commercial-paper industry generally is expected to apply them."

Then things got a lot worse. The suit filed by the three investors—Welch's Foods, C.R. Anthony Company, and Younker Brothers, which had originally joined with Fundamental Investors but had not agreed to settle—had been winding its way through the courts for four years. Now it came to trial.

Marvin Schwartz, Sullivan & Cromwell's senior securities litigator, had sought to bring all the cases against Goldman Sachs together into a unified case and to have the case assigned for trial in Philadelphia as part of the Penn Central bankruptcy case. Lawyers for the plaintiffs, led by Daniel A. Pollack, kept the commercial-paper case separated, so it was tried in New York City. David Bevan, Stuart Saunders, and thirty-three other witnesses, including Gus Levy, were deposed.

As the trial proceeded, Goldman Sachs decided it needed to change litigators; Marvin Schwartz was relieved, and another Sullivan & Cromwell partner, William Piel Jr., fresh from defending Ford in a major antitrust suit, took over the defense on September 23, 1974, in the third week of the trial. He argued that Goldman Sachs's customers were sophisticated investors capable of making their own investment decisions; that the firm's obligation was to act merely as a conduit for such paper without making recommendations on the paper's quality; that customers could have gotten their own information because Penn Central was a publicly held concern; and that Goldman Sachs did disseminate information to customers on certain occasions. Gus Levy told a reporter: "The whole thing is unwarranted and the facts don't support a single complaint against us. These are professional investors who knew as much as we did about Penn Central or probably more."[17]

Pollack's strategy for the plaintiffs was to simplify and clarify the issues so the six jurors and two alternates—all blue-collar workers—would be confident they understood the issue and their decision. It helped that the litigators from Sullivan & Cromwell underestimated Pollack, seeing him as young and inexperienced and not from a major law firm, instead of as a tough, talented litigator, keen to propel his career and aware that with daily press coverage this was a high-profile case. The first phase of Pollack's strategy was to rehearse the extensive record of depositions so the jurors would become familiar with the arcane terminology of the commercial-paper business and would have plenty of time to become comfortable with all the ins and outs of the business and not be intimidated. Testimony took thirty full days.

Pollack often read to the jury long passages in the transcripts from the depositions—particularly Gus Levy's:

> QUESTION: "Were you aware that Goldman Sachs was selling commercial paper of Penn Central while it possessed nonpublic information on Penn Central?"

LEVY: "I was aware that Goldman Sachs was selling commercial paper, but I didn't know whether—yes, yes, the answer is yes."
QUESTION: "Did you do anything about this situation?"
LEVY: "Did I do anything about it?"
QUESTION: "Yes."
LEVY: "I didn't do anything about it because I didn't know what Wilson told the people."
QUESTION: "Were you aware that on February 5, 1970, O'Herron told Wilson [both were partners in the commercial-paper division of Goldman Sachs] that he did not think Penn Central could get $100 million in standby lines?"
LEVY: "The answer is yes."
QUESTION: "Was that nonpublic information?"
LEVY: "I presume it was."
QUESTION: "Did you instruct disclosure of that fact?"
LEVY: "I did not."
QUESTION: "Were you aware that on February 5, 1970, Wilson told O'Herron that in the future, Goldman Sachs probably would handle their paper only on a tap-issue basis where Goldman Sachs did not inventory their notes?"
LEVY: "It was in the memorandum, so I knew about it."
QUESTION: "Was that nonpublic information?"
LEVY: "I guess it was."
QUESTION: "Did you instruct disclosure of that fact?"
LEVY: "I did not."
QUESTION: "Were you aware that on February 5, 1970, Wilson asked Penn Central to buy back $10 million of its commercial paper from the inventory position of Goldman Sachs?"
LEVY: "That was in the memorandum, and I presume I was aware of it."
QUESTION: "Was that nonpublic information?"
LEVY: "That was definitely nonpublic information."
QUESTION: "Did you instruct disclosure of that fact?"
LEVY: "I did not."

QUESTION: "Were you aware that on February 5, 1970, Penn Central agreed to buy back $10 million of their notes from the inventory position of Goldman Sachs?"
LEVY: "I believe I was. It was in the memorandum."
QUESTION: "Was that nonpublic information?"
LEVY: "I believe it was."
QUESTION: "Did you instruct disclosure of that fact?"
LEVY: "I did not."[18]

At trial, it was revealed that Goldman Sachs produced research on commercial-paper issuers on two very different levels: Green Sheets (duplicated on green paper) went out to customers, while Blue Sheets were strictly for internal use. Worse, in the confidential Blue Sheets Wilson wrote a clear "smoking gun" statement: "We don't want Penn Central paper in our inventory." As Pollack explained to the jury, the firm could have said to its customers, "We're going to re-put [sell back to Penn Central] the paper we hold in inventory, so if you'd like to re-put your paper, let us know." He made it clear to the jurors how easy it could have been.

In cross-examination, Pollack got Levy to say that the firm did not disclose to investors important information in its possession:

QUESTION: "Mr. Levy, I take it from your direct testimony this morning that you admit that Goldman Sachs possessed nonpublic information on Penn Central. Is this correct?"
LEVY: "Yes, sir."
QUESTION: "You knew at the time, in 1969 and 1970, that Goldman Sachs possessed nonpublic information on Penn Central, is this correct?"
LEVY: "Yes, sir."
QUESTION: "You did not instruct disclosure of that information to the commercial-paper customers of Goldman Sachs, did you?"
LEVY: "It was our policy, Mr. Pollack, not to disclose confidential information on any of our issuers or any of our corporate clients."
MR. POLLACK: "Your Honor, I expressly ask that the witness be directed to answer the question."

THE COURT: "I think the question should be framed with respect to these three plaintiffs, Welch Foods, Younker, and C.R. Anthony."
QUESTION: "Mr. Levy, you did not instruct disclosure of this information to Welch Foods, Younker Brothers, or C.R. Anthony Company, did you?"
LEVY: "I did not. It was against our policy."
MR. POLLACK: "I move that everything after 'I did not' be stricken as not responsive, your Honor."
THE COURT: "Yes, I will strike it."
QUESTION: "Penn Central financial officers did not ask you to withhold this information from Welch, Younker, and Anthony, did they?"
LEVY: "Not to my recollection."
QUESTION: "On another subject, Mr. Levy, is it a fact that you had no opinion yourself of your own as to the creditworthiness of Penn Central in 1968, 1969, or 1970?"
LEVY: "Well, it is true I relied primarily on the credit judgment of Mr. Wilson and his credit man, Mr. Vogel, but obviously I was involved February 5th and 6th—rather, February 6th—and I followed the credit memorandums, so I had some idea what was going on and I knew a lot."[19]

In another cross-examination, John Weinberg, the partner to whom the commercial-paper division reported, explained that he got many pages of Green and Blue Sheets, seldom more than skimmed them, and promptly tossed them into his office wastepaper basket, saying in the straightforward way that usually established his credibility with all sorts of people but this time would backfire with the jury: "I throw them away. I'm a big wastebasket man." Pollack would return to this phrase. It had a real impact on the jurors in his summation to the jury.

Pollack began his summation by asserting that the "test of basic honesty is clear: treat your clients as well as you treat yourself." Then he took advantage of Weinberg's candor about top-level supervision not being careful or close: "In supervising and controlling the profitable commercial-paper business, where was Mr. Weinberg, who was responsible for management and oversight? Where was—and I quote—the 'big wastebasket man'?"

Then he summarized the way the jury should proceed in its deliberations: "The North Star in this case is clear and simple: did Goldman Sachs know—and not tell? If you find that they knew and you find they did not tell their clients, then those clients are entitled to full recovery."

In a lengthy opinion, the court ruled that there was ample "objective data to lead a reasonable observer" to conclude that Penn Central's commercial paper "was not prime." The judge brushed aside Goldman Sachs's argument that it was so rated by Dun & Bradstreet's National Credit Office: "The private determination of that branch of Dun & Bradstreet cannot bind investors or the courts."[20] He then pointed out that there was at least some evidence of circular reasoning: that National Credit Office had based its prime rating on Goldman Sachs's continuing to offer the paper, plus Goldman Sachs's assurances of Penn Central's wealth in real estate.[21]

In late October 1974, the jury of three men and three women, after the month-long trial, found unanimously that Goldman Sachs knew or should have known that the railroad was in financial difficulties that would put it in bankruptcy, and ordered the firm to pay back the three million dollars the plaintiffs had paid for Penn Central commercial paper between January and April 1970, plus nearly one million dollars in interest.

In defense of the firm's failed trial strategy, a partner contended, "We drew an anti–Wall Street judge, so we went for a jury trial, with Sullivan & Cromwell advising that the firm would be okay because commercial paper is specifically exempted from the Securities Act, so it is not a security. However, the issues were too complex and too subtle for the jury to parse, so Goldman Sachs lost."

In March 1975, Goldman Sachs settled out of court, for $1.4 million, a suit by Getty Oil that had sought two million dollars plus five hundred thousand dollars accrued interest for losses on Penn Central commercial paper purchased five months before the bankruptcy.[22] The settlement at fifty-eight cents per dollar of face amount plus accrued interest—more than double any previous negotiated settlement in the Penn Central bankruptcy—was apparently made because of the federal court's jury award at 100 percent plus accrued interest five months earlier. This left nearly twenty lawsuits worth twenty million dollars still pending.[23]

In October 1976, Goldman Sachs lost another suit as Judge Morris Lalter of the federal district court in New York decided against the firm and awarded six

hundred thousand dollars plus interest to the University Hill Foundation, a fund-raising unit for Loyola University of Los Angeles.

In December 1975, after a nine-day trial, Goldman Sachs was ordered by Federal District Judge Charles M. Metzner to pay five hundred thousand dollars—100 percent of the claim made by Franklin Savings Bank. The president of Franklin had called Goldman Sachs on March 16, 1970, expressing interest in buying $1.5 million of commercial paper, and was offered five hundred thousand dollars of Penn Central paper due to mature June 26, 1970, and one million dollars from a different issuer.[24] The judge said Goldman Sachs didn't disclose its self-protective actions to Franklin Savings before the bank bought the Penn Central paper, and added that while such disclosure might have done great harm to Penn Central, Goldman Sachs had an obligation to either make the disclosure or abstain from trading in or recommending the securities concerned.

"I understand the reluctance of Goldman Sachs possibly to be the cause of such calamity to our economic structure," Judge Metzner wrote. "In addition, it had close business if not personal ties to the Penn Central management which would be jeopardized in the event of collapse. However, it is disclosure of just such information . . . to which the antifraud sections of the securities laws are directed." The judge added that he believed this to be "the perfect example of an omission to state a material fact necessary to make the statement not misleading. When Goldman Sachs sold the commercial paper, it was understood that it was holding out the paper as creditworthy and high quality. The information that it failed to disclose was clearly material."

In August 1977, another decision—a decision in favor of Goldman Sachs—was reversed. Back in June 1976, the firm had won its first victory as Federal District Judge H. Kenneth Wangelin had said that Alton Box Board Company was not "a widow defrauded in a blue sky scheme," but rather a "sophisticated investor," and had dismissed Alton's $625,000 claim.[25] However, the Circuit Court of Appeals overturned that ruling and ordered Goldman Sachs to pay Alton $599,186 plus 6 percent interest, noting that the firm had confidential and undisclosed information about the railroad it did not disclose to Alton and that eight days before the sale, the firm had been told by Penn Central of an impending heavy loss in the first quarter.[26]

Gus Levy's friend I. W. Burnham summarized the end result: "Penn Central

really hurt Gus—and came awfully close to seriously hurting Goldman Sachs." If all the investors in Penn Central's commercial paper had gone to trial as effectively as Welch's, C.R. Anthony, and Younker Brothers, the firm could have been liable for financial settlements far beyond its capital. The adverse publicity that would have come with large losses at trial would have badly hurt the firm's long-term efforts at reputation rebuilding after Goldman Sachs Trading Corporation. Moreover, with the sharp downturn in the 1973–74 stock market, the firm was running at only breakeven. For a partnership, the combination of break-even operations and a large cash settlement could have been severely destabilizing, and the history of Goldman Sachs could have been, in a word, derailed.

But that full nightmare did not develop. The firm lost less than thirty million dollars spread over several years.

George Doty found a silver lining: "Some real good came out of it. All the partners pulled together to work through a life-threatening situation. There were no recriminations and no fault-finding. The firm was seriously challenged, and it rose to the challenge. Another benefit was less obvious: Humbled and chastened by Penn Central, Goldman Sachs avoided the disease of arrogance that did long-term harm to other firms on Wall Street."

John Whitehead later acknowledged, "Penn Central really hurt and did real harm to the reputation of Goldman Sachs. Naturally, we increased our controls to prevent such events, and in particular made a clear division of responsibility between credit approvals and client service." The firm operated for ten years under the terms of the SEC consent decree.

Senior debt held by the firm was converted into Penn Central stock at zero cost basis. With the firm's partners all in the 70 percent tax bracket, the loss was partly covered by insurance and partly written off. Years later, at a much lower 25 percent capital gains tax rate, the shares regained some value and were sold, and Goldman Sachs came out ahead. As Gus Levy laconically commented, "We may have made some money on all this, but I can assure you, it was not the approved method."

Daniel Pollack, attorney for the plaintiffs in the decisive New York trial, served Foster Grant Corporation as a director. So did Gus Levy. After the trial, Pollack was quietly advised that when his term ended at the next annual meeting he would not be renominated.

Less than a decade later, an entrepreneurial initiative would have Goldman Sachs establishing an important relationship with the federal organization that had taken over Penn Central's railroad operations. In 1981, Mike Armellino of Goldman Sachs, Wall Street's leading railroad analyst, read an official notice in the Federal Register that Conrail would at least consider going public. This large-scale transition would involve a complex series of transactions and would provide a splendidly lucrative opportunity—if all went well—for a major Wall Street firm to act as lead underwriter. While Goldman Sachs had virtually no business record in railroad finance, other than its notorious experience as Penn Central's commercial-paper dealer, Armellino reckoned that, if the firm could get involved in an advisory capacity well in advance of any public securities offerings, it would be poised to compete for a lucrative position in any future underwriting. He wrote an internal memo recommending his idea and asking if anyone could lend a helping hand. Within days, a copy was back on his desk with a longhand comment from John Whitehead saying he knew secretary of transportation Drew Lewis quite well and would be glad to arrange an introduction.

Goldman Sachs became investment adviser to the Department of Transportation in 1982 with a team composed of Armellino, Don Gant, and Eric Dobkin, who recalls: "Winning the business? Absolutely. That was my mission in life. I *had* to win!"

In late 1986, Morgan Stanley attempted to force its way in as co-lead manager by going through Congress to get legislation requiring a reconsideration, but Transportation simply went through the motions and then chose Goldman Sachs again to lead six investment banking firms that all participated equally in the sale for $1.6 billion of 85% of Consolidated Rail Corporation—one of the largest public offerings of that era, with commissions estimated at $80 million.[27]

Though wounded by the Penn Central trials, Gus Levy soon seemed back in form. "Gus never reached his limit, never topped out, was always increasing his capacity," observes Whitehead. Doty agrees: "Gus was always changing and growing. He was still growing; his judgment was still improving—and so was his effectiveness."

8

GETTING GREAT AT SELLING

By the 1960s Goldman Sachs was already well along in developing one of its decisive competitive strengths—selling securities more effectively than the rest. But that strength began as a real weakness.

Although a member of the New York Stock Exchange, the firm hardly had a sales force in the thirties and forties. Half a dozen old and tired men—too old and too tired to switch to better jobs during the Depression and the war—were really just order takers, serving out time. As Bob Menschel remembers, "Institutional investors were not active in the market and were being very lightly covered by a group of older guys who sold anything and everything—stocks, bonds, convertibles, and municipals—but their approach to sales was not at all effective." In the department then called retail sales (later securities sales and later still the equities division), Goldman Sachs's weaknesses were so obvious that they presented an opportunity. As partner Ernest Loveman sardonically observed, "We're so far down, if we change at all, we *have* to rise."

At most Wall Street firms, the majority of front-office people were "family" or "money" or children of clients, and each group brought its own form of office politics and resistance to change. But for those who had little and were hungry to

get ahead, even small changes could be seen as interesting possibilities. As outsiders, the people of Goldman Sachs had little to lose by taking the risks of being different.

So in the fifties, when Ray Young, widely recognized within Goldman Sachs as a great team captain, began looking for ways to develop a sales force that would concentrate on building the firm's business with the still small but rapidly growing "institutional" investors, his plans encountered little resistance.[1] By contrast, entrenched retail salesmen at many other brokerage firms greeted similar efforts with turf-protecting fights and internal squabbles that often seemed interminable.

Traditionally, the business to be had from retail brokerage customers was most definitely not controlled or "owned" by the brokerage firm. Accounts with individual investors were jealously guarded by the individual brokers who had found them, prospected them, and brought them to the firm where they happened to be working. Each broker would split the brokerage commissions generated from each of *his* accounts with whichever firm provided him the best support services, such as space, statistics, custody, executions, and record keeping—and the best deal on the commission split. The firm did not choose the broker; the broker chose the firm. If the broker could not get the deal he wanted with the firm he was at, he simply moved to another firm—and took his accounts with him.

At firms with well-established retail sales forces, a "good producer" would concentrate on his core business with traditional retail accounts—doctors, lawyers, entrepreneurs, and those who had inherited wealth. He might have a few institutional accounts—banks, insurance companies, or investment companies—where he had an in with one of the decision makers, but most institutions were house accounts that the broker could not take with him, and for these, the broker was expected to meet the institution's modest expectations for routine service and little more. He understood reality: He had no good way to increase institutions' volume of business. The typical retail broker didn't compete for a large share of the business done by the institutions he covered for his firm—he didn't have the abilities or the social acceptability to do much more than not screw up. But times were changing.

Institutional investors were getting larger and more active, and the commissions they generated were also getting larger—and larger. For their ballooning

commissions, institutions wanted more service and better service, particularly thorough research on the economy, major industries, and specific companies. The traditional retail stockbroker's abilities were not competitive with the research- and service-intensive approach being taken by a new group of specialized institutional brokers.

The need for conventional brokerage firms to reorganize to compete better was real. Still, the retail broker would fight to hang on to his institutional accounts, even if he was seriously underproducing with these accounts, because their scraps of business were lucrative: The broker got 30 percent to 40 percent of the gross commissions collected by the firm. Some of the major retail firms were still fighting account by account over these turf issues twenty years later. Resolutions of these disputes were typically grudging compromises—determined by short-term political considerations but clearly not optimal for building a vibrant long-term business.

Goldman Sachs had few conflicts over who "owned" each institution because it had few retail salesmen with assigned accounts. The firm was free to organize its institutional business in the way Ray Young wanted, and Young took full advantage of this opportunity to innovate. He had all of the institutional units reporting to him—research, research sales (salesmen who merchandised the firm's research to institutions), and sales trading (salesmen who developed important relationships with institutional traders and managed their market orders).[2] "Ray really got us started," said John Weinberg appreciatively. "He was a great recruiter and trainer." While Gus Levy—with his penchant for foisting the sons of his friends onto sales—could be a problem for Young, nobody else would dare. Young was recognized as tough and absolutely straight-arrow, particularly in the management committee, where it mattered most. No matter who was in an argument, everyone in sales accepted Young's judgments. They had to. "I've heard you," Young would say. "Now, I'll tell you what we're going to do." And if facial expressions suggested Young's conclusion was not fully accepted, he would add: "You should consider immediate and total acceptance of my decision an absolute condition of employment. Period."

"Ray Young knew that in a service business, the client *always* comes first," recalls Bob Menschel's brother Dick, also a partner. "He was always explaining to us that putting the client first was always—over the long term—best for the

firm and for each individual. Ray was beloved. He was scrupulously fair and nonpolitical within the equities division and was known and trusted to be a strong advocate-representative for the division on the management committee because Gus and L. Jay both respected Ray, and everyone knew it."

Ray was all about integrity and clients," partner Lew Eisenberg recalls. "He came to my desk one day, collaring a young sales trainee, and asked: 'Is this kid with you?' I said yes, and Ray laid it on the line: 'You have one hour to decide whether he's out or he stays,' and strode away. The trainee had gotten a really good order in Allied Chemical—and then was heard taking about it in the elevator to another trainee. Ray was very clear about the rules, and rule one was that nobody *ever* talks about clients or clients' business. Half an hour later, after a very serious talk with the trainee, I told Ray my judgment was we should keep the kid. Ray called us both down to his office and asked the trainee gruffly: 'What have you learned?' The answer showed he had gotten the message: 'To keep my big mouth shut—sir.' That was acceptable to Ray—this one time."

Young called one of his salesmen, Eric Dobkin, late one morning. "Are you going out to lunch with a client?"

"No, I'm eating at my desk."

"Come on up. I'm in town." And that's how Dobkin was told he was going to Chicago—for six years. At the end of those years Young phoned Dobkin again, again asking if he was free for lunch. "But since I'm in Chicago, he can't mean today," Dobkin recalls, "so I ask, 'What about tomorrow?' So I flew to New York City for a meeting with Ray, Richard Menschel, and Jim Timmons, who had been running the [SEC Rule] 144 restricted-stock business and was leaving the firm. They wanted me to take Jim's place. All I wanted to know was if I'd be able to make partner. 'That seat has a partner now' was all they said—and all I needed to hear."

Young was decisive, a characteristic that salespeople appreciated. He built a strong sales team partly because he really knew the business and partly because everyone knew he believed entirely in the code of loyalty up, loyalty down. "Once when I was thinking about firing a salesman," recalls partner Jim Kautz, "Ray asked me, 'Have you ever been fired?' I said no, and Ray said, 'I thought

not. Always remember, when a guy gets fired, he *never* forgets it—for the rest of his life.' Ray understood salesmen and sales management and was instrumental in the firm's hiring MBAs into sales."

The strategy to build strength into sales was to get really close to the customers, looking for ways to be helpful and asking for a chance to show what Goldman Sachs could do. "If we could get a start, a foot in the door, we knew we could prove we were decent, likable guys doing business in a truly professional way," remembers Bob Menschel. "We really lived with our customers—at IDS, Fidelity, Capital Research, Dreyfus, Morgan, and the insurance companies in Hartford. Over and over again we suggested, 'Give us a try. When none of the other firms can do your trade, we believe we can. If you ever have a difficult block, we'd like a chance to show what we can do.' Many, many threads had to be found and pulled together to make the whole really work well. Goldman Sachs had very little franchise in those days, and we were always looking for an entry point. We put together a group of enthusiastic younger guys who liked the securities business, enjoyed sales, and wanted to do a professional business. Our group wanted to do everything *differently*—and started by buying out the older guys with one- and two-year guarantees of their past level of business. Then we turned our attention to building a real business, knowing we would have to do things very differently."

Harold Newman, a particularly effective salesman, adds that the people recruited into securities sales, as the department was known in the sixties, were a breed apart from the conventional stereotype of a stockbroker: "We were identified as people with standards and focus who were creative and spoke straight."

A trip to Las Vegas in 1963 was the beginning of a practice that contributed mightily to Goldman Sachs's later success: teamwork in sales. For years, a group of friends within the fledgling securities sales group had gone to Las Vegas twice every year—in March with their wives and on their own in October. Included in the group were Young and two retail salesmen, Harold Newman and David Workman. Speaking for the pair, Newman proposed to Young that they would be more productive if they could combine their efforts—with one man always in the office to take customers' orders, while the other was always out prospecting for new business—and then pool all their commissions as partners with a fifty-fifty split. "David did not like cold-calling, but I didn't mind it," recalls Newman. "But

when I was out I needed someone to cover for me if one of my customers called. So our proposition was that we'd work as a team and one of us would always be in the office to take the calls while the other was always out drumming up new business."

Richard Menschel, knowing the usual problems of such an arrangement, was strongly opposed. "Conflicts will abound. You'll never work it out. The details will lead to arguments that will ruin you." But Young was game to try it. The proposition fit well with Gus Levy's dual emphasis on individual performance and teamwork—and it worked so well that more pairs of salesmen, and then larger and larger groups, were soon going "joint."

Before, each salesman had typically been on his own with a "you eat what you kill" approach to work and compensation. Bob Menschel worked out a teamwork-motivating system of compensation for institutional sales. First, Menschel got agreement from the firm that sales would get payouts of 15 percent of gross commissions. Then the group agreed that all institutional commissions would be put into one pot and each salesman on the team would get a certain percentage of the total for the year—with annual percentages reset by Menschel. Recognizing that it would be difficult to predict who the winners would be for the coming year, Menschel reserved a third of the total so he would have managerial discretion over a significant part of the pool and could reward those who did the most for the sales partnership, which grew to over forty participants. With this innovative compensation structure, "everybody focused on one thing: total gross credits," recalls Bob Menschel. "We all saw all the tickets because sales and trading sat next to each other. For the true team player, with this setup the opportunities were virtually unlimited."

While Bob Menschel developed institutional-sales teamwork through commission pooling, his brother Richard organized the high-net-worth sales force for focus. "Dick Menschel conceived of specializing in sales," recalls partner Lee Cooperman. Menschel believed in covering a specialist buyer with specialist salespeople for research or trading or convertibles or preferreds, particularly if any competitor firm had a specialist salesman covering a specialist buyer. Research sales was separate from sales traders, and listed sales traders were separate from OTC sales traders. But if five or six salespeople covered a major account, they pooled all their business and shared the total in previously agreed percentages.

Pooling commissions in partnerships became an increasingly important part of the Goldman Sachs way. Another important part of the firm's compensation was simply that Goldman Sachs salesmen were paid more. They believed they were special, took pride in their work, and knew they worked harder and for much longer hours than most competitors.

"We had very low turnover," recalls Eisenberg—usually only 5 percent a year when at other firms it was 20 percent or higher. "Some might even say our turnover was too low." But the customers did not complain. They liked continuity with highly motivated, entrepreneurial salesmen always looking for new and better ways to be helpful. The firm's typical salesman-customer relationship was well developed, comfortable, and important to both sides, while competitors' relationships were often new and still "in development." The difference was huge. Goldman Sachs was the number one stockbroker for a large majority of all institutional investors, including nearly all the largest and most active institutions.

"We were particularly focused on recruiting very smart people who really cared about and wanted to be part of a real team," says Dick Menschel. "We were thorough in our interviews, and lots of interviews were required before you could gain admittance to our team. Knowing how hard it was to get accepted, we all respected anyone who had passed the intensive screening of all those interviews. If they had passed that process successfully, we knew they belonged. And we all had staying power. Teamwork was crucial. We were always backstopping each other—and we *liked* each other. We had a passion for the business and lots of fun."

Menschel hired salesmen carefully. His screening criteria were always the same: Candidates had to be very presentable and very bright. If a candidate made it past the first round, judgments centered on one key driver: How hungry was he, how much did he need to succeed? Having some family money—in the sixties, still the first screening criterion at most firms—was not a positive at all: It was a real negative. Menschel wanted driven people, because he wanted a driven sales organization that would accept his strict discipline.

In 1968, when ten million shares of trading volume was a good day on the NYSE and a block cross of ten or twenty thousand shares would certainly be the event of the day, Eisenberg got a call from an excited trader at a major institution in Hartford with an outsize order: Sell fifty thousand shares of American Cyanamid!

Quickly, Eisenberg, Bob Mnuchin, Ray Young, and Gus Levy huddled and decided to position the block at a price half a point below the market. They made their bid, and the institutional trader, clearly pleased, said, "Print it." As the trade showed on the tape, Eisenberg felt a wave of private pleasure. A few minutes later, Gus Levy came by and silently patted Eisenberg's back. Ray Young took the new hero out to lunch, a rare and therefore significant sign of celebration.

All very satisfying. But not to last.

Returning to his station after lunch, Eisenberg found twenty pink message slips—all from the same institution's trader. Eisenberg called. The trader blurted out: "You're not gonna believe this. I'm virtually certain to get fired. I messed up on that order. It was not an order to sell. The order was to *buy*. And if you think that's bad, here's what's really bad: I added a zero. It was for five thousand shares, not fifty thousand!"

Eisenberg slumped in his seat, astounded. He had to tell Levy right away. But tell him what? As he moved to Levy's dark-glass cubicle, he knew he'd have to tell it straight. "Gus, there's a terrible problem. There was an error on that big trade."

"Whose error?"

"The account's. The order was totally incorrect."

By this time, the market price of the stock had moved up one and a half points, or more than seventy-five thousand dollars.

"How well do you know him? Is he stupid or a crook?"

"Gus, I believe the guy simply made a dreadful blunder—a straight-out, *very big* mistake."

"Okay. Then we're gonna make him into a very good client of ours. We'll take the error. The loss is ours."

Eisenberg assumed his career was virtually over and was thinking how to tell his wife that night. But he was wonderfully wrong. Within a week, the institutional trader and his boss were taking Eisenberg to lunch to thank him: "You and Goldman Sachs have shown us the utmost professionalism. And we will demonstrate our appreciation to you by being a very major client of Goldman Sachs for a long, long time." The institution proved true to their word.

Speaking of Levy, Young, and their sales teams, Al Feld says, "They weren't gods; they were only human. But when push came to shove, they would always

do what was *really* right." Leaders are known by two things: the people they hire and bring together and the beliefs they hold to when they really have to choose. You only know what a person *really* believes in when he chooses to do something even though it costs him—because he really believes it's the right thing to do.

When Ray Young retired in the seventies, Dick Menschel took over sales management.[3] There were no middle managers: Everybody in sales reported directly to Menschel, who had exact knowledge of each salesman, his accounts, and his standing at each account. "Menschel was a motivating mentor," recalls partner Bill Landreth, "precise in his memory of specific details. He insisted that every memo have the correct middle initial of both the writer and the addressee. It might have just been another dimension of his controlling style, but we all believe *he* believed it showed greater respect."

While every other firm worked to maximize cooperation between sales and trading, at Goldman Sachs securities sales was separate from trading because Dick Menschel and Bob Mnuchin couldn't get along. Their personalities and their ways of working were just too different. Menschel was all about process and the value of details, facts, and accuracy, while Mnuchin was disruptive and often deceptive. As one partner explained, "Dick never allowed any swearing or funny business, while Bob ran a locker room, where guys played games, and cursed the stars." For management committee meetings, Menschel would prepare meticulously for six to eight hours and arrive with a series of rigorous questions about details; Mnuchin would come to the meetings with his copy of the preparation papers still unopened and, perhaps just to twit Menschel, would deliberately make a show of opening them for the first time at the meeting table. Menschel kept careful records of his personal expenses, while the firm's bookkeepers couldn't close their accounts because Mnuchin had several paychecks shoved inside his desk drawer uncashed.[4]

By the 1970s Dick Menschel had further differentiated Goldman Sachs's sales operation from the pack by developing a comprehensive training program. New salespeople rotated through all the firm's business units for on-the-job training, with formal sales training sessions twice every week. Cases and role-playing were used, and the sessions were taped. The whole group would critique each trainee's performance. It was fun and professional. Training ran for six or seven

months, with retraining required every five years. Starting with a dozen trainees in the early seventies, the program peaked with nearly forty in the late eighties, then dialed back to two dozen in the early years of the new century, when changes in the markets reduced the need. Scheduled from 5:30 to 7:30 p.m., always on Friday night, New York's major social evening, the sessions invariably started late, usually around six or six thirty, and then ran until eight or eight thirty. Menschel was then single, so he was okay with running late, but others had waiting families and dinner commitments. Most students thought running late was deliberate—another way to test each person's determination to master the business and show deep commitment to the firm.

Addressing a large group of trainees, partner Roy Zuckerberg once asked: "Are you bullish on the market—or bearish?" As he went around the room, calling on one after another of the trainees, each gave his answer to the question. Some were bullish, some were bearish—all with good, sometimes complex reasons. Finally, he called on a Japanese trainee who was so exhausted from his flight in from Tokyo that he was unable to keep from dozing off in class. Zuckerberg's questioning gaze focused on the trainee as his neighbors poked him awake. Still groggy, he blurted out: "I'm bullish. I'm always bullish."

"Right!" exclaimed Zuckerberg. "In the securities business there's only *one* way to be—and that's bullish! *Always* bullish."

The main feature of each week's Friday session was role-playing with intensively critiqued mock presentations to prospects or customers—with Menschel or Zuckerberg pretending to be the hypothetical customer and asking all sorts of difficult questions. Some questions were information difficult; some were personality difficult; some were policy difficult—and some were difficult in multiple ways. As Bill Landreth recalls, "If Menschel and Zuckerberg were taking sadistic delight in torturing their students, they couldn't have made the experience more challenging—or more educational."

Menschel, pretending to be a big fund manager, would give a role-playing final exam. The sales trainee would come into his office, tell him what stock he was going to recommend, and launch into a sales pitch. After five minutes—when the salesman might be just one-third of his way through his presentation—Menschel might cut in and say, "That's wonderful. Really interesting. You've done a great job of research. I'm really interested. Why don't you buy me ten thousand shares?"

If the trainee wrote that order down on his order pad and returned to giving his presentation—no matter how brilliant and articulate—he would get a failing grade. Why? Because he had already gotten the order and was now, by continuing to talk on *after* getting the order, running the risk of perhaps saying something that might unravel the buyer's conviction. If that happened, there would be no sale: The salesman would have "bought it back."

In a typical role-playing session, Zuckerberg would be on the phone, with everyone in the training program listening in. One night, the student salesman whose assignment was to convert this prospect into a new customer for the firm had been kept in the training program for more than the usual six months, so he felt strong pressure to finally "make it" by showing he had developed the skills and competence to pass the test and get going on his career.

Zuckerberg's hypothetical prospect was typical: a man in his early sixties who owned a small but profitable business—in this case, a nursery for residential landscaping. The pitch was also typical: Goldman Sachs is an unusually capable organization with many capabilities, enjoys considerable stature within the industry and an outstanding reputation, and is interested in helping this particular prospect build his net worth through investments. The firm wants to build an important relationship with this man, so the salesman wants to know how best to be helpful now so they can get started working together.

The trainee was determined to achieve a win-win with this prospect and had been doing well in the early minutes of the call, so Zuckerberg picked up the pace and the challenge.

"Young man, you say you really want to help me do well, is that right?"

"Yes sir! We at Goldman Sachs want to work *for* you and *with* you. We want to help you do well—*very* well, sir!"

"You know my business is growing fine shrubs and trees for residential landscaping?"

"Yes, sir."

"And you'd like—your firm would like—to help me. Right?"

"Yes, sir. We want to help *you*."

"Well, I know one way you can help me—even while I'm helping you. Are you interested in helping me help you?"

"Yes, sir!"

"Good. Here's our plan. You send me a list of your senior people with their home addresses and phone numbers and then I'll call and tell them what we can do to help them make their homes truly beautiful. This will be good for them—and, as you say, will help us too. Okay?"

"Yes, sir!"

Buzz! Buzz! Buzz! "You failed! You got it *all* wrong! You're on the phone for *one* reason—and *only* one reason! Sell securities! You dumb schmuck, you're not supposed to *buy* anything—and certainly not supposed to set up the partners of the firm as prospects for some goddamn *plant* salesman by giving away their home phone numbers and addresses! How dumb *are* you? Class dismissed!"

Delaware Management was one of the largest and most active institutional accounts in Philadelphia when Eric Dobkin was assigned in the late sixties to see what could be done to increase Goldman Sachs's share of its business. Knowing that the people at Delaware already thought well of Goldman Sachs, Dobkin needed to find a specific lever to increase the firm's business significantly, so he made an appointment to see John Durham, Delaware's top portfolio manager, after the NYSE's close and asked him what should be done to earn more business. Durham answered, "Tell me your best research ideas."

"I'll do that—and I'll do even better," replied Dobkin. "After the close each day, I'll call you with a complete—and unique—rundown on which stocks are being bought and sold by the really smart institutional fund managers."

"Call and Stephanie will put you through."

"For the next ten days," recalls Dobkin, "I called and Stephanie put me through. I gave Durham the rundown on what the major institutions were doing, but there were no direct responses to anything I'd been saying. So, to move forward, I asked very respectfully, 'How am I doing?'

'Fine.'

'So John, what are *you* doing?'

Click. Durham hung up.

"I was obviously wasting time and getting nowhere," recalls Dobkin. "I needed a different approach. So I studied the Delaware Fund prospectus and its

list of stockholdings and put myself in Durham's position, trying to guess what he might be buying or selling."

Dobkin calculated that if he could give Mnuchin a good indication of what Durham might be buying or selling, Mnuchin would give him five thousand or ten thousand shares to work with. If Durham took the bait, Goldman Sachs would know which way Durham was moving, so the firm could go out to find the other side and create some sizable block-trading business. "I gave Mnuchin my best sense of what Durham was doing. Bob enjoyed playing cat and mouse, and pretty quickly we created better and better trading volume with Durham, and the classic more-the-more phenomenon [the more business you do, the more business you get] took hold and our commission volume really took off. We did increasing business in blocks, options, converts, and we were soon number one across the board for Durham and Delaware."

On another occasion, Goldman Sachs had "positioned" a two-hundred-thousand-share block—over eight million dollars' worth—of a Midwest utility's thinly traded stock and had found only one institution that might be a buyer of that much: Delaware. But Delaware's trader was not ready to pay the price. Gus Levy was convinced it was the right price. They were only an eighth of a point away from a cross, but each side was waiting for the other to move. Gene Mercy was on the call and was feeling the pressure coming from Levy. Mercy decided to take a risk and go over the trader's head and speak with John Durham.

"John, we've done a lot of trades together over the years. In putting them together, I've come your way when you needed some help. Do I have any chits that I might call in?"

"Probably."

"Okay. I need you to come up an eighth on this utility block, John."

Pause.

"Okay."

Gus Levy *almost* smiled and *almost* said something.

In 1979 Mnuchin and Dobkin developed a new niche product—debt-equity swaps—and did a lot of business. "Then we invented installment sales, which became a very big business for the firm. With a forty-nine-percent tax rate on

short-term capital gains, when a takeover involved a cash tender offer the installment sale enabled the selling shareholder to defer the date on which the IRS recognized his gain, so he got a lower tax rate. This arrangement was a very easy service to sell, and we usually knew which investors to go after. We went around to all the best law firms, explaining exactly how it worked, so they would bring us any potential customers we'd missed. We met many interesting people and interesting families—when [former deputy secretary of defense] Paul Nitze's family sold the Aspen ski resort we 'installed' their sale. In our best year, installment sales accounted for a full three percent of the firm's total earnings and was a very good feeder of extra business for PCS [Private Client Services]."

Being *a* broker, even a major broker, is not comparable to being the number one broker for a major institutional account. Over and over again, the typical large institutional investor does about 12 percent or 13 percent of its total commission business with its number one broker, 10 percent with number two, and 8 percent with number three. If Goldman Sachs focused all its skills and energy on being number one while other major competitors averaged third or fourth rank, the firm would generate a full 50 percent more business—at a much higher profit margin because its costs were nearly the same as the competitors'. And in trading, "them as gots, gits," so even in one of the most open and competitive free markets in the world, it would be possible to build up a defensible and sustainable competitive advantage. Goldman Sachs's continuity of sales coverage and superior sales skills enabled it to be number one broker for many, many institutions that grew larger and larger in terms of assets under management and commissions generated. As in every service business, continuity and strong relationships matter.

That's not all. Goldman Sachs decided in the eighties to focus on the giant accounts—the one hundred largest accounts in the world. This was not as narrow a focus as it might seem at first. In the United States the fifty largest institutions now execute 50 percent of all the trades on the New York Stock Exchange and an even larger proportion of the equally large volume, in underlying dollar value, traded each day on the Chicago Board Options Exchange. And these same giant accounts are even more important in the distribution of new-issue underwritings.

Not all the largest accounts were in America. One was in the Middle East. In London, Bill Landreth was in an important telephone conversation with John

Buchman of the Kuwait Investment Office, and Buchman could hear Mnuchin on Landreth's SS1 squawk box in the background.

"Bill, what was Bob talking about?"

"We have a big sell order in GE. It's for 750,000 shares."

"Bill, is it for sale at the market?"

"Yes."

"Bill, we'll take it."

That meant a perfect cross—with Goldman Sachs dealing for both buyer and seller and earning commissions on both the buy order and the sell order. That meant commissions on 1.5 *million* shares of stock. In market value, it was the biggest trade ever done—with no capital and no risk. Right people, right place, right time. Stars and moon in alignment. All within minutes. For Mnuchin, it was just too much. The iron man was blown away. He had to get an explicit confirmation: "Bill, I'm calling you right away on a secure line. Be ready for my call."

Kuwait Investment Office soon became a major account. "They were good traders—and good buyers," remembers Landreth. They were great clients, too. Kuwait helped save Goldman Sachs from what could have been one of its worst embarrassments. When Landreth offered to introduce the bizarre British publisher Robert Maxwell—who was doing a lot of trading—Kuwait Investment Office executives had no doubts. No doubts at all. "No deal, Bill. We won't work with that man or his company. Period. Ever." Later Kuwait Investment more directly helped Goldman Sachs by buying a major position the firm had gotten stuck with in underwriting British Petroleum.

Bill Landreth got a call late one night in 1979—just before midnight. "Bill, this is important. Very important. You'll have to trust me because I'm absolutely sworn to secrecy—so trust me and get dressed and come *now* to Heathrow Airport. I'll give you the exact address. It's the strictly confidential location of a safe house. And, Bill, come alone."

Landreth dressed, got in his car, and drove through the nearly empty streets of London to the area near Heathrow and the safe-house address he'd been given. Bodyguards were obviously everywhere. Landreth was patted down and taken inside and into what was clearly a very private room. Through another door, a

slim man of average stature in a well-tailored suit entered: a representative of the shah of Iran. "The shah is going to sell his entire portfolio of U.S. stocks—for immediate cash payment. The certificates are held in custody at a major Swiss bank. Knowing this is an unusual transaction, I am prepared to accept a thirty-percent discount from the market. Will Goldman Sachs bid for this 'cash now' portfolio transaction?"

"I understand the question," Landreth replied, "but before I can give you an answer for my firm, I'll need to speak with my partners in New York. May I use a phone?" It was already past 7 p.m. in New York, but people were still in the Goldman Sachs trading room, attending to details of the day's trading and preparing for the coming day's activity. Fortunately, Bob Mnuchin was still there.

Landreth spoke with Mnuchin. The appeal was obvious: At a 30 percent discount, Goldman Sachs could buy a hundred-million-dollar portfolio of diversified blue chip stocks and sell them as blocks at prices sure to be more than 40 percent above the early morning bid. The firm could make over twenty-five million dollars!

The reward was clear—but so was the risk. In a few days, the shah would not be the shah anymore. Ayatollah Khomeini would be in authority, with ample power to present extraordinary nonfinancial risks—like explosives in Goldman Sachs offices or cars or homes. Too much "specific" risk. So the decision became obvious: pass. It was the first and only time Goldman Sachs refused to bid on a record-breaking trade. If any other firm took on the trade, the news stayed secret.

During the late 1980s and early 1990s, the equities division was a major contributor to the firm's profits, but with competition continuously pressuring commission rates down to lower and lower levels and costs rising and electronic trading networks taking larger and larger shares of the available business, division profitability would fade away. During the golden years of institutional stockbrokerage, however, the firm had made the most of its opportunities.

9

BLOCK TRADING

THE RISKY BUSINESS THAT ROARED

Bob Mnuchin took the call one morning in January 1976—the most important call any block trader had ever taken: a one-billion-dollar order that confirmed Goldman Sachs's leadership in block trading. The firm was being asked to execute the largest block-trading operation in history.

The head of New York City's pension fund[1] had decided to convert a five-hundred-million-dollar portfolio of common stocks into a specific portfolio of stocks that would replicate the stock market—an index fund. This massive change required five hundred million dollars of stock sales and another five hundred million dollars of stock purchases. Goldman Sachs would have to bid a single price to buy the whole portfolio and create the exact new portfolio the city's pension fund manager specified—and to do so not as an agent, but as an "at risk" principal.

The firm would commit to a total exposure of half a billion dollars. A principal trade this big obviously had to have the approval of the management committee, so Mnuchin and his team went, prepared for a thousand questions. "They asked only five questions," remembers Mnuchin. "And each question was laser-like in its focus on a key trading factor. We answered the five questions and there was a moment of silence and then everyone agreed. It was a go!"

With large yellow pads, Mnuchin and his team worked the whole weekend with price charts, recent research reports, and all their years of market trading experience, plus all the bits and pieces of information they could pull together about what each of dozens of major investing institutions might be willing to buy or sell. "Then we had a plan."

Starting with closing prices on February 4, Goldman Sachs guaranteed the pension fund that the maximum total cost of executing trades of nearly twenty-five million shares would not exceed $5.8 million—including the risk of paying more for purchases or getting less on sales than the closing prices on February 4.

"Wall Street is a very small community," says Mnuchin. "[Normally] you can't make a major move without everyone knowing it. It was so very big, it was like everyone at a World Series game getting up and leaving Yankee Stadium in the second inning—and nobody noticing anything." To avoid being noticed—particularly by competitor firms—Mnuchin and his team worked out a careful strategy. As Mnuchin recalls: "We agreed we would be active every day—no matter what—and that we'd never let the total buying and total selling get separated by more than $5 million. Security was obviously essential—any leaks and the other brokers would trade ahead of us—so a code name was used: Operation Eagle. Small blocks of at least some holdings were sold every day, but for each particular stock, the firm was active one day and then quiet for two or three days. One block of 330,000 shares was sold in seventy-eight separate lots, of one hundred to thirteen thousand shares. Over five weeks, twelve million shares in fifty-two positions were sold and 231 positions purchased in Operation Eagle."

When the last trade was finally executed, Mnuchin picked up the hotline phone to announce, "Eagle has landed." In mid-March, New York City's pension fund announced that Goldman Sachs had secretly finished executing the largest-ever purchase and sale of stocks. The final cost to the New York City pension system for transactions totaling one billion dollars was only $2.9 million—less than one-third of 1 percent—for the largest and one of the most complicated trades in history and an apt demonstration of Goldman Sachs's prowess in block trading.[2]

Most major securities firms shunned block trading. Indeed, they didn't understand and didn't like the whole institutional business, for several reasons. The leading and most active institutional investors were young, irreverent, well dressed, and well educated—admiringly dubbed a new breed on Wall Street—with

limited respect for people they considered old fogies or for the traditional hierarchy of Wall Street. These newcomers wanted new and different services that were expensive to produce, such as in-depth investment research on all sorts of companies and industries, and they wanted much more sophisticated sales attention than most firms were willing to provide, especially to MBAs they considered too young, too irreverent, too well dressed, and too overpaid.

Among the many services these young new-breed fund managers wanted, block trading seemed surely a sucker's game. The "money" partners at most firms saw no reason whatsoever to get involved in such a certain money loser. They were *agency* brokers and underwriters, not risk-taking *principal* market makers and dealers. Buying what smart institutional investors wanted to sell was dangerous: The sellers might know something important. Why take a big risk that the stock really should be sold? And why tie up the firm's limited capital buying and holding, for *days* or *weeks*, big blocks of stock that nobody wanted? Most firms had no interest in the trading business, and buying big, dangerous blocks from aggressive young hotshot institutional investors looked like the worst bet of all. The august partners didn't do trading themselves and looked down on their firms' traders as mere employees. Why should they entrust their family wealth to a mere trader—someone they would never take home for dinner?

As Bob Menschel explained, "Bobby Lehman had the capital at Lehman Brothers, but he could not live comfortably with having his personal fortune put at risk by somebody else, particularly by one of his *employees*—and all the traders were just employees. In block trading, the money must not know who owns it. You can't afford to be too personally involved, particularly in an emotional way, any more than a surgeon should ever operate on his own children. Block trading is a business: It requires lots of rational business decisions being made in a very nonemotional, businesslike way."

At the New York Stock Exchange, commission rates had always been set in terms of one-hundred-share "round lot" transactions with fixed rates per one hundred shares that varied only with the share price.[3] Commission rates were set, naturally enough, at levels considered appropriate for a *retail* stockbrokerage business, because retail activity had always dominated the stock market. Daily volume averaged less than one million shares through the 1930s and 1940s and just over one million shares a day in the 1950s. Overall, commissions covered a securities firm's

costs. All the profits came from underwriting new issues. During the Depression and World War II there was little underwriting, so firms had learned how to avoid all unnecessary costs. The demands of serving institutional investors—particularly block trading—appeared to bring *very* unnecessary costs.

Then, in the l950s, the stockbrokers' world began to change. The profile of the "typical" investor was changing, from the moderately affluent individual investor occasionally buying or selling a few shares through his retail stockbroker to the continuously active, professional institutional investor who was active in the market all the time, buying and selling positions in dozens of different stocks every day. Because the institutional investors were growing and managing portfolios more intensively, the volume and price of trading increased again and again. In 1960, NYSE daily volume averaged nearly two million shares. By the end of the decade, average daily volume doubled to four million shares as institutional investors, competing for "performance," increased their buying and selling. Daily volume growth continued to expand, reaching 1.5 billion shares a day in 2007—one thousand times the volume fifty years earlier.

Institutional investors were and are very different from individual investors. Their decisions are much larger. Orders are not for one hundred shares, but for one hundred *thousand* shares—and they want to execute their large transactions quickly and at a definite price. Their new demand produced an opportunity for Goldman Sachs and a few other firms that were led by aggressive, experienced traders to create a whole new kind of business: block trading.

When a portfolio manager wanted to sell fifty thousand or a hundred thousand shares of a particular stock to raise cash to pay for another, more promising stock, he contacted one of his major stockbrokers (who were getting well paid—often more than a million dollars in commissions every year—for executing the institution's high-commission, risk-free agency orders). If the block-trading stockbroker could not find the other side for an agency trade, he would be expected to buy or "position" the block with the firm's own money and take the risk of a sudden trading loss.[4]

Block trading was clearly risky business, because the institutions had reasons to sell—often compelling factual reasons such as a company's serious earnings shortfall. If the selling institution had just found out about a real problem and got out slightly ahead of the crowd by selling a block to a Wall Street firm, everyone

knew that other institutions would soon learn the same bad news and become sellers too. The price of that block might suddenly drop, so the pain of loss on a "positioned" block of stock could be sudden and awful. As long as no buyers were found, the firm's capital would be tied up, which could put the firm, at least temporarily, out of the trading business. As Dick Menschel explained, "The merchandise has to be moved swiftly. Otherwise, it ties up your capital, which means you're out of the business flow until you get liquid again. But also, tired merchandise can go rotten awfully fast and cause big losses."

Time clearly is money in block trading. If firm A doesn't "create" a trade very quickly, firm B or firm C or D will try to steal the trade away. With high fixed-rate commissions, the incentives were powerful. A broker with an order to sell ten thousand shares of a typical stock would earn a commission of forty cents a share, or four thousand dollars for the block. For one hundred thousand shares, the commissions were forty thousand dollars. If the broker was able to find a willing buyer and execute the trade as a cross—acting for both buyer and seller, he'd earn the commission on both the buy side and the sell side—they were a total of eighty thousand dollars. If a firm could execute a single hundred-thousand-share cross every trading day for a year, the extra annual revenues would be twenty million dollars, with little or no incremental costs. Adding two such crosses would add forty million dollars. Adding one 250,000-share cross each day would add fifty million dollars. As Senator Everett Dirksen might have said, "Pretty soon you're talking real money."

"Gus stands out as a real innovator in block trading," says Dick Menschel. "Gus was well positioned to do this for two important reasons: He knew the arts of successfully 'positioning' blocks through his experiences with block trades and taking on positions when running arbitrage, and he knew the skills needed for what we now call the capital markets business—who owned and might sell; who might buy and why; how the market did work and could work; and how to develop others' trust so he could 'make it happen' on specific trades." From 1955 to 1965, Goldman Sachs had had almost no competition in block trading. Levy worried about other firms getting into the business. As one way to keep competition away, Goldman Sachs partners would often bemoan publicly how tough and costly the block-trading business could be—and never acknowledged how profitable it really was. Meanwhile, Levy was bolder and more aggressive than any

other block trader. As his friend I. W. "Tubby" Burnham would recall, "Gus was making markets for far bigger blocks than any other firm. Gus liked and understood risk."

The "secret sauce" of the block trading business was to attract the business by developing a reputation for having capital and being ready to commit it to position blocks of stock whenever an institution wanted to sell, while at the same time not using the firm's own capital. It was often possible to find the other side of a pure agency trade, usually within hours and often within minutes, by being constantly in touch with all the potential buyers. The risk-control imperatives for success in the business of block trading were clear. First, buy blocks only from institutional traders whom the broker could trust to treat his firm fairly and who, if the position nose-dived, would make up a firm's losses by doing extra business later. Second, be able to resell blocks *very* quickly so the inventory kept turning over. Ideally, business would be attracted by the availability of capital and would be priced as a risk-taking *principal* trade but then executed quickly as a no-risk *agency* trade.

The keys to swift reselling were market information and close client contacts at all the major institutions. In addition to a sales team that could quickly man the phones, searching among dozens of institutions across the country for potential buyers, Goldman Sachs also needed a systematic way of knowing who was about to become a buyer and how to encourage potential buyers to "get real" and take action. A firm that is known to have the *sellers* will attract the buyers, and a firm known to have the *buyers* will attract the sellers. In market making, business begets business. And perception matters greatly: If the important buyers and sellers perceive that a particular firm is the place to go, that firm will have the decisive competitive advantage of getting the first calls. If a firm gets the first calls, particularly the first calls on important blocks, that firm's reputation as the go-to firm goes up and up.

Block traders worked to develop "the other side" with the NYSE floor specialists by inviting specialists, who regularly made markets of a few hundred shares for the traditional retail investor, to participate in larger institutional blocks for, say, one thousand or five thousand shares. Block traders also worked with floor traders (exchange members who roamed the NYSE trading floor, "taking the other side" when an excess volume of either buying or selling temporarily

distorted the market) by welcoming them to make a market in that stock for that trader.

To become that go-to central clearing firm for buying and selling, a wide-ranging communications network of good, active contacts is essential. The quality of contacts is measured by the institutions' speed in taking a particular firm's calls and their willingness to show trust by opening up and talking about what they are doing or might be doing. The other key factor is the ability to influence *potential* buyers (or sellers) to commit to action now. The best way to reduce the risk of getting caught with a block that can't be moved is to increase the order flow—the volume of buying and selling that the firm sees and can participate in. The best way to increase Goldman Sachs's order flow was to develop superior service relationships with the traders and portfolio managers at the major institutions and convince them that Goldman Sachs was the go-to firm for block trading—that Goldman Sachs would provide the most help when an institutional trader needed to sell a particularly difficult block of stock. "Somehow, it all came together," says Mnuchin. "A group of really quite extraordinary people of great talent at a time when the basic nature of the business was changing very rapidly. Teamwork. Working together. Focusing on customer needs and how to solve *their* problems. That's what we were all about in Trading." Teamwork at Goldman Sachs was becoming a whole-firm phenomenon. As partner Gene Mercy explains, "We did trades the desk didn't want to do because a salesman had been working on a particular customer for weeks, and this was our first chance to show what the *firm* could really do."

Levy drove Goldman Sachs to be the dominant firm in institutional block trading, creating supply or demand or both to trade ever larger blocks of stock—ten thousand shares, fifty thousand, and more. Levy organized, inspired, and drove the firm's sales traders to develop the closest working relationships with every major institution's senior traders and to make more calls more quickly to more customers than any other firm. Goldman Sachs matched this effective service organization by committing its own capital to buy or sell millions of dollars of almost any stock to match supply and demand and "do the trade, get the business."

Levy rose to prominence on Wall Street as block trading emerged from being just an offbeat occasional specialty into being the most important part of the institutional stockbrokerage business. During the 1960s and 1970s, block trading

gathered momentum as mutual funds and pension funds grew rapidly in assets, shifted the mix of their ballooning portfolios toward equities, and increased the speed of portfolio turnover in their accelerating competition to achieve superior investment performance. The rapidly expanding business of block trading was concentrated with the few stockbrokers who were willing to take risks by using their firm's own capital to "take the other side," buying what institutions most wanted to sell or selling what institutions most wanted to buy.

Still, block-trading risk takers were unusual on Wall Street. Most Wall Streeters kept thinking of the trading business in one historically valid but increasingly obsolete way: Every trade was separate from every other trade; nobody owed anybody any favors; *caveat emptor* and *caveat vendor*. If an institutional seller came to a dealer looking for a bid, the dealer and the account both knew they were adversaries in a zero-sum game—just as they are today in commodities, fixed-income securities, currencies, and derivatives. Most Wall Street firms were so used to thinking of their business in this day-by-day and trade-by-trade way that they were unable to see the business that could be developed by combining intensive service with risking capital and accepting occasional losses as a necessary cost of developing profitable long-term relationships with the major institutions' senior traders. Nor did they understand that executing a large, repetitive share of each institution's continuous and increasing flow of commission business would, over weeks and months, earn large profits. The institutions' senior traders needed the block-trading firms to satisfy their portfolio managers' liquidity requirements, and only a few firms could and would provide that liquidity consistently.

Levy's unrelenting drive to do the business—*all* the business—was so intense that customers would actually commiserate with the Goldman Sachs traders and salesmen covering them, crying and laughing together at the intense pressure Levy put them under. One example of the fun to be had was a cross-stitched "sampler" that Bob Menschel had made up, framed, and placed prominently in the institutional sales department adjacent to the trading room:

A 250,000 SHARE
BLOCK A DAY
WILL KEEP GUS LEVY
AWAY

A thousand copies were made up and sent out to clients. Hundreds of clients proudly put them on the walls of their trading rooms all across the country.

With such incentives, as more and more shares were traded in blocks, all the block traders made special efforts to develop close relationships with the institutions' senior traders, flying to Boston for dinner at Locke-Ober's or to Chicago for hockey or basketball games or going fishing, golfing, or skiing—and always by calling and calling and calling, sometimes calling the same buy-side trader at an institution fifty or more times in a single day. Soon hotline direct wires were installed at the institutions' trading desks, connected directly to the trading desk at Goldman Sachs. Having hotlines became so important that one institutional portfolio manager managed trading relationships with masking tape—taping over the lines of block-trading firms he thought were underperforming.

Competition between stockbrokers developed in two ways of particular importance to the largest and most active institutions: research and trading. Research was increasingly important to the institutions. While most individual investors' buying and selling were primarily "informationless" trades occasioned by nonmarket events such as receiving a bonus or an inheritance or needing money to buy a house or pay college tuition, the institutional investors were in the market every day buying and selling shares. They based their trades on the relative attractiveness of the stocks they owned versus stocks they were considering, so they wanted to be well informed about what they might buy or sell and why. They demanded accurate, detailed, up-to-the-minute information and shrewd analysis of important trends that could affect a company's future earnings.

Gus Levy made markets for bigger blocks than any other trader because he understood risk and liked taking risks. Goldman Sachs's main rival as king of the hill in block trading was Bear Stearns. Sy Lewis, managing partner of Bear Stearns and a fierce competitor in block trading, was Gus Levy's personal rival and personal friend. Both men were determined to win the competition—and winning was not just a matter of pride. They were competing for control of a big, profitable business. Just as Olympic gold medals are often won by differences of less than a tenth of a second, small differences between block-trading firms were often decisive. That's why Levy was unrelenting in his pursuit of every possible piece of business. "God forbid you missed a trade and Bear Stearns got it," remembers partner David Silfen, "because Gus knew he'd be playing golf on

Saturday with Sy Lewis, and Gus didn't want any razzing from Sy or from the others in their group." Nor did he want any razzing from his partners about taking losses in block trading.

When the firm incurred trading losses early one year, Levy told Institutional Investors, "The only reason we ran in the red any month was not because of normal business, but because of inventory losses. And that's the nature of this business. If you're in the dealing business, you know you have to lose some money sometimes. It's not major; in fact, it's very *un*major. I think we've learned a lesson. We're not going to be so high, wide, and handsome next time. This means we will turn our inventory, or try to turn it, quicker. We aren't going to play wishful thinking. There is an adage, and it still holds true on Wall Street: something well bought is half sold. That's the trick of the trade." Within the firm Levy made it even clearer: "A good trader eats like a canary and shits like an elephant."

In addition to courting the institutions' senior traders, Goldman Sachs and the other block-trading firms made direct contact with the portfolio managers, who told the senior traders what they wanted to buy or sell. At the same time, to serve the institutional investors' needs for information and knowledge, a new group of "research" brokerage firms built their business with a heavy emphasis on in-depth investment research communicated through long, detailed reports, conferences, telephone calls, and personal visits by their expert analysts. Their research enabled the best of these brokers to gain market share in the rising tide of institutional transactions. Still, the best competitive position was to have strength in both research and trading. That's what Levy insisted on at Goldman Sachs, so it became the leading institutional stockbroker.

Levy worried that other firms, particularly Salomon Brothers, with its bold, risk-taking trading reputation in bonds, would muscle in on his lucrative block-trading business in stocks. His fears were realized in the seventies. "When Billy Salomon decided to learn the equity block-trading business," recalls Bob Menschel, "he offered to put up the capital to take on half of all our positions. We all knew that meant Solly was going to get into the stock business with the same competitive intensity they were showing in the bond business. But, as I told Gus, 'He will do this with somebody, so why not with us for now?' So we were soon in business together."

Levy wanted "all our share" (and he really saw no need for the second and

third words in that short phrase) of the ballooning institutional business, so he took three bold initiatives. First, Goldman Sachs would allow any institution to allocate all or part of the total commissions on a trade executed by Goldman Sachs as a "give-up"—paid by the firm's check to another broker for its research.[5] This shielded institutions from pressure to trade blocks through research brokers to pay for their research services, or to compensate retail brokers for selling mutual funds, or to compensate the brokerage firms for maintaining large bank balances with them. It also discouraged research firms from developing block-trading skills and becoming direct competitors.

"When give-ups came along, other firms fought it," recalls Menschel. "We accepted reality, saying 'So be it,' and sought to make the best of it, welcoming the chance to do the trades and then sending out the give-up checks to other brokers. We were confident that if we executed the trades, we would maximize our breadth of inquiry [the future trades that would come to Goldman Sachs first]." While the rates at which brokerage commissions were charged were fixed by the stock exchange, the proportion that would be given up was fully negotiable. Years later, the commissions themselves would be made negotiable.

Second, Goldman Sachs would commit large amounts of its own capital to position blocks of stock that the institutions wanted to sell, accepting the inventory risk of buying the unwanted block before other institutional buyers could be found or rounded up, and before competing brokers could jump in and "steal the bacon." Levy's team would work the phones, urgently striving to find potential buyers and bringing them to the point of decision so the positioned block could be resold. With Levy's driving leadership, with thirty million to forty million dollars of firm capital made available for positioning blocks, and with an extraordinarily effective sales organization covering all the active institutions, Goldman Sachs set record after record for giant trades. In October 1967, Levy traded at the close of trading a block of 1,153,700 shares of Alcan Aluminum at twenty-three dollars, off 1⅛ from the previous trade. Valued at $26.5 million, it was the largest trade that had ever been done. On one day in 1971, Goldman Sachs did ten blocks of seventy-five thousand shares or more, including four over two hundred thousand shares; that year, largely on the strength of block trading, the firm earned record net income. In 1976 it traded over one hundred million shares in blocks on the NYSE.

"In evaluating leaders," says Dick Menschel, "the central question has to be 'Who made a difference?' and on this criterion, Gus Levy stands out as a real innovator in developing the business of block trading." Levy and his key lieutenants had that unstoppable drive to build a major, very profitable business, and they built the organization that would do it. One part of that firmwide focus was the buildup of research, but research was always a means to better trading, not an end in itself.

Levy insisted his salespeople make frequent direct contact with the portfolio managers and analysts who originated investment decisions that the traders executed. The question was how? The answer was investment research, but not the research on "interesting small companies" in which Goldman's research department had specialized under partner Bob Danforth, looking for investment ideas for the partners' personal accounts. Research had to focus on the major public companies, the ones most of the major institutions owned most and traded most.

Already, portfolio managers at Levy's largest trading accounts—Dreyfus, Fidelity, J.P. Morgan, and State Street—were pointing out that Goldman Sachs was their largest broker, often doing as much as 15 percent of their total brokerage business, but was not providing anything like an equal portion of the investment research they needed on large corporations. If Goldman Sachs didn't change and become far more helpful in research on major companies, Levy's largest accounts bluntly told him, Goldman Sachs would not continue doing nearly so much of their trading business. They would cut him back—way back.

Levy knew that any reduction in order flow would harm Goldman Sachs's ability to create the other side of block trades and to generate the liquidity to get out of unsold block positions by selling smaller lots on the market. Any unwinding of the "more, the more" compounding of Goldman Sachs's block-trading business would be costly: Block trading was the real money spinner at Goldman Sachs, and because block trading was *his* business, it was an important part of Levy's strength as the firm's leader. So his third initiative was to transform research. As usual, Levy got the message quickly and was soon saying, "One mistake we made in research is that we really didn't—with the exception of IBM and a few others—concentrate on the big stocks. That has been a very big mistake." Goldman Sachs had to become a leader in research on large corporations now, not because anyone really wanted to, but because Gus Levy said they had to.

Having research that really mattered to the institutions would give Goldman Sachs the powerful advantages of *time* and *access*. If the firm's analysts and salespeople were recommending Merck or Sears or IBM through in-depth written reports and one-on-one visits to the analysts and portfolio managers at all the major institutions, they would know more and sooner which institutions were most likely to become buyers if Goldman Sachs had a large order from a seller—or sellers, if the firm had a big buyer. Combining valued research with intensive service at all levels of the decision process, the firm was often able to anticipate what the traders at these institutions would otherwise find out about only several days later. Having insight into potential buying or selling decisions well in advance of their actually being made was a wonderful advantage in getting more and more of those big orders.

Simultaneously, Levy decided that Goldman Sachs was capable of serving as investment banker to large corporations—particularly the new conglomerate companies. The conglomerates were doing most of the acquisitions and thus were most often in the capital markets for financing and most eager to know what the arbitrageurs and key people at the major institutions were thinking and doing, and likely to do.

In 1969 Levy announced, in his "no questions expected" way, that from then on, Goldman Sachs would concentrate on major companies in *all* its work—and obliged each of his key lieutenants to lead in making this new strategic commitment work in research, trading, and investment banking. Not only did the change mean deliberately abandoning the firm's traditional focus on smaller companies in investment banking and in research, it meant committing the firm to a business strategy in which other larger and more prestigious investment banks were already well established.

Fortunately for Levy and Goldman Sachs, America's major corporations were entering a strong growth phase and not only needed more capital, but also were adding investment bankers to their traditional syndicates. As the tide of institutional investors' interest turned from "small caps" to "large caps," Goldman Sachs was ready and caught the wave. The firm's underwriting business expanded rapidly, capitalizing on the powers of institutional distribution developed through equity block trading. As he did so often, Levy visibly led the

charge, convincing one major company after another to make more and more use of Goldman Sachs

Investment Banking Services, the business development organization that had become increasingly effective under John Whitehead's leadership, was now prepared for the challenges of competing with the major establishment firms that made up the formidable "bulge" bracket—the recognized leaders in investment banking. In addition, advice on mergers and acquisitions was beginning to develop as a separate product line under the leadership of Steve Friedman. The profitability of this business could and would be stunning. Still, even as other divisions blossomed, the core of Goldman Sachs's business was block trading.

I want you in Gus Levy's office—*now*!" Bruce McCowan, who had replaced Danforth as partner in charge of research, was about to get direct, absolute, imperative instruction on where research stood in the hierarchy from the dean, Bob Mnuchin. Less than an hour earlier, McCowan had been asked for a research perspective on a stock that Trading was working on as a block trade. McCowan had been distracted by a customer's call. When asked just a few moments ago for an update, he had said he would now be returning to the matter and would call when he had an answer. That would *not* do. Not at all. That's why he got the command call to be in Levy's office—*now*.

Once inside Levy's small glass office on the trading floor—as Levy watched, solemnly puffing his cigar—Mnuchin poked McCowan's chest to command attention and laid it on the line: "When I say jump, you say 'How high?' *This* is where the firm makes its money. This is where *everything* and *everyone* must focus." No ifs, ands, or buts. None at all. Research was only important when it served trading.

Mnuchin's waiting periods rarely extended beyond "right now." The morning call every day was at eight thirty in New York. But that was 5:30 a.m. in California, so one of the sales traders in Los Angeles would listen in from his home and then drive in to work. One day, Mnuchin had a series of major positions he wanted to sell and called each office to hear what help they could give him. When he called L.A., the trader's wife answered and said he was taking a shower. Mnuchin went nuts.

. . .

In building up the block-trading business, which in the early 1970s produced over two-thirds of the firm's annual profits, Gus Levy had plenty of help. Among the people who performed strong roles as members of the "phalanx" were two standouts: Mnuchin, who ran the institutional block-trading desk, and L. Jay Tenenbaum, who managed the overall trading department, which included over-the-counter brokerage, convertible bonds, and risk arbitrage.

"L. Jay Tenenbaum worked *under* Gus," explains John Whitehead. "Gus was never abusive, but you wouldn't work *with* Gus, but *for* Gus. L. Jay stayed as long as he could stand working under Gus. They were very close in many ways, but the cumulative pressure of the moment-to-moment intensity of working for Gus was very hard to sustain indefinitely." Levy would frequently call members of his team at home—before seven in the morning and after eleven at night, or even two in the morning—usually saying only, "Gus—is he there?"

Mnuchin was ambitious and cheerfully admits that "partly by assignment and partly by initiative, I began to back Gus up." From the first, Mnuchin had hustle. Recalls a colleague, "Whenever a trader went to the bathroom, Bob was in his chair."

One day, Levy was out of the office for a few hours when a call came in from an institution that wanted to sell seventy thousand shares of RCA, a tremendous block in those days. "I wasn't second or third in command," Mnuchin recalls, with a grin like the old-time comedian Joe E. Brown's that comes easily to him, "I was just there. I called some accounts, but I couldn't get a firm bid. So I made a bid—forty-nine and a half, I think it was, three-quarters of a point down from the last sale. Then I called back the one institution that had showed a real interest and asked if they would now buy at that price. I held the phone for at least five minutes. You don't know how long those five minutes lasted. But they bought it. When Gus came back, he was very complimentary." And Mnuchin was in.

While never close personally, Mnuchin and Tenenbaum had great professional respect for each other. Tenenbaum, whose mother, like Mnuchin, had been a champion bridge player, observed, "[Trading] involves the same skills—the ability to determine where all the cards are sitting and the way the bidding is going and the ability, too, to keep all the separate situations clear."[6] Mnuchin

himself observes that a big factor in block trading is memory—"training yourself to retain facts, the almost unconscious ability to have a mental filing cabinet."

It was a long time before institutions found it as natural to ask for a block *offering* when they wanted to buy stock as they found it to ask for a *bid* when they wanted to sell. In the early days, they tended to use block trading only when they were selling—and their selling tended to be in down markets. As Mnuchin explains, "The entire habit or process of active institutional transactions—of their revisiting their portfolios and making changes—was in its earlier stages. So, if you had, for example, a block of twenty-five thousand shares you wanted to sell at forty-nine dollars, it was very unlikely that you would find another institution that wanted to buy that size block at that specific price at that specific time. The frequency of finding the other side of a trade was small, very small, but this created opportunity. Once block trading became a product with a relatively broad base, as opposed to an occasional pick-your-spot situation, the positions we wound up holding were not a profit center in themselves, but the volume we created and the aggregate commissions we generated—minus the loss on positions—for the most part became, overall, a profitable business."

The real risk in block trading comes when things suddenly go wrong and the block trader has bought or sold a block and cannot find the other side. "The hardest aspect of this business is the problem position," says Mnuchin. "When you can get out of a stock that you're long at a small loss and buy back a stock you're short at a small loss, that's an easy decision. It is painful when there isn't an apparent opportunity to unwind a position or the price moves farther and faster away. Then you hesitate. Then you pray. You hope that it will get better—or you use the wrong judgment and believe that it *will* get better. Those were situations when it was absolutely fantastic to work with Gus Levy."

Mnuchin recalls Levy's support "during the hardest single time I had before becoming a partner in 1965." An institution wanted an offer on Motorola for what was then a very large block, about 100,000 shares. He offered to provide the stock at nearly a point above the price of the last sale, and they said they'd buy it. "Well," he says, "you never know which trade is the one that will not create supply and demand. On this particular transaction, no supply of Motorola filled in. We were short *all* of it. I handled the position very badly, and the stock was just a steamroller. It wouldn't stop. We did this transaction at a price

in the mid-sixty-dollar range, and, if I recall properly, we covered the last shares of the short at $109 or $110. It was a monumental loss—significant seven figures. I wasn't thinking about my partnership prospects—I was worried about my *employment* prospects. I had some genuine concern that I'd be fired as a result of this Motorola deal. Well, Gus was absolutely terrific about this one. Instead of getting fired, I was shortly thereafter made a partner."

Known as the Coach for his hands-on, "get the customer on the phone and start talking—and stay with it" management style, Mnuchin would do much the same sort of thing for others on the team that Levy had done for him. "It may sound corny," he says, "but this business is really like a football team. I'm the playing manager. Or maybe the quarterback. Good quarterbacks are only made by good teams, and I like to think I'm a good quarterback. And a good quarterback can sense when his linemen are blocking hard and when they're just blocking. You have to get yourself up for this business every day. You have to be up emotionally, and keep everybody else emotionally keyed up, all the time. You've got to drive and motivate people. If you're placid or a little bit tired or depressed, you won't turn the routine calls into something. You won't create the big business."[7]

Mnuchin, as everyone in that part of the business did, used smoke and mirrors and said slightly different things to different people, but he could keep all those differences clear in his head and always knew exactly what he'd said to each account—so he never got caught. Bob Rubin once observed, "Bob had tremendous charisma within the firm. When, every once in a while, you'd have a time when markets would fall apart on you, Bob would go on the trading desk, be supportive and keep everything going." Adds partner Bill Landreth, "On the SS1 open-line communications system, Bob Mnuchin's commitment and the motivation he inspired in his global sales organization were truly electric." It would have been an exasperating and frustrating existence if he hadn't loved it so. "And I do love it," avows Mnuchin. "I think to be good at it, you have to. It's not a science. There's no one right way to do things, no contract with specifications. Every piece of business is different, and you never know what's coming down the pike. And aside from the money you make, it's tremendously exhilarating when you do a big trade—when everything works." Mnuchin enjoyed playing the block trader's equivalent of "chicken," calling institutional traders and offering to buy blocks—*any* blocks—at either the last sale or on an uptick.

Mnuchin laughs knowingly: "Some of our worst trades have resulted from pride. When it goes wrong, it is a lonely, desperate feeling, even though the partners are terrific and supportive. There's a tendency to be either very high or very low. So when I'm high, I temper it, knowing another day will come. And when I'm low, I temper that, too, so I don't make it worse emotionally. Then afterward, I try to learn from the defeats and repeat the victories."[8]

In a rare compliment, Levy observed, "Bob is the best trade-putter-together I know of in the business." The senior trader at a major institution, reflecting the intensity experienced by those on the receiving end of the Mnuchin treatment, said, "Mnuchin is the most aggressive guy on the Street. He'll move heaven and earth to get a trade."[9]

Levy's focus on what was best for Goldman Sachs could, on rare occasions, cause him to be badly out-traded—most obviously during the SEC's drive for negotiated commissions. The Antitrust Division of the Department of Justice fired the first warning shot when it concluded in the late sixties that fixed rates were a monopolistic practice; it wrote a letter to the SEC asking why fixed rates should not be disallowed, particularly since firms were clearly discounting them regularly to favored institutional customers. Caught off guard, the SEC rushed to get organized and initiated a major study of institutional investing and related brokerage practices. Levy was not only the head of Goldman Sachs, he was also the chairman of the New York Stock Exchange, so he might have felt he was conflicted in serving two masters. Most exchange members wanted to keep fixed commissions as long as possible—preferably forever. Knowing the other major block-trading firms had a special-interest reason to be against give-ups, Gene Rothberg, a smart, tough senior SEC staffer,[10] saw an opening and gave Levy a choice: The give-ups were really a form of price negotiation, so Levy should either agree to negotiated commission rates or give up give-ups.

Since "where you stand is where you sit," and Goldman Sachs was distributing many millions of dollars of give-up checks to other brokers, Levy immediately saw that Goldman Sachs would be far better off by giving up give-ups—so he went for it. What he didn't recognize was that this would be the fulcrum on which the government would eventually oblige "voluntary" acceptance of negotiated commission rates. Nor did he recognize that he had just been strategically out-negotiated.

In Levy's second round with the government, he took another loss: He spoke in favor of negotiated rates because he really thought commissions—particularly for the large, difficult trades in which Goldman Sachs was the undisputed leader—would go *up* if they were no longer fixed. He just *knew* that the other firms could not keep up with Goldman Sachs, so for Levy, it stood to reason that his firm would gain market share and would be able to insist on higher rates for doing the tougher trades if rates were negotiable. Later on, Levy could see that rates would probably decline some, but he still believed Goldman Sachs would gain revenue and profits overall, because he was sure he would gain market share. In the days before May Day in 1975, Levy toured the major institutions, confidently saying, "If commissions drop more than twenty percent, we'll get *all* the business." He was very wrong. During the first day of negotiated rates on very large trades, senior trader Bill Devin called from Fidelity: "We're seeing a lot more than 'down twenty'—and from good firms." It was the start of a thirty-year collapse in commission rates from forty cents a share to well under four cents.

The persistent search for opportunities to do business—to dominate and control the market, partly to maximize volume and partly to preempt any business going to any competitor—can be illustrated many, many times in the ambitious development of Goldman Sachs. One example was in the sale of stock by corporate "insiders," which was strictly limited by the SEC's Rule 144 to 1 percent of NYSE trading volume in any six-month period—unless the seller was responding to an unsolicited bid. On Dick Menschel's initiative, Goldman Sachs developed a specialty business of showcasing its institutional block-trading activities to large individual holders of "Rule 144" stock. Far from feeling pestered or annoyed by calls from Goldman Sachs salesmen, corporate executives with Rule 144 stock saw these calls as an invitation to be included in the action—and as a potential source of those valuable unsolicited bids.

As the leader of the firm's Rule 144 business unit, partner Jim Timmons limited his calls to people with at least twenty million dollars in stockholdings to stay focused on his prime prospects. To gain maximum coverage of the whole market, Timmons got weekly reports from a Washingtonian who rode his motorbike to SEC headquarters each week to be the first to receive the regularly released insider stock activity reports, which were available only there. And in New York City, he organized an innovative information network on which the firmwide

business development operation was based. He made Goldman Sachs the clear leader in Rule 144 business and fed good new-business leads to the Private Client Services brokers. An executive who sold a block of Rule 144 stock suddenly had five million dollars—or ten million dollars, or more—of cash to reinvest.

Another niche market tapped by Goldman Sachs was the business of corporations' repurchasing their own common stock. Goldman Sachs built up a business specialty that required no investment in research, put no capital at risk, and was a productive feeder for other businesses of the firm. While most stockbrokers considered share repurchase just a minor sideline, at Goldman Sachs the minor sideline grew to generate high-margin, risk-free business with annual revenues of one hundred million dollars.

The firm had regular access to corporate treasurers through its large commercial-paper business, and treasurers whose companies had large-scale programs to repurchase their own shares found accepting Goldman Sachs's calls offering a block of stocks doubly attractive. The treasurers saw buying blocks as far more convenient and cost-effective than a long string of hundred-share purchases could ever be. In addition, they could avoid intraday price disruptions. If Goldman Sachs could get a corporation's buy order for a large-block share repurchase, it could then scour the institutional market, looking for a willing seller—and another block-trading "crossing" opportunity.

When "NSI 100,000" appeared one day in the early seventies on the illuminated, outsize ticker tape that dominated the far wall of the trading room, Timmons was stunned. This was supposed to be *his* block of one hundred thousand shares of Norton Simon common stock. He had been promised the trade by the company as part of its share-repurchase program, and he had been able to find a willing seller for a perfect cross and a full commission of seventy-five thousand dollars. Even more important, Timmons had confidently assured the others in the trading room nearly a week ago that he had it all set up—and far more important, he had given that same confident assurance to Gus Levy.

Now, having lost the trade completely, he'd have to face Levy. But first Timmons reached for the phone to call Norton Simon Inc. When the treasurer came on the line, Timmons spoke quietly and directly: "One hundred thousand shares

of NSI just printed on the tape. You promised that trade to me five days ago. I'm calling to ask your help. You've got to explain it to me, because I have to go explain it to Gus." Timmons was no clerk; he was a Goldman Sachs partner.

"Jim, I owed business to Bear Stearns. This trade was my best way to give them some business. I knew one of us would have to face getting chewed out by Gus. Better you than me, Jim. So yes, I lied to you."

Timmons put down the phone, pulled himself up out of his chair, and began the long, long walk across the trading room to the darkened-glass cubicle. Levy didn't look up when Timmons got to the door. Timmons stood waiting for the usual slight indication of recognition, but there was none. As more and more seconds passed, Timmons knew he wasn't going to be acknowledged.

Levy rose from his desk as though he were alone, moved past Timmons, and walked deliberately to the center of the trading room where he silently took up a position next to Bob Mnuchin. Not dismissed, Timmons stood frozen as he realized the obvious: Levy was not going to speak to him.

Feeling the full burden of failure, Timmons began the long walk back across the cavernous trading room toward his seat. As he passed the desk of Bob Rubin, known to be one of Levy's few favorites, Rubin's barely audible voice gave this saving counsel: "He only does that with guys he knows he can trust." Levy's lesson was clear and indelible. Never, ever ease up on the unrelenting execution of *any* transaction until *after* it has been absolutely completed.

A quarter-century later, Timmons's memory of that experience, and the lesson learned about how to get business done, was still vivid.

10

REVOLUTION IN INVESTMENT BANKING

The Ford stock offering, a triumph for Goldman Sachs and Sidney Weinberg, also helped launch the career of John Whitehead. With his friend and partner, John L. Weinberg, Whitehead would lead the firm in decisively changing the basic structure of Wall Street and advance Goldman Sachs from the cluster of firms in the lower middle ranks of investment banking all the way up to global leadership. Unusually talented, shrewd, and classically upwardly mobile, the good-looking, soft-spoken Whitehead was typecast for Wall Street leadership and ambitious for his firm and for himself. As a competitor later summarized, "John was the consummate investment banker of his era."

Successful people and successful organizations seldom favor change, particularly change in their own sources of success in accumulating great wealth. They oppose disruption and strongly favor stability, consistency, and reliability in the business norms and personal behavior that they know best and that have worked so wonderfully well for them as individuals. Investment banking was steeped in traditions that had brought great wealth to many. Over fifty years, the ways of Wall Street had been more and more carefully developed in greater and greater

detail and had become increasingly stable. Nothing was more codified on Wall Street than respect for other firms' client relationships.

Through the 1970s, proudly traditional Wall Street firms would not deign to solicit business. "Nobody called on corporations," explains partner Jim Gorter. "It just wasn't done. The old school ties governed, and changes, if any, came very slowly. For example, Motorola [founded by Paul Galvin] used Halsey Stuart because Mr. Galvin had a personal friendship with Mr. Stuart. That's the way it was and the way it had always been. Investment banking firms expected clients to come to them." Even into the late 1970s, elite firms like Morgan Stanley and First Boston would send engraved invitations to specific corporations—and even the government of Mexico—informing them that they would now be welcome to make an appointment to visit the firm at its office to discuss the possibility of becoming clients.

Within all the leading investment banking firms, individual partners had *their* client corporations, on whose boards of directors they usually served. Thus they would always know well in advance if any financing were to be done; they would be involved from the beginning in shaping the nature and timing of that financing and be alert to repel any competitors that might presume to offer their services. And while syndicates were organized firm by firm, the economics of every firm depended on the productivity of the individual partners. They jealously guarded their particular clients because in an "eat what you kill" world, their incomes depended on the business they personally brought in.

As Whitehead recalls, "Back in the old days of the forties and fifties, the 'historical' syndicates of underwriters were taken terribly seriously and were considered absolutely sacrosanct. Once a firm was in a particular underwriting syndicate as a major, it was a major for life. Changes came very rarely. I can remember resenting quite bitterly the fact that Kuhn Loeb and Dillon Read—which I considered at the time to be old-fashioned and not up to Goldman Sachs in their talents—were included in the 'bulge bracket' as leaders in all the underwriting groups that Goldman Sachs was not in. Nobody was willing to face the reality and change those historical structures."

Attentive service to each firm's own clients was extremely important. There was little or no shopping around for different investment bankers and very little price competition. Moreover, few companies, other than utilities, turned regu-

larly to the capital markets to raise either debt or equity capital, and if they ever did, they certainly wouldn't abandon their long-standing traditional banker and risk such an important transaction with a different firm—particularly a small, stigmatized, second-tier firm like Goldman Sachs.

During their time together working on the Ford offering, Whitehead had earned Sidney Weinberg's confidence. Even though he was not yet a partner, he was able to get Weinberg's okay that a study of Goldman Sachs's new-business activities might be worth undertaking. The study was authorized on January 20, 1956, and completed several months later. But on the advice of his friend John Weinberg, Whitehead cautiously kept in his desk drawer the crucial report—which explained the risk of depending on one single person, even one as remarkably effective as Sidney Weinberg—until *after* his formal admission to the partnership.[1] Whitehead says knowingly, "Rocking the boat did not pay off with Sidney Weinberg."

Whitehead's memorandum advocated a complete change in the firm's organizational structure—a change that would, in time, decisively accelerate Goldman Sachs's becoming the nation's and then the world's preeminent investment bank, and in time would cause every major competitor in the investment banking industry to restructure too.

Redefining a business and reinventing the firm—often very substantially changing itself and its way of doing business—are themes in the extraordinary growth and expansion of Goldman Sachs. Yet almost always the firm projected smooth consistency that masked its unrelenting determination to advance in competitive position and increase profits.

The most sincere business compliment is when competitors change their strategies and organizational structures to imitate another firm's business strategy and the structure through which that strategy is being realized. The compliment of replication is all the more substantial when competitors believe the particular business they are adjusting is the crucial core of their own strategies and when their previous organizational structure has been the pathway by which their senior executives have achieved their prominence, power, and affluence. At Goldman Sachs, Sidney Weinberg had been succeeding greatly within the old, established structure. In his irreverently unique way, he had become a master of that traditional structure, and it had enabled him to become accepted as an

effective, powerful leader. So why would he be open to making *any* change, let alone endorsing major change?

Into this unpromising environment, Whitehead proposed to separate executions from solicitations and to have everyone in investment banking at Goldman Sachs work either on soliciting business and managing relationships *or* on executing specific transactions. Nobody would do both, even though that was the way it had always been done on Wall Street. The idea of soliciting business with a team of people who did nothing else was entirely new and different for investment bankers. It was distasteful to many—including Sidney Weinberg, who knew how important *he* was—and to many it seemed a sure waste of money because it could not possibly be effective. Who, after all, could compete with Sidney Weinberg or with any of the other leading bankers at Wall Street's leading firms, who as professionals all took pride in delivering the services they sold and sold only the services they themselves delivered? Everyone knew that all investment banking business had always been done at the highest executive levels and could only be handled by skilled and experienced partners. Weinberg naturally believed he had unique skills and abilities to develop relationships—skills and capabilities that were not about to be matched by a mere commercial-paper salesman. Like other traditional investment bankers, Weinberg believed that only the banker who would actually execute the transaction could possibly fully understand what to promise or propose, and he saw soliciting other firms' clients as unprofessional. Sidney Weinberg would see no merit in making any change.

He certainly made no response to the copy of Whitehead's memorandum he eventually received, and Weinberg was none too pleased when he learned that copies had also been distributed in blue covers with a spiral binding to each of the firm's partners. However, since Whitehead's proposal had been developed in response to Weinberg's own written directive, it was automatically on the agenda for the next partners' meeting. After Weinberg's dismissive introductory observation that "Whitehead has some crazy project on his mind," Whitehead explained his plan.

As he presented the proposition, it was simple: Pointing with deference to Mr. Weinberg's formidable success in bringing business to the firm—and making no mention of the obvious risks in Weinberg's clearly getting older—Whitehead explained that if *ten* men were out selling and each of them could produce just

20 percent of what Mr. Weinberg produced, they could, as a group, produce *twice* the business the firm was then getting through Mr. Weinberg.

In suggesting the separation of the sales and service function from the production function, Whitehead used the example of manufacturing companies like Ford. The successful automobile salesman doesn't go out on the factory floor to make the product; he goes back to sell more and serve his customers because that's what he is best at—while others do what *they* do best: make cars. "Production and distribution are quite different," Whitehead said. "Building relationships to bring in the business is one function; executing the specific transactions is a very different function. The different functions need different skills, drives, and personalities. Demand versus supply. Most people—by skills, interests, and temperament—are better at one or the other, and the opportunity for management is to match each person to the role where he has the best fit, will have the most interest, and will do the best work."

For Whitehead, there were two important dimensions to the problem with Wall Street's traditional practice of just one investment banker doing it all for his client. First, sales and selling were not demeaning; they were the vital strengths of a great organization and should be so recognized. It takes time and thoughtful attention to each client organization to become an expert on the opportunities and problems that particular client must deal with successfully; to understand how those problems and opportunities are changing and might change as time passes and circumstances develop; to keep all the relevant people at each client fully informed about and confident in the firm's special ability to serve effectively; and to make them confident and comfortable that the firm to use for each major transaction is, naturally, Goldman Sachs.

Second, selling should be separated from manufacturing to be sure the best manufacturing skills are dedicated to making the best product. Producing the best-manufactured product is key to delivering the best service, and there are just too many specialized products in investment banking for anyone to be a true master of each and all of them.

Weinberg briefly expressed offhand skepticism in the meeting and was clearly not supportive. "He rather obviously ignored the whole idea," recalls Whitehead, "but it was important that he did not explicitly reject the idea either." No formal vote was taken. With no direct opposition, Whitehead boldly and

quietly decided to act. "Since there was no vote," he explains, "we had not voted no. So I just went ahead."

Weinberg never did endorse Whitehead's concept.

Jim Gorter, who built the core of Goldman Sachs's national power in the Midwest and ran the firm's important Chicago regional headquarters for many years, explains: "While the actual implementation was somewhat different from the proposition as written, this was the decisive event in the development of Goldman Sachs and of investment banking as an industry." "Of course," acknowledges Whitehead, "it would take ten years and several false starts to get the proposition all worked out in operation, but it was clearly different. And we knew that Goldman Sachs had to be different to make a real change in our competitive position in the business." Observes Jim Weinberg, "Most great ideas develop rather slowly with a few lucky breaks and then gather momentum. Only later do they appear to be the stroke of genius."

So that there would be no incremental cost for the firm—which could provoke objection—Whitehead's first step in the early days was to invite two commercial-paper salesmen to add some of the firm's other products to what they were already offering in their regular marketing territories. "As salesmen, they were naturally interested in this enlarged opportunity," says Whitehead. (Years later, he acknowledged that it was "a rather sleazy gambit" to start with the firm's commercial-paper salesmen, but it was a start and there were no alternatives.) Whitehead soon added men from the buying department, such as Alan Stein in California and Fred Weintz in the Midwest, and called his unit the new business department—later renamed Investment Banking Services and called IBS. IBS men became more and more effective in developing relationships and winning business, and success in executing transactions deepened their confidence that the product professionals they represented were so intensively specialized and experienced in their particular product that they must be among the best in the entire industry. The central question became, where should the firm's relationship managers concentrate so they could be most productive?

"As we looked at the overall market, the hundred largest corporations were all pretty much locked up by the leading Wall Street firms," says Whitehead. "Most had just one major investment banker, and often a partner of that firm was already sitting on their board of directors, determined to protect his firm's

relationship and keep all the available business—so there wasn't much chance in those early days to get them to change to Goldman Sachs. But there were many, many *other* corporations, so we focused on them." Into the mid-1970s, Goldman Sachs concentrated on smaller and midsize corporations, the so-called Fortune Second 500—and many even smaller companies. Whitehead's group initially worked with a list of five hundred companies. This list was soon expanded to one thousand and then to two thousand. As more people were added to IBS, the list each covered was cut from two hundred down to one hundred companies, so more and more companies were covered more and more intensively. By 1971 every one of the four thousand U.S. corporations earning one million dollars or more had an investment banker at Goldman Sachs responsible for trying to do business with it. In the five years between 1979 and 1984, the firm added five hundred new clients, literally doubling its clientele. Within a generation, every major firm on Wall Street was obliged by competitive realities to adopt Whitehead's organizational concept.

Having gotten their selling experience in the commercial-paper business, the commercial-paper salesmen knew the disciplines of patience, persistence, and procedure. They had to build comprehensive credit files on prospective issuers long before they did any business so the firm could respond swiftly if and when a company might call to say it had decided to issue commercial paper. As Fred Weintz recalls those early days, "An IBS man would write a report to the buying committee explaining the company and what it wanted to do with the capital. Then there would be extensive checks with competitors, suppliers, and customers to find out what the company and its management were really like. I was always making new calls, but we wanted to develop *relationships* and would try like hell to do a good job for each client. We knew that if we did our work really well for each client, more business would follow and we'd get recommended to others. Our competition for underwriting consisted of Blyth, Merrill Lynch, First Boston, and McDonald."[2]

But Whitehead wasn't looking for mandates to sell just commercial paper: "I was always looking for some other things we could sell. So I might see a possibility at one of the companies for, say, a debt private placement and say, 'Ted, why don't we also sell these folks a private placement?' And Ted would try it out on his next visit and write it up in his call report. And then I'd say to Bob and others,

'Did you notice that Ted's already talking to company X about a private placement? Looks like a good idea.' And pretty soon, Bob would report on *his* call reports that he was recommending a private placement to company Y"—with Whitehead deliberately and repeatedly taking note of Bob's good initiative when talking to the others in IBS and to Bob himself.

Acknowledging how closely he monitored the sales effort, Whitehead recalls, "I read all of the call reports, often sending them back with notations like, 'Did you try to offer them service A?' or 'Did you ask about service B?' Soon enough, one of the men somehow got a mandate to study a company's dividend policy for a fee of twenty-five thousand dollars. Not much of a fee, even in those days, but recognized as business we'd never have had except for his efforts. A memorandum celebrating this wonderful accomplishment went to all the partners. The triumph for a whole year would be that Goldman Sachs had persuaded some company not to use Lehman Brothers for some issue and instead to use Goldman Sachs, or to add Goldman Sachs as a joint manager in addition to their historical banker, Morgan Stanley. Those small gains were celebrated as great achievements."

Whitehead was optimistic—and determined. As he recalls those years, "Pretty soon we'd get another mandate and do another transaction, and would celebrate that fine achievement rather widely and visibly. We kept doing this until the whole team was engaged in selling our broader and broader product line." With Whitehead's persistent and cautious "prune losers, feed winners" style of management, the whole IBS organization became constructively infected with commitment: first to specific actions and transactions and later to an overall strategy—and eventually to a firmwide culture and a commitment to a new, organized way of doing business.

By making relationship management conceptually equal in stature to executing transactions, Whitehead was able to recruit skillful people into an organization that became notoriously effective at finding business and distributing new product ideas. It gave Goldman Sachs a decisive competitive advantage over other Wall Street firms, plus a growing reputation for competence and commitment among corporate prospects and clients. No other firm could match it. Even competitors called it "the machine."

Whitehead recalls with a smile how the business was built: "We would, of course, defend and protect our own clients, taking full advantage of our being

their traditional investment bank, and saying to a CEO who had just come into office at a firm client, 'Oh sir, you wouldn't even *think* of changing your company's long-established investment banking relationship, because this is something that has gone on for generations before you came on the scene. You'll be CEO for only a few years, but the relationship between Goldman Sachs and this company will certainly continue on forever.' But then with other firms' clients, of course, we talked a very different line, saying 'Who does Morgan Stanley think they are, to claim that they *own* you? You are an *independent* company. You have every right to pick your own investment banker based on whoever you think is the very ablest, and not be bound by past history.' "

Whitehead's first task was to build IBS into an organization that could successfully initiate, develop, and build business relationships with many, many corporations. The second and simultaneous task was to elevate the stature of IBS within the firm to equal the traditionally dominant buying department where skeptics and resisters were numerous. This equality in stature would depend on the ability to recruit and keep exceptionally talented and ambitious professionals working in IBS for their full careers. For several years, Whitehead led the recruiting each year at Harvard Business School. He was also always looking for unusually capable commercial bankers who might transfer for more opportunity, and he recruited people from other firms, concentrating on ambitious younger people who had good training and experience but might feel stymied in their careers. Whitehead would offer them the opportunity to have their own accounts and a promotion to vice president.

Fred Weintz recalls how things were: "Not long after John Whitehead put forward his plan to establish a new business department, Jim Weinberg persuaded me to apply for a transfer from commercial-paper sales. Commercial paper was not very profitable, but it was a good way to get started with a company while looking for a chance to do a future public offering if the company earned at least one million dollars. And obviously, it had to be a *quality* company to pass with Sidney Weinberg. The firm was also trying to recruit commercial bankers on the theory they knew how to call on companies for financial business, and was offering them twelve thousand dollars a year. But when I was taken on as an internal transfer, it was for only $7,500 because the firm's cost controls were so very strict. Following the pattern used for commercial-paper sales, we were organized by

geographic areas, with five men in New York, two in Boston, one in Philadelphia, and one in St. Louis. I had Ohio and Indiana—except, of course, for any companies in the territory that were Mr. Weinberg's. We were always striving to rationalize our business and the operation of the new business department. We knew we were nowhere in oil, and Morgan Stanley and First Boston had most of the top one hundred corporations. Goldman Sachs had a few in the top one hundred list, but most of our clients were spread across the next thousand. We had group meetings all the time trying to figure out ways to improve our business."

Whitehead recalls, "Since there were hardly ever *any* changes in investment banking relationships in those early days, our task of breaking in was daunting. We would evaluate our performance by how many new clients we added in a year versus how many we lost. After a long year's work, we might be up three or up six or something like that." It didn't seem to work at first. New Business took the credit for things, and the overheads went up, and small gains were celebrated as great achievements, but the flow of business did not really increase. The idea that commercial-paper profits would "finance" the expanded new business organization looked to some like wishful thinking. As George Doty observed: "Goldman Sachs's new business development organization was by no means an overnight success. For several years, it was a money loser. That's one of the main reasons other firms did not duplicate it. Who wants to duplicate an experiment that is a radical departure from the tried and proven, and doesn't seem to be working all that well?" It would take ten years and several false starts before Whitehead's innovation worked out. Sidney Weinberg never did like it or support it and was, according to Whitehead, "number one in new business until the day he died."

Whitehead gave more and more of his attention to things managerial, particularly business planning. One day in late 1963, Gus Levy, the intuitive, forceful, deeply engaged frontline leader, had cornered Whitehead in the hallway to bemoan the dreadful news that with all its hiring of people, the firm was now saddled with a huge annual overhead of twelve million dollars. Levy worried aloud, "We'll have to take in a million dollars every *month* just to break even!"

Whitehead offered reassurance that, with some planning, this apparently awesome cost burden could actually be covered by normal and expected opera-

tions. For starters, Whitehead said he would estimate that the investment banking part of the firm would do at least one private placement a month—and, taking a pad of paper, wrote down "12 x $50,000" to record the fees that might be expected from this line of business, which, at the time, was a major product line for the firm. Then he added a line for commercial paper and then another line for a third service and so on until he had accumulated six million dollars in expected revenues, all from investment banking.

Then he asked Levy, who ran both arbitrage and stockbrokerage, "And what would you guess you can expect to do?" Responding to an implicit competitive challenge and quickly catching onto the play of the game, Levy ventured an estimate of the commissions to be generated by each of his twenty-five largest stockbrokerage clients—and then those likely to come from the next fifty—and then added something for arbitrage. As each new item was put forward, Whitehead wrote it on his pad. Then, noting that the total came to more than the previously daunting twelve million dollars, Whitehead had a rough business forecast for the coming year and wrote across the top, "1964 Budget." With this simple start, the discipline of planning was on its way to becoming a hallmark of the firm. Revenues were soon twenty million dollars, with expenses at fourteen million dollars—and pretax profits were six million dollars.

The investment banking business began to change in the 1960s as the volume of underwritings and the mergers-and-acquisitions business both picked up and institutional investors rose to dominance in the debt and equity markets. Even more important, major companies wanted more than one banker, and they began to use joint managers for their underwritings. More and more, investment bankers lost their "captive" clients.

Investment bankers traditionally prided themselves on being generalists who could execute any transaction or perform any banking service that client companies might want or need. Whitehead's organizational innovation was to divide and conquer. By focusing each banker on one specialty, Goldman Sachs would be able to deliver the best of both and do so over and over again, eventually anywhere and everywhere. Pairs of specialists—one expert on the product or service and one really knowing the company and all its key people and how they made

decisions—could beat the generalist investment bankers from traditional firms, occasionally at first and then, increasingly, time after time.

"Pretty soon the system began to work pretty well," recalls Whitehead with characteristic understatement. "Prestige for this group would necessarily come later—with the results." If the rest of the firm had doubts about the stature of the group, that was resolved decisively by Whitehead's persuading Sidney Weinberg's highly regarded elder son, Jim, to leave Owens-Corning Fiberglas and join IBS, where he was very successful *and* a Weinberg. In addition, as the years went by, others within the IBS group were promoted to partnership.

After an IBS new-business relationship manager won a mandate, he would turn over full responsibility for the execution to a specialist in that particular type of transaction. The relationship manager who developed the business would continue to be responsible for seeing to it that the client was pleased with the transaction and for seeking additional business. Meanwhile, the execution specialists, as they accumulated more and more experience, became leaders in their specialties. They could focus all of their time, skill, and energy on what they did best, knowing that the relationship professionals would bring in more—and more interesting—work for them to do on behalf of major clients who would already be committed to the undertaking. As Whitehead summed it up, "When our selling people knew they were representing the very best, most experienced, and most skillful *product* specialists, they could speak with pride and conviction when advocating a specific transaction to one of their clients. And they also knew they could turn the execution entirely over to the firm's product specialists, while they continued to devote all their time and energies to doing very well what they did best: working closely with each of their clients to be sure they kept bringing in the most business. They knew their prospects and their clients would get 'best execution'—and it was always easier to brag about a colleague than about yourself."

The combined strength of pure relationship managers doing what they did best, matched by pure product experts doing what they did best, would, in time, give Goldman Sachs a decisive—"unfair"—competitive advantage and a steadily growing reputation for competence and commitment among corporate prospects and clients. Gradually but steadily, the transaction specialists became confident that the relationship specialists really knew their companies and were good at finding and developing business opportunities and would call them in only when

a company was genuinely interested in their transaction specialty, so their time would always be well used. And the relationship specialists steadily gained confidence that the transaction specialists had more experience than their counterparts at other firms in their particular product specialties and knew the inside stories on all the most recent transactions—which gave them special credibility in competing for new business. As both groups eventually learned they could depend on each other, this was good for esprit de corps. And this interdependence fit well with the Goldman Sachs culture of teamwork and the subordination of "I" to "we" that had originated with the Sachs family, was consistently advocated by Gus Levy, and was always insisted upon by John Whitehead and John Weinberg.

Specialization by industry—in addition to specialization by geography—began institutionally in the early 1960s with partner Dick Fay focusing on finance companies. Then Burt Sorenson, also a partner, started to focus on utilities. When Barrie Wigmore, a Canadian, joined the firm in 1971, Whitehead's strategic objective was to accelerate the pace at Goldman Sachs by recruiting people like Wigmore, who wanted to achieve something special in their careers, were more than willing to work long hours and weekends to make it happen, and saw change as exciting and fun.* The original plan was to pair Wigmore with Charlie Saltzman, a retired general who had served at a senior level in the State Department before he was hired into the firm by Sidney Weinberg. Already in his sixties, Saltzman was near retirement, so Wigmore was in line to take over coverage of his companies in a year or two. But before that change ever took place, Whitehead decided it would be better to put Wigmore in charge of trying to develop business for Goldman Sachs in the huge public-utilities business.

Corporate-bond issuance was dominated by public utilities, but Goldman Sachs had no fixed-income research and no strength in bond sales. Moreover, most utility issues were competitively bid; Goldman Sachs historically had little interest in that low-margin business. But Whitehead still saw possibilities.

* Wigmore was surprised by the pace he found. Used to working on weekends, he came in on Saturday to find the doors to Goldman Sachs closed and locked. Nobody came in back then on Saturdays. Similarly, late-afternoon meetings would be brought to an abrupt end in those days by statements like, "Uh oh, time for my train!" Wigmore's readiness to extend the workweek was seen as an inconvenient nuisance by others at the firm.

To Whitehead, utilities represented a major opportunity—not because they did over half of the total public securities offerings by corporations; not because they were sure to continue to be major users of Wall Street underwritings in good economies and bad; not because there were so many of them; not because they were located all over the country; and not because utilities were important to such prestigious investment banking firms as Morgan Stanley, First Boston, Merrill Lynch, White Weld, and Salomon Brothers. In Whitehead's view, utilities represented a major opportunity because Goldman Sachs had almost no business with utilities—so "the opportunities were unlimited." Whitehead explained the opportunity: Wigmore could develop his own strategy, wasn't expected to spend time protecting existing business with old clients, and could go anywhere and do anything.

The one utility that the firm did any business with in the early seventies was the right one: Telephone. In truth, AT&T was not a firm client; it was a Gus Levy client. AT&T habitually sold common stock on rights offerings through warrants, and this automatically created an arbitrage situation involving the "when issued" shares. Since Levy headed the firm's arbitrage desk, he automatically became an important participant in the underwriting process and soon established a reputation with AT&T as an expert on share pricing—an expert whom AT&T wanted to consult before setting the terms of each new offering. Levy, who was chairman of Nelson Rockefeller's campaign finance committee, had become a member of New York Telephone's board of directors, so his firm frequently was listed as a comanager of AT&T's new issues—but never as the lead manager. Levy had developed such a strong relationship with AT&T's treasurer that even though Goldman Sachs lacked retail distribution and was weak in bonds, it would get a call announcing how much business it would be getting in each new underwriting—prestigious business the firm was glad to have.

So AT&T was a start. But would there be any followers? Wigmore took an inventory of his weak strategic position: Utility stocks were of no interest to most of the firm's institutional clients—and all of its important accounts. The firm had none of the small retail customers who traditionally bought utility stocks. The firm itself had little interest. Ray Young, head of sales, was clearly opposed: "We have no business in selling utility stocks." The firm's total revenue from utility business in 1970 was only twenty-five thousand dollars. Every utility already had long-established, stable investment banking relationships, and utilities were

notoriously cautious about changing their sources of finance. Changing these settled relationships would be difficult. The firm didn't know the complex ins and outs of the many and arcane utility regulations—regulations that were important and differed from state to state and from one type of utility to another. Wigmore didn't know anything about the rating agencies and how they did their work—except that they were important. And Wigmore didn't know the lawyers of the utility bar, but he did know he had to get to know them. Wigmore didn't know any utility executives, and they didn't know him.

Barrie Wigmore was a long, long way from his family home in Saskatchewan. But things were changing at Goldman Sachs. Under Whitehead's leadership, the investment banking department was developing a new aggressiveness. New-business developers were calling on clients and nonclients alike in search of business, and the specialty departments around the firm were encouraged to provide a constant stream of new ideas. Thanks to an unparalleled recruiting process, a lot of smart young people were generating ideas.

Structural changes are always resisted and always difficult to implement successfully, and the firm had a long-established tradition of all relationship bankers being generalists. This was important from a management perspective because as different opportunities waxed or waned, people could easily be moved around and redeployed. This tradition added two key elements to Goldman Sachs's strategy: low fixed costs and ample resources with which to pursue and maximize gains from any unfolding opportunities. People at other firms would say, "We should do this for the prestige" or "for our rank in the league tables" or "to protect our relationship" or "to show our commitment." Not at Goldman Sachs. Goldman Sachs has always been more clearly and more consistently focused on *profits* than the other firms.

Goldman Sachs was also more consistently aggressive, as illustrated by Wigmore's pursuit of an appointment with an important prospect in the early 1980s:

"Sorry, Mr. Wigmore, my whole day is fully booked."

"When do you start your day?"

"Six o'clock."

"If I came in at five forty-five a.m., could you see me?"

To develop business with utilities, Wigmore knew he would have to outflank the established firms and be innovative, so he searched for ways to differentiate his business-development initiatives and capitalize on firm strengths that had not

yet been applied to utilities. As an outsider, he had to be ready for possible breaks when and where innovation might be welcome. Wigmore's team eventually included over thirty professionals—analysts, IBS relationship managers, and product execution experts. Every Monday morning, they all gathered at 8 a.m. for breakfast and open discussion, reporting on every aspect of the unit's business and probing guests from other departments for new ideas. While the specifics would differ each week, the agenda was always the same: What's new and changing? What smart, new things are competitors doing that we can learn from? What opportunities might be developing?

Everyone was encouraged to come up with new ideas, no matter how far out, and to test them. "It was good for business and great for morale. We tried out all sorts of ideas," recalls Wigmore. "Some were nonstarters. Some were crazy. But some of them really worked. It was exciting to be in the hunt, and it was really exciting when we developed a winner. Pretty soon, we were earning a reputation in the industry for being well informed and imaginative, so more and more people wanted to talk with us and hear what we had to say and work with us on developing new ideas."

Most of the new ideas applied to the capital-hungry electric utilities industry. Some of the new ideas that worked:

- The firm arranged the first nuclear-fuel lease with commercial-paper backup. In these transactions, the firm bought nuclear fuel in a special subsidiary, Broad Street Services Corporation, financed it with commercial paper guaranteed by bank letters of credit, and then leased it back to the utilities. This used the firm's strengths in commercial paper and in leasing, an unusual specialty few competitors knew much about. A similar opportunity was found in equipment leasing.
- Pollution-control revenue bonds capitalized on the firm's strength in tax-exempt finance.
- The aggressiveness of the private placements department opened up new opportunities. When an institutional investor told one of the Goldman Sachs private placement experts that he wanted a specific type of bond, Wigmore's team would quickly scour the utilities side of the market, asking, "How would you like to borrow ten million dollars now at such and such a rate?"

This unorthodox approach—the exact opposite of the traditional approach, where a borrower prepared an elaborate offering statement and initiated the process—worked well and soon made Goldman Sachs a go-to intermediary in this new and fast-growing segment of the capital market.

- Eurobonds, sold through the Netherlands Antilles, opened another niche market and provided a way for American utilities to get their names and creditworthiness known in Europe's expanding capital markets.
- SAMA—the Saudi Arabian Monetary Authority—had huge cash flows to invest in the late 1970s, and interest rates were not as important to SAMA as credit quality. Through the contacts of partner Thomas "Dusty" Rhodes, the utility group arranged two- to five-year private placements with SAMA for many of the highest-grade U.S. utilities.
- Utilities that wanted coal-fired power plants could negotiate long-term supply contracts with coal-mining companies. But the coal companies could not afford the investment—as much as one hundred million dollars—in the outsize dragline equipment sometimes needed to mine the coal. Nor did the coal companies have enough taxable income to use the huge depreciation charges from such an investment. Solving this problem was easy: The utilities would arrange the financing for their coal suppliers through Goldman Sachs—and another financing specialty with good profit margins was developed and systematically offered to every utility that was a potential user.

These innovations were successful and profitable for the utility group, but they were all concentrated in the debt markets. Innovations there might gain Goldman Sachs respect and business within the utility industry, but common-stock equity financing was the utilities' lifeblood and ultimately determined whom they considered to be their investment bankers. Goldman Sachs needed to penetrate the equity market. But the effort faced big obstacles both outside the firm—competitors were entrenched and determined to defend the business—and inside. Things began to change, however, when Ray Young, the leading resister inside Goldman Sachs, retired, and Dick Menschel became head of sales. Open to new ideas, Menschel listened to Wigmore's proposition: "The sales force doesn't know much about utilities. If you'll give me *one* guy—part time—so we can teach

him all about utilities so other sales people can feed off his knowledge, I'm sure we can really do some business in utility stocks." Fortunately, Menschel assigned Tom Tuft to work with the utilities group. Tuft would become the leading institutional seller in the country of electric-utility stocks and go on to become the chairman of the firm's equity capital markets group.

Working with the research department, Tuft and Wigmore developed an easy-to-use sales tool that could be run off the computer every day. It showed, in rank order, the deviation in every utility stock's yield from its historical relation to the industry's average yield. Taking the simple assumptions that the market was usually right on its pricing of *each* utility relative to *all* utilities and that reversion to the mean would tend to bring any "wanderer" back toward the norm, money could be made by selling the "highs" and buying the "lows." Casualty-insurance companies—able to exclude from taxes 85 percent of dividends received as income—learned to use the information. Trading off the model, they became increasingly active trading customers with, of course, Goldman Sachs.

For Goldman Sachs, with its leadership in block trading, the next steps were easy, at least in retrospect: Offer blocks of new-issue utility stocks to institutions it knew were buyers, without the cumbersome, expensive, and time-consuming process of organizing a retail-oriented, multifirm underwriting syndicate and conducting a road show all around the country. Now, through just one firm—Goldman Sachs—utilities could raise fifty million to one hundred million dollars of low-cost equity capital in just one day. There was none of the usual "market uncertainty." And the execution cost to the issuing utility was compellingly low: only 1 percent to 2 percent instead of the customary 3.5 percent underwriting spread.

The next step would be continuous offerings. The firm persuaded the utilities that doing one big offering every year or so was not as likely to achieve their objective of low-rate financing as using a shelf registration (one registration statement covering several future issues of the same security) and taking advantage of market opportunities as they developed. Recalls Wigmore, "We began this sort of offering with medium-term notes, which were just one step along the maturity curve from the firm's great strength in commercial paper."

Advancing to longer-term debt and then to equity offerings was, at least in retrospect, a natural progression. If an institutional investor was interested in

buying one hundred thousand shares of common stock, that buyer interest would be taken directly to the utility as an offer. With its stock facing none of the market pressure so often caused by a major syndicated equity offering, the issuing utility typically got a better price for its shares. Goldman Sachs became known as unequaled in efficient execution of institutional stock purchases, and this added to the firm's overall credibility.

With these new underwriting tools and Tom Tuft's leadership, the firm gained new respect in the equity arena. It could increase its business by getting a bigger share of each underwriting—which it pursued vigorously. The turning point came on a deal for Florida Power & Light, traditionally one of the smartest companies in the industry, when it agreed to do a major nonsyndicate offering through a three-firm team: Goldman Sachs, Merrill Lynch, and Salomon Brothers. "Goldman Sachs was absolutely focused on placing those shares. The two other firms were not so focused on making it happen. This gave us a real opportunity," recalls Wigmore. "First, we sold all of our own allotment. Then we took back *all* of Merrill Lynch's allotment—and sold one hundred percent. And then we went to Salomon, who told us they still had eighty percent of their allotment. So we took that back and sold all of it, too."

Of course, this aggressiveness upset established underwriters like Merrill Lynch and Morgan Stanley as Goldman Sachs began picking off more and more business from 'their' clients, but it was great business for Goldman Sachs. No underwriting risk. No capital tied up. And no disruption to an established business relationship. "The utilities loved it too," recalls Wigmore, "so they began giving us other business as well. It was great, really great."

The firm's experience and effectiveness in distributing utility securities in the United States spliced nicely with its drive to build up business in the United Kingdom, where, starting in 1979, Margaret Thatcher's new government was strongly committed to privatizations. If Goldman Sachs could win those enormous, highly prestigious assignments from the British government, it would be taking a giant step forward in establishing itself in London and on the Continent. The firm had several things going for it. First, it was no stranger to UK institutional investors that were experienced, major investors in utilities. Scottish institutions in Edinburgh, Dundee, and Glasgow had been especially regular customers for utility underwritings, so they had gotten to know the firm and the firm knew them.

More important, Goldman Sachs had been developing expertise in underwriting offerings for investor-owned utilities. As Wigmore says, "We really understood the investors; we knew the market." Wigmore demonstrated Goldman Sachs's usual competitive intensity—flying over on the red-eye, meeting for luncheon in London with senior UK Treasury officials, and then coming right back to New York on the late afternoon flight. Her Majesty's Treasury got the message: Goldman Sachs was committed.

Almost simultaneously, Tom Tuft, frequently working with Bob Rubin, had success in utility privatizations in Mexico and Spain. The utility group had a parallel success with the gas-pipeline industry. Because the firm still had a weak hand with electric utilities, Wigmore concentrated at first on the pipeline industry, which had a more industrial mind-set that suited Goldman Sachs's traditional skills. Fortunately, White Weld, one of the traditional pipeline investment bankers, was in decline at the time, and other firms were slow to specialize in pipeline business. In new issues by pipeline companies, the firm went from zero to ranking number one. "But at first," says Wigmore, "we started, as always, beating our heads against the wall with the intensity of our calling and calling." Fortunately the pipeline companies saw themselves as industrials, not utilities, so they liked that Goldman Sachs was an industrial underwriter.

As pipeline companies tried to diversify, Wigmore saw the opportunity to apply the firm's mergers-and-acquisitions skills in the gas industry. Then, in the mid-1980s, when unfriendly tender offers became popular, Wigmore had a revelation: "The pipelines were sitting ducks—targets for hostile takeovers. The numbers were staring me, and anyone else who would look, right in the face." So he made the rounds of the pipeline companies to warn them: "You'll get raided—or LBOed!" This warning was more correct and timely than even he realized. When Cities Service was forced to sell off its gas pipeline in 1984, it attracted an astonishing twenty different bidders. "It was so obvious what that meant: The whole pipeline industry was now in play. All I could say was the obvious: 'Watch out! Here it comes!' "

As one of the first units organized to serve investment banking clients in a single industry, the utilities group broke the firm's traditional geographic mold—because, by intense specialization, it made more profits. In 1985 the merger of American Natural Resources and Coastal States Power produced the largest fee

the firm had ever earned. Then Northern Natural Gas merged with Houston Natural Gas. The utility merger business exploded. M&A bankers like Mack Heller, Mike Overlock, and Peter Sachs joined in, and the transformation was under way. As volume continued to expand, the firm could justify forming more and more industry-focused groups. David Leuschen started the highly successful oil and gas unit. Joe Wender started the banking group, which soon expanded into all finance industries. Other specialties included telecom, retail, health care, and forest products—each of enough size that it could flexibly adapt to opportunities developing within its industry.

Whitehead's "phalanx" organization—ad hoc combinations into effective teams of interchangeable specialists—was virtually unstoppable against any competitor organized in the old-fashioned "one banker does it all" star system that divided each banker's time and experience between executing a variety of different kinds of transactions and developing numerous client relationships.

Fortunately for Goldman Sachs, the effectiveness of Investment Banking Services was well established before the proliferation during the 1970s of investment banking products. The investment banking business changed then as the volume of underwritings and the mergers-and-acquisitions business both picked up. Investment bankers lost their captive clients as companies wanted more than one banker and increasingly chose to use joint managers for their underwritings and other firms for specific specialties. With the professionalization of the debt and equity markets through the increasing dominance by large, sophisticated institutional investors, the traditional power of the investment banker was no longer determinant. The markets themselves were increasingly dominant because the rise of active institutional investors made them faster, cheaper, more price-certain, and responsive to innovation. Companies could choose different investment bankers for different services, shopping for the best firm for each transaction.

This opening-up played directly into the expanding array of capabilities at Whitehead's Goldman Sachs. While another firm might have better individual bankers, they could not be masters of every product specialty, and while a traditional banker concentrated on executing a transaction, he could not be out soliciting more business or defending a client relationship with extra services. Goldman

Sachs was designed for competitive advantage, and with each passing year, that advantage got stronger and stronger. No matter how brilliant a competitor's banker might be, he found it harder and harder to keep up with the IBS machine.

Whitehead's IBS organizational structure also made it possible for Goldman Sachs to follow a low-risk and high-impact "fast follower" strategy on new products and services. Let other firms be first with new ideas, absorbing the costs and pains of being on the "bleeding edge" of innovation. Study what worked and improve it if possible; sort quickly through more than a thousand client relationships to select the most likely prospects for the new service; then, using IBS as the delivery system, take the transaction specialist to all the most promising prospects; and finally, by outselling the innovating competitor, come from behind quickly to do the most business and become the recognized experts in the new service.

Sidney Weinberg's very individual way of building relationships and executing transactions made him the best banker of his era, but his way never would have worked in the greatly changed business of the sixties, seventies, and eighties. Ironically, Sidney Weinberg had mastered the investment banking business that his protégé, John Whitehead, made obsolete. Each man, in his own way, was crucial to the success of Goldman Sachs in his own era. Intermediaries, particularly in a dynamic, fast-changing business like wholesale financial services, must always be changing and reinventing themselves and their ways of doing business to advance against the strongest, most skillful and aggressive competition in what economist Joseph Schumpeter accurately described as creative destruction—even when what's being destroyed is a firm's own business.

While understandably proud of the deals and transactions he brought in for execution and of the client relationships he developed, Whitehead acknowledges that his principal and most enduring contributions came from his organizational initiatives, particularly reorganizing investment banking. Still, he was very effective as an aggressive, frontline competitor for business.

Surprised once to learn that another firm had proposed a financing and that one of his best clients had decided, since it fit their needs, to go forward with the competitor's proposal, Whitehead immediately called the company's CFO. After the personal pleasantries typical of close relationships, Whitehead turned to the real purpose of his call: "Having just learned of your decision to do this specific

financing, would you be okay—if, of course, this other firm would agree—since we are so well recognized by investors as your principal banker, to comanage this particular offering? I'm confident that, with both of us working together, you would get a better market reception and, most probably, a better price." Naturally, with nothing to lose and potentially a real benefit, the company agreed, if the other firm would go along.

Whitehead than called the banker at the competitor firm. "We've been bankers for a very long time for this company and it would be awkward for us to have your firm acting as the sole senior manager on a public offering by the company. I've spoken with my friends at the company and, while they like your initiative on this particular financing, they would have no trouble at all with our jointly managing this offering. Of course, as we both know, there are always many, many ways for friendly firms in Wall Street to help one another as the years go by. And, candidly, it would mean a lot to us at Goldman Sachs if you could see the merit in not excluding us, since we are their traditional investment banker." Whitehead went on a bit more, but the other banker had already gotten the message, and knew he would be wise to accept reality and to do so promptly: "John, why don't we agree right here and now to comanage?"

At the company's headquarters, Whitehead and the competitor banker met with the CFO to determine the terms of the transaction. Graciously, Whitehead—apparently recognizing the competitor's having initiated the transaction—said, "Why don't you begin with your thoughts on pricing?" The bait was out and the other banker went for it. "We think the interest rate we can go to market with is fifteen and a half percent, and that at this rate we can raise twenty million dollars."

"Why not develop how you arrived at your pricing conclusion," prompted Whitehead. So the other banker explained his reasoning, making it clear that, in his firm's carefully considered opinion, this was the very best possible price—and maybe even a bit of a stretch. This locked him into his position and made it easy for Whitehead to go right around him. "At Goldman Sachs, we look at this issue and the market somewhat differently. If that's the best our fine competitor can do, then I'm pleased to say that we at Goldman Sachs are prepared to offer a full twenty-five basis points *lower* cost to our good client." Two weeks later, Goldman Sachs was sole manager of the offering.

When they saw each other again a year later, the competitor said, "John, you taught me a lesson—a very expensive lesson." Whitehead replied: "Maybe it seems expensive to you in the short run. But in the long run, you'll never leave yourself so open to a competitor. You're young. Over the years ahead, I'm sure you'll profit from the experience."

Shortly thereafter, Whitehead invited the banker to luncheon in one of the firm's private dining rooms. This time, his interest was more personal: Whitehead wanted to know if he might be interested in joining Goldman Sachs. This inquiry was not unusual. Over the years, Whitehead developed the practice—and strongly encouraged all others in IBS to join him—of recruiting the best people at competitors. This concept soon became codified: It was almost okay to lose an important transaction if you recruited to IBS the competitor who won.

Whitehead recognized early on that dividing the spoils, or allocating credit for transactions among Goldman Sachs people, could easily become divisive. After all, how and why would relationship specialists fully appreciate all the contributions that had been made by transaction experts—and how and why would transaction experts fully appreciate all the important contributions made by the relationship specialists to the firm's overall success? So Whitehead installed a win-win approach to compensation that would help avoid confrontations and help build strong teamwork and encourage everyone to concentrate on making the phalanx system work: 100 percent credit for each transaction would go to *both* sides. If a client assigned to Murphy did a transaction with the firm, Murphy got full credit, whether Murphy actually did anything or not. So there was zero reason to try going around Murphy or to ask potentially ugly questions about whether Murphy was 60 percent responsible or only 50 percent, or merely 30 percent, responsible for the completed transaction—"delineation perfection" that could easily hurt feelings and distract people from focusing 100 percent on working for the client.

After each transaction, an internal memorandum would detail the specific contributions of each banker. So all got recognition for what they had done, and all saw the importance to the firm's success of all the other contributions, clearly emphasizing the importance of the firm's commitment to teamwork. As Whitehead explains, "Talented people want recognition and respect for their skills and their achievements even more than they want money. They need and appreciate acceptance and respect."

When approaching the annual compensation review period, Whitehead would send a memo to all members of IBS asking for input, "so we'll be sure to know all you've done this year." Each person would write up his own report card, which Whitehead and others would carefully study. While other firms concentrated on "production"—the volume and profitability of transactions—Whitehead established at Goldman Sachs that half of a banker's bonus depended upon evaluations from others of how helpful he was to them, a compensation process that strongly encouraged everyone to focus on making the firm's phalanx system work well. These evaluations were written and collected into what became known ironically as the "slam book." To encourage reaching out across organizational lines, compensation for teamwork across organizational boundaries was celebrated and rewarded. So were individual achievements: "Of course we all care greatly about real teamwork," Whitehead would say, "so we're very glad you gave a lot of credit to so many other people. We just want to be sure you know how very much we really appreciate all the good work we know *you* have done!"

If there was a fault in Gus Levy's management style, it was that he was not a very good delegator," says Whitehead. "Gus was not a planner; he was a day-to-day operator. To Gus, short range was what's happening this morning—and long range was what's going to happen this afternoon. He felt that Wall Street was a constantly changing field in which it was hard to plan, maybe almost impossible to plan. You just sort of took advantage of the opportunities when they appeared. It was a trader's instinct that created his success. And so others of us, rather than Gus, were the ones who thought in terms of looking ahead and what activities we should go into."[3]

Planning concentrated the partners' energies on generating the firm's growth. To get closer than competitors to the market, planning meetings were held not in October and November as at other firms, but in January and February. To avoid taking productive people away from their line responsibilities, these planning meetings were held on weekends—actually, three consecutive weekends—when plans were presented, challenged, and revised until approved for immediate action. This was a two-sided coin. On one side was the intense,

hands-on engagement of the partners in every aspect of the firm's operations that had made Levy such an effective player-leader. But on the other side was the risk of simply projecting incremental improvements in the same old businesses, not reaching for significant discontinuous change and innovation. Some plans were too cautious, some were too ambitious—depending on the personality of each department head. To overcome this, financial reporting during the year matched plans to actual revenue and actual costs. "Soon both the cautious and the dreamers learned to do better and better annual planning *and* execution," says Whitehead. While remarkably sophisticated in later years, the planning process was ponderous in the beginning. After sitting through branch-by-branch reviews of each and every line of business, Whitehead decided, "By God, that's the last time I'll sit through plans for both Albany *and* Detroit." He decentralized the firm's planning process to the divisions and departments.

In sustained pursuit of his strategic goals, Whitehead combined disciplined planning with reserved affability. He was quite unconcerned about being demanding of others. Smoothly rational rather than emotional, he never fraternized with the troops or had pals within the firm. Respected, but not loved or even particularly well liked, and often considered aloof from the others, who regularly socialized together, Whitehead was called, behind his back, the great white shark. He never cajoled or coddled and could be hard on investment bankers who sought praise or had a high need for ego celebration. Whitehead calmly obliged conformance in large matters and small. To ensure completion of call reports and expense reports, Whitehead once simply instructed the financial manager to hold onto everyone's monthly paycheck—partners included—until each person's call reports and expense reports had been correctly filed.

"Investment bankers are quite sensitive to public versus private critique," says partner Roy Smith, who played a key role in the early years of building Goldman Sachs's international business. "They'll accept private criticism, but never public ridicule. John could twit bankers in public, and they didn't like it one little bit. They resented it."

Whitehead not only designed and staffed his productive organization, he *made* it work, saying to one banker after another, "You *can* do it," and always clearly implying, "and if I hold you to it, you *will* do it." "John was almost regal in the way he acted," says Smith. "I never met anyone else like that in my life.

It's really quite amazing. He tells you exactly what he wants you to do; gives you the clear understanding you have no alternative and *must* do it; then proceeds to encourage you to believe you might very well be *able* to do it; and then continues on to give you the feeling you might even *enjoy* doing it, particularly if you commit your every effort to be *sure* you'll succeed."

"We had no big *and* bad ideas," explains Whitehead with evident satisfaction as he reflects on the firm's development. "We knew it would take a generation to complete the change of our position in the marketplace. Doing thousands of little things, day after day, inching along as consistently as you can, in the right direction as best you can tell, is *management*—and motivating or inspiring everyone to work together for long-term purpose is *leadership*." Whitehead didn't waste any energy, gaining force and effect through the "no waves" consistency of his commitment to a few long-range objectives and his steady, rational approach. The firm's development was not organized around grand strategies, but grew out of a continuously aggressive drive to move ahead. "As we made changes almost continuously, we had many, many failures," concedes Whitehead. "But they were almost always *little* failures that could be stopped without harm to the firm. We never felt the way to go forward was with a handful of superstars or some big acquisition."

If Goldman Sachs wanted to get into a business, it preferred to give the challenge to some of its own most promising young people. "When, as we rarely did, we decided to go outside the firm for talent, we avoided hiring whole groups or teams. Instead, we would identify the very best people, get to know them well, and bring them over individually. These new individuals would learn the Goldman Sachs culture and either blend into the firm or they would not make it at Goldman Sachs. We always tried to be creative with the new techniques and new financial products, but I never thought we had to be first with everything. I was perfectly happy to have another firm be first with a new idea because I was confident that with our superior marketing organization, we would improve the product and then achieve dominance through distribution, while those other firms put their reputation at risk if it didn't work. We control our growth rather tightly so things don't get away from us."

Whitehead remembers Gus Levy saying, "We're greedy, but long-term greedy, not short-term greedy." "Gus," he says, "wanted to do what was right for Goldman Sachs in the long run and didn't deny that he was greedy for that,

but he didn't want to be greedy in the short run if it . . . well, you can see what the phrase implied."

As George Doty noted, "Gus would *never* have retired." On October 26, 1976, as always working himself much too hard, Levy flew on the red-eye from the May Department Stores board of directors meeting in Los Angeles to New York City for a full day at Goldman Sachs plus a meeting of the New York Port Authority. During that meeting, he had a stroke. Nobody noticed at first, assuming his blank stare was partly fatigue and partly his ability to tune out for a while to focus on some problem—but then he collapsed. He was in a coma at Mount Sinai Hospital for several days and then died on November 3. He was sixty-six. "Gus killed himself by working so very hard," said John Weinberg, "knowing he had a bad heart. But he wouldn't have been willing or able to live his life any other way."

While Levy lay in a coma, Weinberg went to visit and was there when an elderly American Indian quietly entered the room. Weinberg spoke first: "Hello, I'm John Weinberg, a longtime friend of Mr. Levy's. Can I help you, sir?"

"No, thank you. I'm here to help Mr. Levy find his way to the happy hunting ground. No help will be necessary, thank you." The Indian, perhaps a Navajo remembering Levy's long-ago service to the tribe, spread out the prayer rug he carried, knelt on it, and softly began praying. Two days later, after Levy had died, he rolled up his rug and left as quietly as he had come.

Bob Mnuchin had worked under Gus Levy for nineteen years. Their relationship was marvelously productive in business results, but through all the daily pressures of doing the business as they did it, their personal relationship had absorbed the many stresses of the block-trading business. Levy had traditionally begun the morning call that engaged all nine regional offices in a concerted campaign to do *all* the business that might be doable that day. Mnuchin traditionally came on the speaker system second. Now he was alone.

Mnuchin was direct: "As you've all heard, Gus Levy died yesterday of a stroke. There'll be time to discuss his contributions at a later time. Right now, as he taught us so well, it's important that we all get on with our work and the job to be done today. That's what Gus would have wanted." Mnuchin then turned to the work of the day.

At Levy's funeral, over two thousand people came to the imposing Temple Emanu-El on Manhattan's Fifth Avenue. The prayer was given by Cardinal Cooke, and one eulogy was given by I. W. Burnham, Levy's old friend and a Wall Street leader. The other eulogy was given by one of the richest men in America and one of the great powers in the Republican Party, particularly in New York, Governor Nelson Aldrich Rockefeller. His repeated theme in his eulogy for Gus Levy caught the sense of the congregation: "Oh, what a man he was!"*

"Gus was always gruff—and always very fair," recalled a former partner. "He could put the fear of God into you if you missed a trade. But you knew he wanted you to do well and you knew if you ever needed him that he'd be there for you. One Friday after Thanksgiving, I took my young son in to see the firm and showed him around. I called Inez to see if it would be okay to go down to the trading floor, and she called back to say it'd be okay at lunchtime. While we were there, I noticed Gus's cubicle was empty, so we went over. Just then, Gus came along and naturally wanted to know what was going on, so I introduced my son. Gus shook his hand and we left. Back home, my son drew a picture of a stick figure with a big cigar and wrote "Big Gus Levey" under it. A few days later, I asked Inez what she thought of my giving it to Gus, and she thought it was a great idea. Years later, after Gus died, she was cleaning out his desk—and there it was. He'd saved it all those years."

After he and John Weinberg jointly succeeded Levy as head of the firm, Whitehead's effectiveness on high-level strategies and policies was matched by a focus on clients' operations. "John was consistently very clear-minded and insightful," said partner Jun Makihara. "When we brought TGIF, a fast-growing restaurant chain, to the executive committee and presented all the great numbers for this fast grower, John said, 'I've never been in one of these restaurants, but this is clearly a fad. It can go as fast as it has come. We need to watch closely—and report to this committee—same-store sales every month.' He was certainly focused on the right thing. Within months, problems were starting to show, but

* The eulogy was written by Goldman Sachs's public relations manager, Ed Novotny, who met briefly with Governor Rockefeller just before the service began to give him the text, as requested. "I can't read this!" exclaimed Rockefeller. "I'm dyslexic!" The text was quickly retyped on a special typewriter so the governor could read it at the appointed time during the service.

they were only visible on the one measure John had made us focus in on. You learn a lot when people like John Whitehead are reviewing your work."

Looking ahead, Whitehead had no great plans to change—just to improve. "We will continue to expand internationally. However, we must be careful not to let the firm grow too big and lose the intimacy that we and our people treasure."

Later others would argue that Whitehead's deliberate, careful approach was not as aggressive as the firm should have been, partly because the increasingly competitive markets were changing and partly because Goldman Sachs had been changed by Whitehead and Weinberg so it *could* be more aggressive and more innovative. "John Whitehead believed in the IBM approach," says Steve Friedman. "Develop superior, strong relationships with the maximum number of clients and be conservative with new product and service introductions because they don't all work and you don't want to harm those relationships that took years to develop and that you'll want to come back to again and again. This leads to cautious incrementalism on the product side and no big, breakthrough innovations, because if you're not looking hard for innovations you certainly won't find them. And the general feeling was: Don't innovate. It's not wanted and in fact was clearly *un*wanted. So innovators were taking career risk, and risk was the major no-no."

In 1985, after thirty-eight years at Goldman Sachs, Whitehead was asked to become deputy secretary of state to George Shultz and served until early 1989. He has since served in a broad range of powerful public positions—chairman of the New York Federal Reserve Bank; chairman of Lower Manhattan Development Corporation, the organization responsible for rebuilding and revitalization after 9/11; and trustee of an impressive set of educational, artistic, international, and social institutions. His corporate activities have been confined to AEA Investors, a private-equity investment company, where he "can see lots of old business friends roughly my own age."

EXCELLENCE, reads the small sign on Whitehead's desk. He had it with him throughout his years at Goldman Sachs. He also had it on his desk at the State Department, where many spoke French and some asked: "Is it a noun—or a title?"

11

PRINCIPLES

The longest-lasting, most visible, and perhaps most important of John Whitehead's contributions to Goldman Sachs materialized in just one Sunday afternoon in the late 1970s when he was alone at his home in New Jersey writing longhand on a legal pad. In writing, recalls Whitehead, "I tried to be direct, even pithy—and tried very hard to avoid anything that might read like motherhood." Contemplating the growth of Goldman Sachs, he had realized with concern several weeks before that even with the firm's remarkably low staff turnover of just 5 percent, steady increases in business were producing a 15 percent annual increase in staff. In just three years, over half of all the firm's people would be *new*. Thinking through the implications, Whitehead became uneasy. With the firm steadily getting larger and more diverse and adding so many new people, the traditional but inherently slow one-on-one "apprentice" approach of passing along the core values of Goldman Sachs would surely be overwhelmed by the number of new people. Without appropriate action, the core values could not be successfully passed on to the increasingly large and diverse staff. The firm's unique culture, which Whitehead believed was crucial to its growth and success, would be put at risk by the firm's own success and growth.

Whitehead kept coming back to a gnawing question: "How could we get the message to all those individuals who were new to Goldman Sachs in such a way that they would understand our core values, come to believe in them, and make the firm's values *their* values in everything they did every day?"

Whitehead collected what he thought were the existing but unwritten principles of Goldman Sachs, thought about them for weeks, and then spent that Sunday afternoon writing them out longhand. The list began with ten major statements, but Whitehead soon heard from George Doty, a devout Catholic, that that seemed sacrilegious. A list of ten principles was too close to the Ten Commandments—so the list was expanded.

With a few changes by other partners, "Our Business Principles" was set in type and copies sent to all employees and their families at their home addresses. As Whitehead explains, "Our annual review was being issued at just this time, so I made sure we clipped 'Our Business Principles' on the front and had copies sent to all Goldman Sachs employees' homes. And, just to be sure, envelopes were carefully addressed to John Smith *& Family*, so they and the members of their families could read them and enjoy reflecting with some pride on the nature of the firm with which they were associated. We thought the wives and children of our employees would enjoy seeing what kind of firm their men were working for and what values they lived by at work, recognizing that many were absentee fathers. We got great feedback on this, particularly in quite moving letters from spouses."

The Principles have been featured in every subsequent annual review published by Goldman Sachs. For example, the firm's 1990 annual review stated: "Our Business Principles are inviolate. They are the core around which everything else has been built. One of the major tasks in the 1990s will be to ensure that these values are clearly understood in our increasingly complex, international firm. Teamwork, integrity, placing our clients' interests first, and the other core values expressed in these Principles are the center of our competitive strategy and represent the only kind of firm at which any of us wants to work."

Despite major changes in the firm's size, organizational structure, and business, the Principles, with minor changes for political correctness over the years, have endured. Featured somewhat self-consciously in each year's annual report and referred to frequently, they have taken on totemic significance within the firm. The Principles now are:

1. Our clients' interests always come first. Our experience shows that if we serve our clients well, our own success will follow.
2. Our assets are people, capital, and reputation. If any of these are ever lost, the last is the most difficult to regain.
3. We take great pride in the professional quality of our work. We have an uncompromising determination to achieve excellence in everything we undertake. Though we may be involved in a wide variety and heavy volume of activity, we would, if it came to a choice, rather be best than biggest.
4. We stress creativity and imagination in everything we do. While recognizing that the old way may still be the best way, we constantly strive to find a better solution to clients' problems. We pride ourselves on having pioneered many of the practices and techniques that have become standard in the industry.
5. We make an unusual effort to identify and recruit the very best person for every job. Although our activities are measured in billions of dollars, we select our people one by one. In a service business, we know that without the best people, we cannot be the best firm.
6. We offer our people the opportunity to move ahead more rapidly than is possible at most other places. We have yet to find the limits to the responsibility that our best people are able to assume. Advancement depends solely on ability, performance, and contribution to the firm's success, without regard to race, color, age, creed, sex, or national origin.
7. We stress teamwork in everything we do. While individual creativity is always encouraged, we have found that team effort often produces the best results. We have no room for those who put their personal interests ahead of the interests of the firm and its clients.
8. The dedication of our people to the firm and the intense effort they give their jobs are greater than one finds in most other organizations. We think that this is an important part of our success.
9. Our profits are a key to our success. They replenish our capital and attract and keep our best people. It is our practice to share our profits generously with all who helped create them. Profitability is crucial to our future.
10. We consider our size an asset that we try hard to preserve. We want to be big enough to undertake the largest project that any of our clients could

contemplate, yet small enough to maintain the loyalty, the intimacy, and the esprit de corps that we all treasure and that contribute greatly to our success.

11. We constantly strive to anticipate the rapidly changing needs of our clients and to develop new services to meet those needs. We know that the world of finance will not stand still and that complacency can lead to extinction.
12. We regularly receive confidential information as part of our normal client relationships. To breach a confidence or to use confidential information improperly or carelessly would be unthinkable.
13. Our business is highly competitive, and we aggressively seek to expand our client relationships. However, we must always be fair competitors and must never denigrate other firms.
14. Integrity and honesty are at the heart of our business. We expect our people to maintain high ethical standards in everything they do, both in their work for the firm and in their personal lives.

"I was simply putting down on paper the things that we really lived for there as long as I could remember, and tried to foster," Whitehead said. In a follow-through typical of his persistence, each department head was told to assemble all his department's employees for a public reading of the Principles—"Our clients' interests always come first." . . . "If we serve clients well, our own success will follow." . . . "We stress creativity." An open discussion in small groups of what the Principles really meant in that particular department's day-to-day working experiences was to follow, so everyone would see how those abstractions could be made operational in their own particular work. The discussion might run: "On bidding for blocks of stock, for example, if the price is really good for our client, the institution, is it really the right price for Goldman Sachs to buy at? And what if the price drops after we've bought it?" Formal minutes of these discussions were to be prepared in some detail and submitted by the department head to the management committee for review. Even Whitehead's admirers are skeptical that such obedience was ever fully achieved, but it would be hard to find any other organization where so much prominence and serious attention is given to a corporate belief statement for so many consecutive years.

"The Business Principles were not just about the style of the firm or its culture," explains Roy Smith. "They lay out a series of dicta about how to conduct business and how to be truly professional. Considering that John was then an important but not a leading partner, it was all the more audacious to compose and promulgate this set of rules for success." Whitehead, mentioning that he's still somewhat surprised by the organizational significance the Principles have acquired, says: "Since investment banking *skills* are pretty much comparable among the major Wall Street firms, it helps to be recognized as a firm that is unusual in its focus on being ethical."

The Principles are an easy target for those who think they are too many. Some argue that nobody can implement so many beliefs with sufficient rigor and vigor to make all of them equally important. As Steve Friedman put it years later: "When you are waked up in the middle of the night, how many principles can you rattle off while you're just coming awake—three? Maybe four? That's where we should all focus so they are always on our minds and in our thoughts." Others appreciate the comprehensive construction. As Roy Smith puts it, "Those principles are a complete prescription of the firm's business strategy. No other firm in the securities business—and almost certainly, no other firm in *any* business—can say and mean those statements because they cannot commit to and live by *all* of them. But those simple declarative sentences describe the essential nature of Goldman Sachs. And they explain how and why the firm really works."

The Principles not only imply an overarching business strategy for Goldman Sachs, they provide clear guidance on operational tactics. "My commitment to the corporate culture at Goldman Sachs is certainly not religious," says Gene Fife. "It's because it's a very smart way to do very good business." While some other banking firms tried to manage and control with top-down rules, a rules-based management couldn't possibly keep up with the speed of change in the securities business and couldn't penetrate the complexities of many different lines of business in many different markets to address specific situations where values-based decisions might be needed. With a principles-based management, responsibility for decisions is pushed down to the men and women on the firing line. Since they know the concepts of the Principles *and* they know the detailed realities of their specific business, they can be held accountable for knowing and doing the right things in the right way. Hard decisions about doing the right thing are always in the gray

zone and usually somewhere in the middle of that gray zone—and they come up for action much too quickly for leisurely deliberation. Action must be swift. The tight-loose management that is so clearly expected and expressed by the Principles distributes decision-making responsibility very widely throughout the firm without senior management ever delegating its final authority. Trying to formulate all the rules that might be needed would produce such inconvenient bulk—like the IRS Manual—that only a few could ever figure things out even if they had all the time in the world. The Principles have become totemic because they work.

Never content to be a one-trick pony, Whitehead put out another set of guidelines or tactics for IBS business development in 1970—and these *were* ten commandments:

1. Don't waste your time going after business we don't really want.
2. The boss usually decides—not the assistant treasurer. Do you know the boss?
3. It's just as easy to get a first-rate piece of business as a second-rate one.
4. You never learn anything when you're talking.
5. The client's objective is more important than yours.
6. The respect of one person is worth more than acquaintance with 100.
7. When there's business to be done, get it!
8. Important people like to deal with other important people. Are you one?
9. There's nothing worse than an unhappy client.
10. If you get the business, it's up to you to see that it's well handled.

The real culture of Goldman Sachs was a unique blend of a drive for making money and the characteristics of "family" in ways that the Chinese, Arabs, and old Europeans would well understand. More than any other Wall Street firm, Goldman Sachs became tribal: To be successful, it was important to have a "rabbi" who would coach you, sponsor you, and protect you. Teamwork and team play were celebrated—and required. Individuals—Jim Gorter and Terry Mulvihill in Chicago, Steve Kay in Boston, Ray Young, Fred Krimendahl, and L. Jay Tenenbaum in New York, George Ross in Philadelphia—were especially admired as culture carriers and exemplars. Some expressions of "our crowd" were simple. As Terry Mulvihill admonished young partners: "Go to *every* employee's

major life events—every wedding, every funeral, every bar mitzvah. Always get there early and make sure you're visibly social." More than at any other firm, the partners of Goldman Sachs turned out, over and over again, for weddings, funerals, and other family events.

Absolute loyalty to the firm and to the partnership was expected. While strong feelings—including personal dislikes and flashes of anger—were evident to the partners *within* the partnership, an impenetrable wall of silence kept almost all internal tensions invisible to outsiders. No other major firm came even close. One remarkable demonstration of the we-they separation between insiders and outsiders was the speed and clarity with which long-serving partners who left went from being insiders to being outsiders and were soon forgotten. While this may have strengthened the internal bonding, it was an obvious missed opportunity for the organization—and a personal loss for those who, after devoting the most important years of their careers to the firm, were now almost ignored.

The answer to one key question again and again dominated both tactical and strategic decisions: "What is best for the firm?" Even though divisional profit was clearly of great importance—divisional profits eventually drove partnership percentages and the stature of individual partners—partners would time and again defer to other partners if that would make money for the firm.

Personal anonymity is *almost* a core value of the firm. Most things that other firms might celebrate or dramatize are deliberately understated. Morgan Stanley, for example, has elaborate, large, neon-lighted signage with stock quotes visible from several blocks away. In New York, London, or Tokyo, there is no indication whatsoever of Goldman Sachs's presence—other than well-dressed young men and women coming briskly into the building early and going out late.

The Sachs family believed public relations was a bad thing and would have none of it. This was the background within which John Whitehead proposed to compile and produce an annual report on Goldman Sachs. As he explains, "The limits necessary to achieve a compromise seemed pretty strict: no financials; plain, no frills; and a list of our services. And, on advice of Sullivan & Cromwell, we were prohibited from using the terms 'bank' or 'investment bank.' The text began with this sentence: 'Goldman Sachs is today a leading firm in the investment business.' The back page said only, 'Established in 1869.' "

Walter Sachs's reaction to Whitehead's plan for distribution was not positive;

it was "No!" The slim reports would not be mailed out. Copies would only be given out by hand, if and when appropriate. Modesty and understatement were matters of principle at Goldman Sachs.

With actual capital of thirty million dollars, the firm's claim—the only even tangentially financial detail in the report—was restrained: "over $20 million in capital." Goldman Sachs continued to use this figure even when actual capital had accumulated to over one hundred million dollars.

The firm does produce annual reports, but except for the two top executives, all employees are clearly shown not as individuals, but grouped as members of the team. The principal responsibility of those who labor in public relations is to minimize the number of articles about the firm, to discourage pieces about individuals, and to project a tone of modesty and moderation. The head of public relations over many years, Ed Novotny, was not even an employee. Even though fully dedicated to the firm, he had a separate office and phone and styled himself as just a consultant.

The firm's precepts didn't stop with the written ones. Making money—always and *no* exceptions—was a principle of Goldman Sachs. Nothing was ever done for prestige. In fact, the prestigious clients were often charged the most. Every banker was expected to succeed on *two* standards: Serve the client and make money. Both were top priority—always. No exceptions. Be strong. If you must cut fees to win or keep business, do *not* cut fees.

Cost discipline was another principle. Fly coach. Staff leanly, because with the very best people, you can be lean *and* cost-effective—and therefore more profitable.

Open dialogue was another principle. Part of this was posting: keeping *everyone* informed. Part was the deliberately flat organizational structure. During the seventies, the firm initiated monthly meetings of partners. Any partner whose area was doing better or worse than anticipated would be expected to stand and explain the difference. If the difference reflected a problem, then the solution was also expected.

Aggressive salesmanship was obviously a principle. So was working harder for much longer hours than the people at any other firm.

Deliberately taking risk—and being first to learn how to take and manage risk in any emerging new market—was also a matter of principle. In investment banking, the firm continued to avoid risk as a cautious "fast follower," but in trading, while most competitors tried to avoid or minimize risk, Goldman Sachs was almost always alone in the early days of new markets. Therefore it was able to earn high risk-adjusted profits and learn how to succeed in each market over the long term.

Goldman Sachs's capital kept growing, but the firm always needed more capital than it had because its people were so entrepreneurial. The tension between supply and demand provided a constructive discipline.

Independence or freedom to decide was balanced with authority and responsibility as a matter of principle at Goldman Sachs. When a tough negotiator was trying to bully young partner Barrie Wigmore on the terms of an offering, one of his colleagues left the room where they were meeting and called the office. The management committee was meeting, and he was put though on a speaker phone. After hearing his description of the negotiations, the committee decided not to accommodate the prospective client—while Wigmore was continuing to negotiate. When his colleague returned with the decision of the firm's senior management, Wigmore—who was all of thirty-one—said, "No! What business is it of theirs? Pricing a service is *my* responsibility," and that was that.

Independence *and* responsibility were pushed out to those on the firing line because they knew the most. But independence did not mean everyone for himself. Responsibility included responsibility for any negative side effects on other divisions of the firm.

12

THE TWO JOHNS

Gus Levy's unexpected death, at the peak of his powers inside and outside the firm, left Goldman Sachs with no clear answer to the urgently obvious question of who would now be the senior partner. More precisely, which of the Two Johns would take over leading Goldman Sachs? John Weinberg, popular and decisive, managed most of the firm's major corporate client relationships, most of which had been his father's, and to many it would be fitting for him to lead what was still widely considered Sidney Weinberg's firm. John Whitehead was older and had been at the firm longer, but while he had strong advocates, he also had silent skeptics. The Two Johns worked well together and had great respect and affection for each other, but both were alpha males. A contested choice between the two natural leaders could have hurt the firm.

John Whitehead's long-standing interest and leadership in strategic planning; the increasing success of his innovations in investment banking; his considerable visibility in Washington and in the Investment Banking Association; and his initiatives within the firm in promulgating the Principles and in recruiting, public relations, and organizing and upgrading internal operations—all these made him, in his own mind and the minds of others, the natural first choice. But

Whitehead had to know he could only succeed in the senior partner role if he had the explicit support of his friend. He knew that many partners had strong positive feelings about Weinberg—warm, affectionate feelings that differed from their cool, respectful feelings about him.

Outside the firm, Whitehead was generally recognized as the strategic and conceptual leader. Insiders liked Weinberg better. "John Whitehead was clearly a brilliant strategist," said one partner. "But he didn't have that 'connectedness' that's so often vital to great leadership."

"John Weinberg understood people better than anyone else in the firm," said Ray Young. "Like his father before him, John would get it right with people. They *knew* they could trust him and his decisions. John Whitehead was very ambitious and always had his own agenda. We were all ambitious, but our ambition was for the firm. John Whitehead cared about recognition for his personal achievements and his charitable contributions. Later in life, John Weinberg probably gave just as much—but always anonymously."

The consistently cool and articulate Whitehead, aptly described as a "gentleman's-C's type who gets straight A's,"[1] was calmly guarded and one step removed from others as he concentrated on policy and strategy, in contrast to Weinberg's spontaneous emotional directness and earthy candor as he concentrated on transactions. Whitehead inspired respect; Weinberg inspired trust and affection. Everyone at Goldman Sachs knew where and why Weinberg stood on every decision, but many wondered about the core hidden many layers behind Whitehead's smooth exterior. It was amusingly ironic that Whitehead, the patrician, had to work his way through school while Weinberg, the Common Man, had been raised in affluence and gone to all the "right" schools: Deerfield, Princeton, and Harvard Business School.

With Levy gone, everyone expected the Two Johns to resolve the leadership succession. Whitehead had a sensible solution: The Two Johns would take turns. He proposed a "first me, then you" sequence in firm leadership. As the senior of the Two Johns, he would succeed Levy now and would then, after some years, pass the baton to Weinberg and move on to a career in Washington or at a major corporation.

But Weinberg didn't buy it.

What could easily have become a personal "him or me" confrontation

became instead one of the great personal combinations in management as Whitehead deftly offered a different proposal: The Two Johns could lead their firm together as co–senior partners. Forcing a "him or me" choice would have caused division within the firm when it was most vulnerable. It wasn't clear who would have won, and in any case there was too much important work for any one leader, particularly if there were any hurt feelings—and there surely would have been some. Weinberg, who was so often almost instinctive in his good judgment, agreed immediately to what must have seemed a most improbable and unworkable managerial proposition to those who first heard about their unusual plan.

In fact, the first thread leading to this unique proposition was in Gus Levy's will. Levy had identified the Two Johns as coexecutors of his estate. Later Levy took this thought further, as L. Jay Tenenbaum recalls: "When I asked Gus who he had identified as his successor, he told me of his plan to have the Two Johns take over, and I told him: 'Gus, that won't work at all well. You have to have one guy who has the final say.' " Then in 1976, recognizing that the Goldman Sachs partnership could become divided—with some partners wanting Weinberg and some wanting Whitehead—Levy announced that he didn't want to choose between them and had decided to endorse "our usual formula for success in virtually all endeavors: teamwork." Symbolically, both men were soon named coexecutors of Levy's will. The legend within the firm has it that on the day he had his stroke, Levy had a memo on his desk about the advantages of the Two Johns succeeding him—together.

The official announcement of Levy's stroke explained that Weinberg and Whitehead would serve together as acting cochairmen.[2] A week later, they announced they would serve together as senior partners and cochairmen—not with each taking responsibility for half the firm, as others might have done, but with both taking undivided responsibility for the firm as a whole. In establishing their dual leadership, the Two Johns took advantage of their friendship, formed over many years of discussing what they were going to do when they eventually headed Goldman Sachs, as they believed they would, while eating chicken salad sandwiches at Scottie's Sandwich Shop on Pine Street. If either had a strong view, the other deferred, so they maintained broad agreement on strategy and policies. The eventual decision to co-lead Goldman Sachs soon seemed as natural to the Two Johns as it was unusual on Wall Street.

Weinberg reminisced, "During one summer between years at [Harvard

Business] school, I had worked at McKinsey. It was my father's idea, and a good one. I got to know Marvin Bower, the senior partner of McKinsey, who knew a lot about the workings of organizations. When he heard that John and I had it in mind to serve as cochairmen and senior partners, he said it would never work, and that when we had the whole firm really screwed up he'd come down and help us unscrew it. He was great. But somehow we made it work."

The Two Johns sustained a "we two" relationship, as successful parents so often do, based on mutual respect and different priorities—one largely internal and managerial and one largely external with clients—and avoided competition by coordinating frequently. "Though we are very different kinds of people, we happen to be very simpatico," Weinberg once explained. "Our offices are close together. We communicate a lot. We really wear out the carpet between our offices. We have a very collegial approach to management of the firm. John Whitehead and I think very much alike on all sorts of things. We speak on the phone almost every day, and every Sunday evening we talk about the agenda for the next day's management committee meeting and agree on what we need to do."[3]

Whitehead and Weinberg—"the Two Johns" to all at Goldman Sachs—never competed with each other but were intense competitors with the rest of Wall Street, determined to drive Goldman Sachs just as far as possible up into leadership among investment banking firms. Their agreed priorities were clear: recruit the best people, develop more and better long-term corporate relationships, build up capital, tighten managerial discipline, require teamwork, avoid big mistakes, expand the business, persistently increase market share, upgrade the staff and upgrade the clients, increase profitability substantially, grow from within, minimize personal publicity while building the firm's reputation, and keep accelerating. A few years after the Two Johns took over, a senior competitor would say, "Goldman Sachs, as an entire firm, is *driven*—on this it is consistent and unrelenting."

Always determined but cautious, the Two Johns favored a fast-follower strategy in business development and had no room for heroes or stars. "To be a star," advised Weinberg, "getting your name in the paper and all that, is not popular in Goldman Sachs because it's against the culture. If you did that, everybody would call you a showboat. If people want a career here, then go with the

system."[4] Office politics were verboten. "With John and John everybody knew: Don't ever screw around," recalls partner Bob Steel. "They allowed *zero* politics. With strong, respected leaders like John and John, everybody knew not to play politics, particularly politics that were negative about other people. And they had *no* favorites within the firm. With John and John, you knew not to push the boundaries, or to squeeze. They had no fear of anyone or anything. And both men were always ready to make the very tough calls."

Both Johns were clear on what was wrong and what was right. They had deep experience with moral standards from their service in World War II. Changing the norms of personal behavior from the "don't ask" laxity of the past called for swift, decisive, and visible decisions on people, including terminating partners. "Some days, I really hate my job," observed John Whitehead to another firm's CEO, explaining that he had just fired a superbly talented young partner who, under extreme pressure to produce a document for a client, had gotten unacceptable work from a typist and had lashed out at her, calling her a "stupid cunt." A few years later, John Weinberg fired a divisional head for having an affair with his secretary and not coming entirely clean with Weinberg when the story, which mushroomed into a high-visibility embarrassment for the firm, first got reported in the press. Sexual exploits were tolerated if kept private, but the boundaries of privacy were tested in various ways. One man was so extensive in his multiple "private" adventures—usually going by radio-connected Dial Car, the firm's exclusive provider, to his numerous and varied assignations—that drivers could be overheard bantering in amazement on their radios about his heroic exploits, and one day the trading room was a sea of smirks when an attractive young woman came onto the floor looking for more.

"Assuring professional ethics are really lived by is a bit like being a zookeeper," says partner Roy Smith. "You need lions and tigers to have a really good zoo, but you must also keep them under control—or reasonably so." Everyone in Goldman Sachs was supposed to be interchangeable, a member of the phalanx. "We were like horses competing to pull the wagon. You might stop to complain, eat some oats, and go right back to pulling the wagon." At that time Goldman Sachs was strategically a lot like Procter & Gamble: few real innovations, but skillful and unrelenting in execution. When a competitor introduced an interesting new product, the firm would immediately study it and learn all about how to

do it really well—always driving to improve the product as much as possible—and then present the improved product extensively through Investment Banking Services and execute effectively and consistently. With IBS's corporate relationships well established, any new, improved product could be taken rapidly and effectively to large numbers of potential users—in the order of their probability of signing up—often quickly producing substantial market leadership.

The Goldman Sachs that the Two Johns had found in the 1950s had been a "not" firm: *not* intensely competitive, *not* exciting, and *not* important. But competitive intensity came naturally to them. Both men had seen combat. Both understood how successful organizations could be if they always moved faster and more aggressively than their competitors. Both were ambitious as individuals and for their firm. Both believed in understated but unrelenting aggression versus competitors, and both believed that in any competition, the organization that had the best people, made the fewest mistakes, and showed the most commitment to *working* to win would win out. They always played to beat the other firms, to win on every dimension, believing that that was what their toughest competitors would always do, too.

Their remarkable partnership and friendship had its origins when, three years into his rapidly rising career at Goldman Sachs, Whitehead was told by Sidney Weinberg that his son John would be coming to the firm for the summer months between his first and second years at Harvard Business School and that Whitehead should show him the ropes. A year later, John Weinberg joined the firm full time and the Two Johns began the person-to-person partnership that lasted over thirty-five years. The two men became partners on the same day and held the same percentage ownership in the firm throughout their careers.

In the beginning, the two young men set their desks back to back in the squash court. As they ate chicken salad sandwiches at Scottie's each day, they talked freely and exchanged thoughts and ideas on virtually everything—including their frustrations with the way the firm was *not* run. Whitehead explains, "We were only serving time, not learning much and certainly not working at our capacity. John and I were resolved to put much more responsibility to the young people in the firm." As they talked, both Johns became more and more convinced

that they knew many ways to make the firm stronger and better. "We found we thought alike on many, many things. We had the same hopes for Goldman Sachs, and while we shared enormous respect and affection for Sidney Weinberg, we shared major frustrations with him too."

The firm's carefully monitored team atmosphere meant there were fewer of the petty turf battles that plagued the rest of the Street. Goldman Sachs became recognized as "a company—rather than a collection of individuals—that acts more like an organism."[5] Still, the competition for advancement, particularly to partnerships that would go to only a few, was intense. All the people who joined Goldman Sachs were capable and hardworking. Those who made partner had to make a larger commitment to the firm—strive more, devote more time, and take more pressure on themselves and on their families.

"Goldman Sachs was an investment banking firm that added on trading," says Jim Gorter. "So did Morgan Stanley. Salomon Brothers was a trading firm that added on investment banking. At Goldman Sachs, the bankers generally ran the firm, and more partners came from banking than any other division. But the point is that everyone worked *together* all the time. Or certainly almost all the time, because as in any situation there were tensions to work out. The concept or commitment to real teamwork—and no stars because stars denigrate all the others—traces right back to Gus Levy, but was brought home and institutionalized by John and John."

"We were sort of shabby in our offices and low key, low visibility in terms of personal heroes," says partner Roy Smith. "We tended to resent heroes if any were to emerge because we all knew that it was the team approach—the phalanx—that made the difference . . . plus not letting our egos get out of line. We produced a somewhat hard-to-classify mystique of efficiency without too much identity. That sometimes frustrated us when we felt we had a lesser public image than some of us from time to time would like to have seen."

Teamwork was mandatory and celebrated. "I," as in "I did this" or "I won that," was clearly to be avoided. Everything was "we"—"We did this" or "We won that." As one partner quipped, "The I word is so strongly avoided that some people won't even go to see an eye doctor!" Teamwork mattered to clients as much as to those within the firm. Ford Motor Company's president, Philip Caldwell, explained what made Goldman Sachs outstanding: "First, they

know their business. Second, they don't seem to have any internal struggles or strife."[6] The Two Johns worked consistently to develop the leadership and management capabilities of strong performers. Pairs of young "future leaders" were assigned to various managerial slots to see how they would perform together and handle shared power and responsibility.

Another way of building teamwork was to share the profits in good years—and protect people in bad years. To spread participation in the success of the whole firm, the partners contributed 15 percent of profits to a pool divided into "profit shares" in a program administered by each division. In combination with salary and bonus (and the future possibility of partnership), the profit shares were an important part of the firm's ability to make an attractive economic offer to prospective associates. During the stock-market doldrums of the mid-seventies, when the firm scrambled to barely break even, layoffs were avoided, and not only were decent bonuses paid out widely through the organization, but young partners were subsidized so they could make it through the adversity. Really being there for people when it mattered counted a lot in the organization the Two Johns were building.

"Balance was key," says partner Lee Cooperman. "More than any other firm, Goldman Sachs had strategic and organizational balance across all areas of the business. It was a conglomerate that worked. Key to Goldman Sachs's success was that the firm not only had great balance and strength, it also shared the benefits of that balance widely within the firm. Everybody pulled on his own oar and all pulled together. Everybody was part of—and all believed in—the Team. Sure, there were some politics—and as the firm grows, it's probably increasing—but compared to any other firm, the problem of politics at Goldman Sachs was small. The real indicators of teamwork and cooperation—not just within divisions, but also across divisions—are the *certainty* of cooperation and the *speed* of cooperation," says Cooperman, who gives this simple example: "A lawyer at a major Wall Street firm wanted an introduction to the key people in project finance [at Goldman Sachs] and asked a securities salesman how to go about it. 'I'll find out for you.' The lawyer expected to hear in a week or two. That same day, the lawyer was called with a confirmed appointment already set up. The lawyer was startled, but that's typical of the way it works."

Goldman Sachs had a relatively flat organizational structure with virtually

no hierarchy. Teamwork, interaction, and swift, extensive interdepartmental communication were stressed. One of the first lessons taught new associates was "posting." Is there *anyone* else in the firm who can use this information? The firm developed its own culture, based on management by owner-producers and a highly charged, intensely meritocratic environment. "We believed we were the financial world's equivalent of a team of professional athletes," says Roy Smith. "We were very competitive and worked and trained hard. We were good at what we did and wanted to be the best—the world champions."[7] The sustained striving that was so essential to becoming champions needed to be balanced by a perspective that protected the firm and its individuals from going too far. Asked what could derail the firm's strategy, Bob Rubin was candid: "Ego, arrogance, a sense of self-importance. If you allow them to develop, that's when you fall off the track."[8]

"When the firm was small in the sixties and seventies, it was easy to recognize the really bright guys," says George Doty—to see "who were real players and who were just spectators." But as the firm grew, more structured communications were needed. To encourage teamwork and to be sure everyone involved in the important transactions was fully recognized and also knew how important the contributions of others had been, Whitehead and Weinberg insisted on "credit memos" being written to specify each contributor's contributions, and that those credit memos be circulated to all concerned. Still, Doty could feel frustrated: "There are two types of those memos that really get to me. First, is the 'Gee, I'm great' type. Second, and almost as bad, is the 'My people are so great' type with the all-too-obvious implication that the writer must be a superb leader to have so inspired his team." Still, the determination to identify and visibly recognize everyone's contribution minimized misunderstandings, showed everyone how important all the other members of the team were to achieving success, and, while celebrating each person's particular contributions, encouraged realistic modesty. Teamwork and subordinating individuals to the organization helped build Goldman Sachs as a unity both inside and outside.

"Fear and accountability were important, too," recalls Cooperman. "You wouldn't ever want to leave anything not yet done that might or could be done. You were responsible for being the best at each client and for doing the most with each of your accounts. The pressure was always on to do more and to do better.

The firm didn't give any medals or bouquets for doing a good job, but it was very quick to focus on negatives that needed to be corrected. John Whitehead could be very cutting. I'll never forget his memorandum that said: 'We appreciate the business you've brought in. We are also conscious of the other business you have not yet brought to Goldman Sachs.' "

"The Two Johns saw nothing at all wrong with people working very hard and carrying a heavy load," recalls partner Roy Smith. "They were convinced it was better for you to carry more work responsibility—perhaps half again more than your normal capacity—because that meant you accumulated more experience and you would learn more and know more. You'd advance up the learning curve more swiftly and get to a higher level of performance. And sooner or later, if as a result of your hard work you were the best trained or had the most developed skills, you'd be doing transactions for clients that other firms couldn't do as well." Whitehead confirms that view: "Goldman Sachs believes in working very hard because the more work you do, the more practice you'll have and the more you'll learn. In an inherently fast-changing business, you'll develop better skills and greater understanding than your cohorts inside the firm or your competitors outside the firm."

Under the leadership of the Two Johns, Goldman Sachs was sometimes criticized for being slow to innovate or too cautious. Weinberg objected: "We don't perceive ourselves as being slow. We think we're like the tortoise in the race with the hare: we get there, but we don't get carried away with unproven ideas. When it's all your own money in a partnership and you have unlimited liability, you try to take only sensible business risks. Despite our reputation for planning, most of what we did was to see an opportunity and take an action—advancing one step at a time, usually with no clear sense of direction, let alone destination. John concentrated on planning and management, while I concentrated on clients. John had vision. He was tough, too. He would tell people what to do, without messing around."[9]

While Goldman Sachs became capable of making major tactical changes in the way it does business, continuity of strategic vision was long a consistent hallmark. In 1983 Whitehead described the firm's objectives: "Our long-range goal is to become a truly international investment banking and brokerage firm. We want to have as many clients around the world as we have here in America and to be

as highly respected in London, Paris, Zurich, and Tokyo as we are in New York, Chicago, and Los Angeles."[10]

Developing 'franchise' earning power is what every investment banking firm looks for," explains Roy Smith. "The trick is to maximize risk-adjusted earning power as a firm. But of course each individual is looking for maximum earning power too. With thousands of employees—each making his own trade-off of risk versus return and short term versus long term and individual relative to firm and client relationship versus specific transactions—the challenge for management is very great. With all the many conflicts and challenges, and they are *always* changing, it's hard to find and sustain harmony and balance." The ultimate risk is that the truly great individuals like Gus Levy and the Two Johns, as well as everybody in leadership positions in each of the business units, will feel constrained or frustrated by the organization. The creative genius needs to be disruptive and different to be truly innovative. But the larger the organization gets, the more it will seek—and will insist on getting—order and stability. Both are needed, but each is in conflict with the other. Managing these conflicts is what real management is all about in the securities business.

The challenge compounds. With opportunities seized, the firm grows. As the firm gets bigger, it's harder and harder to recruit or fully use or even keep the remarkably gifted, creative, and driven individual performer. Almost inevitably, there is an institutional hardening and the organization ejects the great individual performers, even though it was the great individual performers of the past who enabled the organization to create growth. So management's dilemma is that the organization's franchise—vital to maximize long-term risk-adjusted earnings—must always be protected from the short-term urgency of specific transactions or deals. "Protecting against short-term expediency must be balanced against the opposite problem," says Smith. "If you're too conservative, you'll force out or lose the great individual contributor. Or they won't even join you. If you're not conservative enough, individuals will get out of control and do self-aggrandizing transactions that will harm the whole organization. The more complex the organization and its business, the more difficult this vital role of management will be."

In building the organization they wanted Goldman Sachs to be, the Two

Johns had long been recruiting key people at senior levels. Two of their most successful imports were Jim Weinberg and George Doty. An original and sometimes contrarian thinker, Jim Weinberg was consistently unpretentious, congenial, and insightful. He was his younger brother's closest and most objective confidant and adviser on policy and strategy. In a crowd of intense, controlled egos, Jim Weinberg was cheerfully modest, pragmatic, and gracefully at ease within himself—and found keeping faith with his brother's privacy entirely natural. He wisely identified numerous people for advancement to important positions of leadership, and he was completely unpretentious. He took subways and once, at a fabulous Los Angeles restaurant, asked the captain, "Don't you have anything less expensive?"

Doty, who had been recruited in the sixties, was tough and shrewd as he concentrated on operations and fiscal discipline. As a senior partner in Lybrand, Ross Brothers & Montgomery, later Coopers & Lybrand, Doty had been a major presence, with Chase Manhattan Bank and Dillon Read, among others, as his clients. "I was in some danger of becoming the senior partner of our accounting firm, was forty-six years old, and felt I had the world by the throat. The only man who might have gotten the job instead of me said he would be glad to step back if I'd take it. Still, I had some reservations about Coopers. I'd been disappointed to see how that firm seemed to prefer 'cue balls' as partners—you know, guys who had nothing wrong with them and who were smooth operators—and would steer away from making partners of guys who might be awkward or had faults, but also had some really strong *talents*. Goldman Sachs was different—as I'd been learning at my Naval Reserve unit where John Whitehead and I both served as officers. We had been having long talks about how to build up a truly great professional firm. We got along well and I felt he really had something going at Goldman Sachs."[11]

Whitehead was impressed with Doty's detailed knowledge and managerial understanding of the operations of various little-known units in what most investment bankers rather contemptuously referred to as "the cage"—the place where millions of dollars of cash and negotiable securities were handled daily, which is why it had heavy wire screening for security. Knowing that the best way to get a decision made *and* implemented was to set it up carefully and then hand it off to Sidney Weinberg, Whitehead introduced Doty to Weinberg. "When

Sidney invited me to lunch," recalls Doty, "his timing was perfect. Still, I told him I had real doubts. 'It's not religion, is it?' he asked me. I'm Irish Catholic. I assured him that religion wasn't it. My family was leaving for a long-planned vacation and I promised to give him my answer when we returned. 'Sounds like a furniture store!' was my wife's first reaction. She was thinking of Saks Fifth Avenue, but the plain truth is the firm was not very well known back then. Goldman Sachs was not as profitable as the other firms I knew, but the firm was always more professional, always striving to do what was best for the client, convinced that if the firm really solved the clients' problems for them, in the long run everything would work out well for the firm. This may be a somewhat archaic concept, but it has put the firm in a truly respected role. Other firms were then—and are now—more cash-register oriented."

From the day of his arrival, Doty was powerful: He began as a member of the commanding management committee and had the fourth largest partnership percentage, after Gus Levy and the Two Johns.[12] He was powerful partly because he built an encyclopedic knowledge of how the increasingly complex organization of Goldman Sachs worked and could be made to work; partly because others did not have that knowledge; partly because operational efficiency and effectiveness were becoming decisive in determining the firm's ability to make strategic choices and fulfill objectives while competing with other organizations in a faster-paced and increasingly complex business; and partly because Doty was tough, tenacious, and unflappable.

Even in developing an internal financial management organization, the Two Johns were competitively aggressive, once hiring some financial managers from Merrill Lynch because they thought Goldman Sachs would learn a lot about the competitor's presumably advanced financial management system—only to be surprised to learn how little sophistication that competitor had. Developing talent from within, the Two Johns made Jonathan Cohen their chief of staff and a partner because they had learned they could trust him with anything. John Weinberg once joked, "Jon, when we leave, you'll know so much we'll just have to kill you."

While Whitehead and Weinberg were considered conservative as firm leaders, Doty was *very* conservative in managing internal operations. "Much as I admired and liked George, he could be awfully negative about new things,"

recalls Whitehead. "More than a few times, I had to take him aside and say, 'Now George, new ideas are quite fragile in their newness. You really must be careful because there are always more people who can kill a new idea than there are people who can help it grow up from something hopeful, but still quite young and weak, into something truly useful.' He would lobby other partners to organize resistance to things we wanted to get accomplished." Whitehead adds with a smile: "And he could get me pretty irritated, too."

Doty was all about control, and for him financial control came first. Expenses were watched closely. All partners' tax returns were either done through the firm or turned in promptly for careful review by the firm. "We didn't want anyone not paying any taxes. I'd been infuriated to see Bobby Lehman making millions one year and paying a tax of only twenty-five thousand dollars. I didn't want that sort of thing to hurt Goldman Sachs. We had a policy that partners could not borrow unsecured without the firm's permission. We wanted everyone to focus on the firm's work *all* the time. We didn't want anyone to be worried about paying off debts. Our policy and our practice were simple: 'Mother's lookin'!' "

Doty knew that in all large securities firms there is always the risk of cornercutting, cheating, misfeasance, and malfeasance. As an experienced auditor, he knew that the best way to prevent big trouble is to be persistently diligent on small troubles and that access to early information depended on employees' volunteering that information. Doty explains, "People who know about something that's not quite right won't say anything to you unless they know you want to hear and know you will be listening. In the most casual conversation, they'll leave a verbal thread out for you to see—if you're looking—and hope you'll pull on that thread. Some of the finest people on integrity have the least education. If they know something's wrong and know you're breathing on it, they'll steer you right. When we set up an enormous trading room, we deliberately built it on one floor and had only one men's room. Standing side by side at urinals, everyone's an equal. You can mention anything that looks funny. I went to the bathroom as often as I could in those days—and always with an announcement, 'I'm taking a break, guys,' and then I'd get up a little slowly, so it was easy to follow me. I pay close attention in deciding which people I'm going to give full access to my back."

Doty was responsible for the sensitive discussions held with each new partner

to determine his appropriate capital contribution. New partners came in as a "class" with equal participations in the earnings of the firm, but each one had a different personal balance sheet and a different ability to contribute capital. Some had family money; others had none. Investment bankers, to keep up appearances, usually had themselves pretty loaded up with nice homes on Park Avenue, while traders would be quite liquid. Ironically, the bankers all wanted to put up the *maximum* affordable to make a "statement" while the traders would try to get by with the *minimum*. George Doty decided how much each new partner would be told to put into the firm after examining a new partner's complete financial statement. Doty would ask skeptically, "Is this *all* you've got?"

"Yes, sir."

"Are you *sure?*"

Doty's job was to find the right number, the amount that meant each new partner would feel really at risk and each would have enough of a stake to be credible on any major decision on which he might be speaking before the partnership. As Doty explained, "Your participation in profits would be a function of your business contribution, while your capital commitment was a function of your personal wealth."

Doty's disciplines were not limited to capital contributions. When Gene Fife became a partner, two workmen arrived in his office in San Francisco and started measuring the furniture. "Hey, fellows, why are you doing that?"

"Mr. Doty told us to."

So Fife called Doty in New York: "What's this all about?"

"As a partner, you can have certain kinds and amounts of furniture. You have more than that in your office. That's okay; it's your choice—but you'll have to pay for it. The firm does *not* provide it."

"But it was there when I moved in."

It didn't matter, Doty wasn't listening. Welcome to the discipline of the Goldman Sachs partnership.

With newly elected partners, the Two Johns would execute a classic "good cop–tough cop" sequence, with Weinberg all smiles and virtually hugging the new partner in a warm, man-to-man way: "You're so great. We always knew you'd make it. We're so happy to be your partners. Welcome aboard. You'll do great things and be really great for the firm. Well done!"[13]

Then Whitehead would take the same new partner aside and quietly perform the tough side: "You must know as well as we all do that you're joining a very capable, very hardworking group of the very best in Wall Street, so to keep up with the pace of accomplishment here, you're going to have to work very, very hard and really pour it on. Today's announcement is really just the beginning, because Goldman Sachs partners take on more responsibility and are expected to accomplish much, much more when they are partners. The standards set by those ahead of you are very high—and lots of young lions and tigers are coming right behind you. The firm wants to be the very best. So that means you will be expected always to be your very best and that really means from now on you are challenged to *increase* your productivity and set a very high standard. We'll be watching you very closely in everything you do—particularly now that you're a partner—so be sure you focus on real achievement and real results. Show us what you can do at your very best . . . or recognize we'll know you're not. We're not playing to play here at Goldman Sachs. We expect you and everyone else, every single day, to play to *win*."

The words were strong, and actions spoke louder than words. There was no tenure. Partners who did not perform strongly were cut back in partnership percentage or taken right out of the line—with no regrets.* "To function around here," said Weinberg, "you really have to work hard and give up a lot of your outside activities—even, frankly, your family life to some extent. To do that, you really have to be ambitious and hard driving. Everybody works hard around here. If they don't, they have to leave."[14] As a partner explained, "There's no let-up for the seniors. If they can be pushed out, out they go—so their partnership shares can be divided up among the best and most aggressive people right behind them. In this constantly unfolding, Darwinian process of evolution, the finer, nicer people don't always win out." Still, as a competitor put it, "What's also amazing is that nearly everyone there is nice to each other, at least insofar as outsiders would see."[15]

Weinberg and Whitehead were not only playing to win—to win clients, mandates, and deals—they were also playing to increase market share and "share of wallet" with each client, and then go right on to win still more. Given the drive they inculcated, some competitors would see the firm as a predator: "It's the

* A partner leaving would "go limited" and be paid 50 percent of his accumulated capital immediately and the other half over six years, during which time he would get an above-market-rate fixed rate of return.

Goldman Sachs syndrome: what's mine is mine, and what's yours is half mine," claimed a rival banker.[16] Competition was not limited to other Wall Street firms or even to international competitors. The Two Johns worried about commercial banks, and one of Whitehead's major contributions was his successful lobbying to extend the life of Glass-Steagall, the federal law that kept the commercial banks out of the securities business for decades.

The differences in the ways the Two Johns expressed themselves went on display at the firm's annual investment banking conference when someone asked, "Why is the firm so worried about the commercial banks getting into our investment banking business?" Weinberg, direct and blunt as ever, simply said, "Because they'll screw it up!" Whitehead then rose to give a typically erudite and articulate, and in this case lengthy, explanation of the significant differences in cultures, capital, people, management, and strategic priorities—until he paused, looked over at Weinberg, smiled broadly, and said, "Just as John said, they'll screw it up!"

"John and John *never* had a conflict," says Bob Steel. "At least nobody ever saw any conflict whatsoever. They were each very comfortable being who they were, different as they really were, with Weinberg instinctive and spontaneous and Whitehead the very model of self-control and circumspection—and without any jealousy of each other's successes."

The Two Johns could have made all the decisions, but they chose to respect the strong group they had assembled on the management committee, including Jim Gorter, Fred Krimendahl, George Doty, Dick Menschel, Steve Friedman, Bob Rubin, and Bob Mnuchin. And the committee members appreciated the respectful way they were treated by the Two Johns, so they took their responsibilities seriously and were certainly not yes-men. Still, it was understood that department heads were generally free to run their different businesses their own way. There was an almost senatorial courtesy of assuming that if there were a problem in a man's area, he would work it out. There was none of the "digging right in" insistence on detailed accountability that came later with Bob Rubin and Steve Friedman.

Asked years later to explain the "secrets" that enabled Goldman Sachs to become what was widely considered Wall Street's best-managed firm, Whitehead explained: "We stick to our knitting. This permits us to spend our time trying to be better at what we do without the diversion of being in businesses that we are not comfortable with. I've always felt it's easier to increase your market share

from thirty percent to thirty-five percent in something you are already good at than it is to carve out a five-percent market share in some other business that you don't know anything about. We control our growth rather tightly, so things don't get away from us."

The Two Johns accelerated the pace at Goldman Sachs, expanded the investment banking business enormously, recruited and developed numerous business leaders, and built up the firm's profitability and capital. They led the partners to a series of important commitments to "investment spending" that transformed the firm from domestic to international in scope, lifted it from midrankings to first place, filled out the product line of services and capabilities, and laid the foundation for major long-term growth.

"We never made big strategic bets," says Whitehead. "We fed our successes and gave the winners more and more leeway to do better and better with what they had." New ideas got limited pilot-plant support until they proved their worth—and then the Two Johns fed the winners. Patience, prudence, and unrelenting persistence characterized the Two Johns' leadership—making many modest "three yards and a cloud of dust" incremental advances in market share and in stature. Weinberg and Whitehead were particularly careful not to build up costs and overheads in anticipation of hoped-for business and avoided "swing for the fences" risks. As Bob Rubin observed at the time, "Our approach is dull. But it's not a bad way to run a business."[17]

The Two Johns were always "in there" doing the business with the others, never insulated from either the business or the other partners. "You can't overvalue those two guys," says Steel. "They had their offices at the center of the action—classic John and John. Other firms had executive offices on a separate floor, so as the pace of the business picked up, the senior management got more and more out of touch."

The firm's reputation for preferring to follow and be prudent rather than innovate was a strategic style that fit with its determinedly low profile. Two examples of its success compare it with Morgan Stanley. In 1989 Morgan Stanley took a lot of heat from angry institutional clients and negative press when it bluntly announced a move to rationalize its institutional stockbrokerage business by concentrating attention on the 150 largest accounts, which represented 80 percent of its institutional business, while shunting all other institutional accounts

off to its retail brokers. Goldman Sachs effected much the same change at almost the same time, but did so over several months of quiet explanatory meetings with each individual institutional client, carefully explaining that service levels would actually increase when the account went from being an institutional salesman's smallest account to being an individual-account salesman's largest account. And in 1993 Morgan Stanley was prominent in the press for wresting an enormous tax deal from New York City and State after publicly threatening to move its headquarters and operations to Stamford, Connecticut. Goldman Sachs got a similar tax break, but very privately and quietly. Both firms remained in Manhattan.

I think that labels, good and bad, peel off slowly," said Bob Mnuchin. "I think that we clearly had a label of being somewhere between cautious and maybe overly cautious. And I think that started changing in the late eighties." Steve Friedman confirmed that view of the era of the Two Johns era a few years later when he and Bob Rubin had taken over: "I think historically that was a valid criticism, but certainly not in recent years since we have been at the forefront on innovation. We're a dramatically different firm than we were then."[18]

In one of their annual reviews of the firm's progress, Whitehead and Weinberg noted the increasing speed and complexity of finance and the sort of organization they felt would prevail in such an environment: "Financing activity today is increasingly spontaneous as well as international in scope. In this environment, traditional investment banking relationships—once characterized by long-pondered advice followed by measured preparation for entry into market—have been put under tremendous strain. Investment bankers best able to serve their clients today are those who are knowledgeable about and sensitive to markets, domestic and international; are able to muster resources and act quickly; possess and willingly commit capital to facilitate transactions; and provide considerable ingenuity in designing and marketing securities. It is an environment that tests the mettle of investment banking firms. Those with resources—professionals of top caliber, capital, presence in all markets, a well-honed organization, and a high level of concentrated energy—will assume leadership. Inevitably, investors and issuers alike will turn to the firms that demonstrate these capabilities." They went

on to observe proudly that the firm was "at the top or near it in every one of the more than forty services we provide to our investing and financing clients."

Great and enduring organizational change at a firm like Goldman Sachs does not always come in the form of dramatic events, but rather in the steady no-waves and no-nonsense pursuit of central beliefs. Core beliefs may appear almost intuitive but are actually based on the sort of deep understanding that enables great leaders with the will to excel to inspire many to follow—and oblige others to come along too. If Goldman Sachs was not particularly creative or innovative during the Weinberg-Whitehead transformation, it was responsive to market opportunities, to competitors' moves, and to changes in the environment in the 1970s and the 1980s, so that by the 1990s the firm was well prepared for an enormous surge in business. Profits of only fifty million dollars when John Whitehead and John Weinberg became co–senior partners mushroomed to eight hundred million dollars by the time Weinberg retired in 1990.

As readers will see dramatized over and over again, Goldman Sachs was entering into a period of accelerating transformation. Part of the transformation came externally, with explosive growth in institutional investing, increasing volume in block trading, expanding and accelerating merger and acquisition activity driven by the emergence of conglomerates and a deliberate reduction in antitrust activity—plus increasingly active competitors like Morgan Stanley, First Boston, Merrill Lynch, and a host of domestic and international banks. Part of the transformation came from within the firm, as recruiting brought increasing numbers of talented and highly motivated individuals to Goldman Sachs who were too skilled, well trained, and ambitious to wait for things to happen. Part of the transformation came with the increasing magnitude of compensation that could be earned by creativity, risk taking, and entrepreneurial determination. Part came with serial successes leading to increasing self-confidence, which led to more successes, which fostered greater confidence that hard work, superb client service, and discipline really would pay off. And part came from the Two Johns' determination to make Goldman Sachs preeminent; while driving individuals to work longer and harder to serve clients unusually well—and to copy and improve on other firms' best ideas—they insisted that everyone always work as part of the team. Part came from the strategic power of the IBS system. Part came with

Bob Rubin and Steve Friedman showing that success and rewards would go to those who achieve major results, causing the whole firm to accelerate its pace with increasing self-confidence and greater use of its strategic resources: knowledge, relationships, and capital.

All financial intermediaries must adapt to changes in supply or demand, or both. Most adapt defensively by gradual acceptance and accommodation to the imperatives of change. Those that fail typically accept and adapt too slowly. Those that succeed adapt actively and even aggressively. They hold high standards of performance, have a long-term focus, think and act strategically, gladly drop fading lines of business and search diligently for opportunities for profitable business creativity. Those that succeed adhere to consistent long-term beliefs and policies; they greatly demonstrate a will to excel in strategic initiatives and innovations, and in daily routines of such superb execution that they become anything but routine. As though it had always been its natural destiny, the firm continued its metamorphosis toward the global juggernaut it would become as today's Goldman Sachs.

The great changes brought to Goldman Sachs by the Two Johns eventually had an obvious consequence. Sidney Weinberg's dream was realized: Goldman Sachs became America's leading investment bank, creating the base from which the firm would go on to worldwide market leadership.

Of all the changes brought about by the Two Johns, perhaps the greatest was a profound shift of attitude and self-perception in the minds of their partners. At the start of their era of coleadership, Goldman Sachs was a second-tier contender with many visible weaknesses and only three distinctive but quite separated strengths—block trading, commercial paper, and risk arbitrage—with its investment banking business, except for that flowing from Sidney Weinberg's directorships, largely confined to smaller "middle market" companies, particularly those that might decide to sell out. By the time the Two Johns stepped down, the firm was on its way to being an integrated market leader in every major line of the securities business. Holding the leading position in investment banking with the leading American corporations, it was poised for expansion to global leadership.

Ironically, it would be the remarkable combined successes of the new lines of business spearheaded by the Two Johns and of the firm as a whole that would

convince their successors that Goldman Sachs should go public—a decision the Two Johns would vigorously and unsuccessfully oppose after their time of leadership had passed.

Whitehead and Weinberg made one of their greatest contributions to Goldman Sachs by agreeing, out of their great mutual respect and personal affection, *not* to take one particular action. That example of deference to partnership literally saved Goldman Sachs from disaster.

Through his work with the New York Port Authority, John Whitehead learned of an unusually attractive opportunity to lease a large block of open-architecture floor space, ideal for a large trading operation, near the top of one of the major buildings in the Wall Street area. This one lease would allow everyone in the firm to work together on connecting floors in one major building—with a spectacular view. The lease would run for twenty-five years—well into the twenty-first century. The financial terms were attractive; the firm clearly needed substantial new space in the Wall Street area; and the time had come for Goldman Sachs to set aside its past penchant for low-key, shabby offices. The physical space was perfect, and being headquartered in that iconic space would be a perfect symbolic declaration: Goldman Sachs had become a dominant global leader in investment banking.

Whitehead sketched out the splendid opportunity, but he could see that Weinberg was, for some reason, not buying in. So, out of respect for his partner, he decided to let the subject drop for a week or so because it was not all that time-urgent. He would give his friend time to get on board. Given time, the idea itself was sure to win Weinberg's enthusiastic support.

A week later, Whitehead brought it up again, but got even *less* interest. So he deferred for another week. When he brought it up a third time, Weinberg surprised Whitehead by saying he knew Whitehead had brought the matter up twice before and seemed quite excited about his deal, but even without getting into the details, he would never support such a move.

Whitehead wanted to know why, so Weinberg explained: "I get claustrophobic when I'm in a building where the windows are sealed and can't be opened.

The windows in that building are all sealed—and the space you've been looking at is ninety floors high. John, I could never work in that building, I can't possibly work way up there with windows you can't open."

With that very human explanation, Whitehead deferred to his friend, and they never spoke again about leasing floors for the whole firm near the top of One World Trade Center.

13

BONDS

THE EARLY YEARS

Bond dealing was not important to Goldman Sachs in the fifties and sixties, and Goldman Sachs was certainly not important to bond dealing—until Gus Levy read Salomon Brothers' first-ever annual report. It showed him that a competitor firm was making large profits in bonds, a line of business he and Goldman Sachs had been ignoring. Focused as always on making larger profits, Levy declared, "We gotta get major in bonds. There's big money being made, and Goldman Sachs should be there."

The firm's bond business had been small—very small—because everybody "knew" the bond business was just a prosaic "accommodation service" to investors that tied up capital, made little money—and depended on a firm's being a major new-issue underwriter of bonds, which Goldman Sachs most certainly was not. That had to change.

In fact, Levy was misled. What he didn't know was that a large part of Salomon Brothers' reported profits actually came not from bond dealing, but from its equity position in a Texas energy company, Haas Oil. Salomon Brothers' CEO, William Salomon, had insisted on putting out the confusing report as "advertising" for the strategic thrust he was determined to make into investment banking.

He had decided that the best way Salomon Brothers could become a major underwriter was to show the world how powerfully profitable it had become. He also authorized a major newspaper advertising campaign organized by Ogilvy & Mather around large pictures of his firm's cavernous bond trading room—heralded boldly in full-page ads as "The Room"—to celebrate the market power of Salomon Brothers' trading. But his understandable bragging—which Sidney Weinberg would never have allowed for this very reason—was soon attracting competition from a suddenly awakened competitor: Goldman Sachs.*

Building on its leadership in commercial paper, Goldman Sachs first expanded into a full range of the proliferating variety of money-market instruments. Henry Fowler, the former secretary of the Treasury,[1] was recruited to Goldman Sachs in 1968 by Sidney Weinberg, who had known him from their days with the War Production Board. "With his experience as secretary of the Treasury, Henry Fowler really knew quite a lot about the Treasury bond business and felt strongly that we should be in it in a serious way," recalled John Weinberg. Cheerfully, Fowler began to open doors to the offices of his former counterparts and acquaintances at other countries' central and commercial banks. But his low-key diplomatic approach was not sufficiently aggressive to match Levy's strategic aspirations.

With increasing strength in other money-market instruments and steady expansion in investment banking adding to the firm's well-established leadership in commercial paper, Levy thought it was obvious that Goldman Sachs should complete the strategic triangle and build a major business as a dealer in taxable bonds. He proposed to do so by adding corporate bonds to the firm's commercial-paper business relationships—relationships developed over the years with hundreds of corporate issuers and thousands of institutional investors. As usual, he was unrelenting in his drive to make it all come together. He saw Goldman Sachs as the "sleeping giant" in bonds: All it needed, he thought, was to be roused from slumber and taught how to *change*. "We've expanded our bond business recently,"

* Salomon Brothers's focus on profitability and on wholesale business—disparaging any business done with less than the largest institutions, corporations, and governments—was actually taking it in a radically different strategic direction. It soon dropped out of municipal bonds, where it had been a leading competitor, and out of commercial paper, where it had been only a small player. Salomon Brothers made a major, strategic thrust into block trading, Goldman Sachs's home territory, and into investment banking, mortgage-backed-bond dealing, and, through merger with Phibro, into commodities. That merger would soon be a significant factor in Goldman Sachs's decision to combine with J. Aron.

said Levy in 1969. "We plan to be number one in the bond business. We never plan to be number two in anything."

At Levy's direction, George Ross led a partners' committee[2] in a major study of the business possibilities in corporate bonds. It showed that opportunities for large profits were significant in both underwriting and dealing in the secondary markets. So Levy summoned Ross from Philadelphia to take over from Fowler and run the bond business out of New York. Levy's charge: "It's a big business and a big opportunity for Goldman Sachs." But Ross did not do well in bonds. He was too interested in friendly client relationships to succeed in the confrontational arena of the bond business, so he went back to Philadelphia after two years and John Weinberg was put in his place, reporting to Ray Young.

"Gus put me in charge of the bond department," recalled Weinberg. "I objected: 'Gus, I don't know bonds.' But Gus said, 'You know how to control the traders, so you're it.' And that was that." Weinberg's main job was to find the right leader to build a major bond business. "So I start looking around at our guys and quickly realized that we didn't have anyone who could be a real leader. Then I find a guy at Salomon—Bill Simon, who was later secretary of the Treasury—and was going to hire him when our traders threatened to quit if I hired anyone in over them.[3] I'm not about to be threatened by those clowns, so I laid it out clear and easy: 'You guys have fifteen minutes to come to me and say we'll go along with you and really support this new guy as our head, or *out you go!*' So most of them left that very same day. Fine with me. Then Simon got a big counteroffer from Salomon Brothers and decided not to move to Goldman Sachs. The next day, I'm desperate to find somebody who can take the responsibility for managing our bond positions when I remember Eric Sheinberg is running our convertibles operation. Convertibles are bonds, so I go tell Sheinberg he's got a new job. He argues that converts are almost completely different from straight bonds; they're much closer to common stocks. But I say, 'Cut that: you've been *drafted!*' So he accepts the inevitable and agrees to run the bond positions for a while, while we go looking for someone else—someone who can really do the job and put us into taxable bonds in a major way."

But taxable bonds were only one area of the bond business. While Weinberg was looking for a new head of taxable bonds, a separate effort was being made in tax-exempt municipals. John Whitehead had recruited Bob Downey, whom he had met socially, to leave R.W. Pressprich, where he was working in

municipals, to lead a major buildup in municipal bonds at Goldman Sachs.[4] As a lifelong Republican, Whitehead's proposition was that municipal finance was sure to grow because the states and municipalities would need the money, particularly with the Democrats in power.[5] Downey was so persuaded to focus on the exciting future opportunity Whitehead projected that he took a significant pay cut:

"Do it right" was Whitehead's charge to Downey. "You don't have to do it all at once or achieve everything this year. Don't stretch. Be the *best*." But despite those words, Downey understood Goldman Sachs's drive: "Of course, we worked our asses off because we knew, in the final analysis, that John really expected the business to grow rapidly and put Goldman Sachs at the top of the league tables *very* quickly, and that he required we do it in a first-class way." At the time, it was not at all obvious that Goldman Sachs would be a significant beneficiary of the expected increase in municipal-bond volume. In 1969, the year Downey took over, the firm was not even in the top fifty among new-issue municipal underwriters. As usual, breaking into the municipal-bond business would require an imaginative new product, an innovative marketing focus—and a sustained, driving commitment.

The first major advance came in 1970 when Goldman Sachs invented the Vermont State Municipal Bond Bank, which enabled small municipalities across the Green Mountain State to gain access to the municipal-bond market on much more favorable terms than they ever could get for their individual financings. As Downey explained, "Small issues got no attention from Wall Street or from investors. For example, one bond was issued for Peach, Vermont, with a population of only 19,000. The Vermont banks—the traditional buyers for small, local issues—were out of money to buy local bonds, so there was no market for Peach's bonds without the bond bank."

The Vermont Bond Bank offered bond issues of at least medium size—which made them liquid, or tradable in the secondary bond market—by pooling numerous municipalities' small bond offerings and adding the imprimatur of the state of Vermont, which had a triple-A credit rating. While the state wasn't legally responsible for the bond bank's debt, the bank's credit was based on the state's moral obligation and was rated double-A. The key to success with this innovation was coordination: putting it all together and making it work politically and then financially by aligning payment dates and handling defaults, among other things.

"We went to lots and lots of town meetings and met with lots of town selectmen," recalls Downey. "That December, we raised a total of forty-six million dollars for fifty different municipalities, and we were off and running with our better idea. We brought Maine in two years later with the Maine Bond Bank."

In building the firm's municipal-bond business, not doing the wrong things was almost as important as doing innovative things. For instance, credit analysis was an important part of the firm's strategy in municipals. "But we didn't publish [our reports]," says Downey, "because we didn't want to miff our issuing clients. Merrill Lynch and others did publish—and they got into real troubles with their published research on clients." Instead, he explains, "We would [privately] show a list of the duds we had avoided—like West Virginia Turnpike. While it's not good to get a reputation for being *too* cautious or even chicken, it's always important to know when to say no. And saying no is not the *last* thing you can ever say because you can always come back to the table. You don't want to be just some idiot who is only avoiding bullets. You do want to compete, so just like in the Marines, you have to know when to duck and when to move up and engage. Sometimes you duck first and then engage on the very same issue."

Downey liked to take astute market risks. When Executive Life—which CEO Fred Carr would later drive into a spectacular bankruptcy—issued insured, guaranteed investment contracts, or GICs, they got a triple-A credit rating. The money invested in those GICs came mostly from municipalities that raised money through tax-exempt bonds sold through Drexel Burnham. The municipalities were profiting, at least temporarily, from arbitraging the interest-rate spread between the tax-exempt and taxable bond markets. "But," recalls Downey, "even in a large, diversified portfolio, junk bonds are *not* triple-A. So we stayed far away from the Executive Life issues when originally offered at par. But later"—after Executive Life hit the skids—"at a market price of just forty dollars for every hundred dollars of face value, those same bonds were selling at a sixty-percent discount, and we went in at that market price and did beautifully as the price later rose to eighty. Still . . . there were moments." The price of those bonds once dropped briefly to twenty-five dollars on a rumor that the courts might rule that secondary-market investors were just speculators and would not be treated equally with the somehow more legitimate investors who had bought

at the offering. Fortunately for those who bought in between forty and fifty dollars, that rumor soon evaporated. "By saying no back at the original underwriting, we had a leg up when it was time to organize the bailout financing," Downey says. "It was hard work, but we really did our homework and earned a reputation for professionalism. With our reputation established, business was really coming in and the municipal finance department was making real money."

Confident that the firm would recognize the unit's success in municipals, Downey and others expected Municipal Finance to win its first partnerships. But it didn't quite happen. The division got *one* partnership, for a banker named Charlie Herman. "We were very disappointed because we believed very strongly that our Frank Coleman was too good to pass over. So we wrote a letter to Gus, saying, 'We truly believe Goldman Sachs is the best firm, but we want you to see our department as being important to the firm.' We got no reaction from Gus—and certainly no promises." Disappointment spread quickly across the municipal group.

Downey and his five-man team decided that if partnerships were not going to open up at Goldman Sachs, they had better talk with other firms. After three months of carefully confidential discussions, they agreed to leave Goldman Sachs and go over to Donaldson, Lufkin & Jenrette. Because the formal announcement would be made the next day, their wives had just received big bouquets of "welcome aboard" flowers. It looked all settled when Dan Lufkin, chairman of DLJ, asked his partners: "Have you spoken with Gus?"

"No. Why?"

"As a courtesy—because that's the way it's traditionally done on Wall Street. If you haven't called Gus, I will." And off he went to make the call.

When Levy got the courtesy call on the "done deal," his sixth sense gave him the intuition that the deal for his municipal-finance team to leave Goldman Sachs and join DLJ was not absolutely airtight. During that simple courtesy call, Levy kept the conversation going, personalized it some, and then, moving on to other related topics, got Lufkin—who had political ambitions and might someday need Levy's support within the Republican Party—to blink. No, Lufkin indicated, it was not quite *absolutely* locked up as a 100 percent done deal.

That small opening was all Gus Levy needed. He called Downey down to his office and went to work on him, getting Downey first to wonder and then to worry about how much he could really trust the other firm if they would talk to

Levy without first clearing such a sensitive call with him. "When's the last time you gave your wife a gift of something *really* nice?" asked Levy as he wrote out a personal check for ten thousand dollars.

Less than half an hour after Lufkin's call to Levy, Downey was on the phone to DLJ, saying, "Your chairman told Gus Levy that our deal is not closed," and within hours the deal completely unraveled. Downey and his municipal-finance team stayed with Goldman Sachs and soon got that second partnership. By the end of the twentieth century, negotiated municipal-bond deals had grown to represent over three-quarters of the overall tax-exempt market and Goldman Sachs ranked first in lead-managed, negotiated bond underwritings in all but five of the century's last thirty years.

Still needing strong sales leadership in taxable bonds, Weinberg reached for a young star who, if he was successful where others had failed, would be declared a hero. Months before, one of the bond traders had asked David Ford, "You cover Atlanta, David, so why don't you come with me to visit some accounts in Atlanta?" The trader continued to explain, "That way, I won't have to pay for my vacation trip to Augusta this year." So Ford went on a three-day series of account visits and the trader got his transportation paid by the firm. While they were away, telephone calls came in. First, Dick Menschel called. Then John Weinberg called—both looking for Ford.

"Where in hell have you been?" Weinberg demanded when Ford phoned back.

"Calling on accounts."

"Well, then you must be ready to get to work!" and Ford was switched to fixed-income sales in Philadelphia on the curiously convoluted assumption that since he was effective when working with high-net-worth clients, he must have good quantitative skills—and this in turn meant he could be transferred to fixed-income sales, where numeracy was essential.

A few months later, Weinberg invited Ford to have dinner with him in New York City because he was ready to make Ford, at thirty, national sales manager for corporate bonds. Ford: "I know you're also looking for a head of the whole division, and he'll want to hire his own sales managers. But my dad was in the military, so if you say that's what you want me to do, I will. If you still want

me to take the job, I'll need at least six months to get the key hires in place and get myself established."

"Done."

Ford was brushing his teeth at home in Philadelphia when his wife asked: "How did your dinner with John Weinberg go?"

"Well! He offered me a major new job: national sales manager."

"What did you say?"

"Yes!"

"But you didn't talk to *me*."

The Fords moved to New York, but they never felt comfortable in the city. He soon gave up the sales manager job, and they moved back to Philadelphia.

By the early seventies, Whitehead and Weinberg, as coheads of Goldman Sachs, were determined to move ahead in the secondary markets, for previously issued bonds—first in municipals, where the firm could capitalize on the strengths Downey had established in the new-issue or primary market, and then by expanding in corporates and governments. In 1972 all bond operations were taken away from the regional offices and consolidated in New York City as a first step. Don Shochan, recruited from Discount Corporation, was put in charge at first. But Shochan was eventually recognized as a "crapshooter"—he managed positions by changing portfolio maturities in anticipation of changes in interest rates—and was let go in 1977. Goldman Sachs was again looking for a leader and a strategy to break into bonds.

"Frank Smeal was our man," recalls Weinberg. Smeal had been approached a year earlier by Levy, Whitehead, and Weinberg when they correctly sensed that Smeal was no longer a leading candidate to be chosen CEO of Morgan Guaranty and might be receptive to their offer. But Smeal refused. As he later explained: "I wouldn't work for Gus Levy. But after Gus was gone, it was different." The change in leadership at Goldman Sachs was one major factor in Smeal's decision. Another difference was that Smeal had just been badly disappointed when finally passed over as CEO at Morgan Guaranty. In negotiating the terms for his joining Goldman Sachs, Smeal proved he was a good trader: He came over in April 1977 with an annual guarantee of five hundred thousand dollars and a significant

partnership percentage—nearly equal to Weinberg and Whitehead—with a slot on the management committee.

Smeal moved quickly to develop a strong, customer-oriented sales organization, started producing value-added research, and expanded the firm's market making. He was soon making real progress. However, the whole world of bond dealing was about to go through a once-in-a-lifetime transformation and, as others would soon see, the service-intensive strategy Smeal understood best would be pushed aside by capital-based, quantitative, risk-taking strategies that focused on principal trading—buying and selling for the firm's own account rather than just executing customers' orders. But the transformation was not yet visible. Smeal was moving to establish a traditional organization for the traditional bond business.

Jim Kautz had been in bond sales in the St. Louis office when he declined a 1975 "invitation" from Gus Levy to go to New York to head municipal sales. "That was the longest plane ride in my life—an hour and a half with Gus Levy, who was returning to New York from a May Department Stores directors' meeting in St. Louis. Gus spent the whole flight telling me why I should change my mind and take the job." A few years later, when Smeal gave Kautz another offer to be overall sales manager for the fixed-income department, he quickly took it.*

In a thirty-year career at the Morgan Bank, Smeal not only had been executive vice president and treasurer, but also was important in the Bond Dealers Association. His name and reputation were far bigger than many at Goldman Sachs realized, but his style hardly matched the firm's. A connoisseur of fine wines and great restaurants, he went out almost every evening with customers and competitors, networking extensively in the old-school way he knew so well from his years at Morgan. He wore tailored suits, expected younger people to defer to him as "Mr. Smeal," and believed serious meetings were held in conference rooms and scheduled for specific times at least a few days in advance so everyone could prepare properly. But at Goldman Sachs, everybody used first names, nobody wore suit jackets, and the most significant meetings were "on the fly," impromptu trading-room gatherings to make urgent decisions.

Smeal's style conflict was first seen in recruiting: He assumed that as department head, he would do his own recruiting. An early casualty of this

* Kautz's predecessor as head of bond sales was John Gilliam, who had joined the firm in the 1950s, fresh out of Princeton, and sold stocks in the Midwest. He and Smeal never bonded. Gilliam says, "Frank Smeal was a fake."

misunderstanding was Arthur Chiang, who had been recruited in 1977 to Chase Manhattan Bank from Chicago's Harris Bank to run Chase's government and municipal bond operations. At the Greenbrier Hotel for a major dealer's conference in 1979, recalls Chiang, "as I came off the tennis court, Frank asked me to sit with him under a tree." Chiang knew a lot about Goldman Sachs and was impressed with the firm's commitment to recruiting college graduates and MBAs while Salomon Brothers was still looking to upgrade back-office clerks with few or no credentials beyond street smarts and a lot of hunger. Chiang also recognized the significance of the powerful changes that were coming rapidly to Wall Street with derivatives like T-bill futures, which were just being introduced on the Mercantile Exchange in Chicago. Derivatives would soon change the scale and the basic nature of the bond markets. These sophisticated new instruments would bring important opportunities for bond dealers to manage their business in an entirely new way without taking major market or interest-rate risks.

"Frank asked me to join Goldman Sachs as head of trading and research in governments and mortgages," recalls Chiang. "After three days of intense consideration—because I knew there was a real need at Goldman Sachs for my skills and experience with derivatives—I accepted. Then, suddenly, surprise! One day later, Frank told me he had not made an actual *offer.*" Backpedaling, Smeal—who had just been told that in a partnership, recruiting decisions were always made collectively by at least a dozen people—said his offer was not definite, but rather "a proposition to consider as an adventure"! But since Chiang had already made his commitment, meetings with several partners were hurriedly arranged, and after a few days of intensive interviews, the "proposition to consider" was made a real offer and Chiang joined the firm. "But there was no office space for me," he recalls, "except a small interior room with no windows—and two doors."

Chiang's most important changes were initiating the use of derivatives and hiring two future leaders, Jon Corzine from Continental Illinois National Bank and Mark Winkelman from the World Bank. Chiang never fit into the firm personally. Some said he was "too ivory tower"; others said he was felled by internal competition. "In the end," recalls Chiang philosophically, "Frank fired me solo—the same way he had tried to hire me."

That wasn't the last of Smeal's difficulties. His experience at the Morgan Bank had been in municipals and Treasuries, but the major business challenge at

Goldman Sachs was in taxable corporates, a very different business. Smeal was an experienced administrator who knew lots of senior people and greatly enjoyed the old-school relationship diplomacy. But that was no longer the way the bond business was being done and not the way to build up a major business rapidly in the face of huge, rough, risk-taking, richly capitalized, and determined competitors like Salomon and First Boston. They understood how vital it was to *their* future to keep and defend their market leadership, which was key to their profits and to their status in corporate underwriting. "Not only did he not know the Goldman Sachs culture or the firm's ways of doing business—informal, fast, open, etc.," recalls a partner, "he wasn't up to speed on the mathematics that were coming into dominance in the bond-trading business. He never really understood how modern bond traders make money for the firm. Frank should have been a senior adviser, not responsible for hands-on leadership charged with driving the unit to build a major business. Looking back on those days, Frank's real role was as a high-grade placeholder until the firm could put some business builders in charge that understood the Goldman Sachs culture and could hire the strong hitters we needed to build the business. Frank's true role, whether he or anyone else realized it at the time, was to give us some external credibility when we were so very far behind Salomon Brothers and First Boston, and we could see that Lehman Brothers, Morgan Stanley, and Merrill Lynch were all moving up strongly."

For a few years Smeal seemed to achieve a major success. Fixed Income went from barely break-even to what appeared to be a highly profitable division of Goldman Sachs. But profit reporting can be very misleading. The division was reporting robust profits only because it was liquidating the firm's base of business in corporate bonds.

Steve Friedman laid out the problem to John Weinberg. Sure, there were signs of success that hid the core problem. Reported profits were up a lot. The firm's increasing strength as a municipal-bond underwriter in the new-issue market was being matched by sales and service operations in the secondary market. With the help of former treasury secretary and now partner Henry Fowler, the firm was establishing itself as a government-bond dealer. Fixed-income research had been introduced and was becoming a competitive strength. Trading risks were carefully minimized.

But in corporate bonds—the business that was new to Smeal because

commercial banks like J.P. Morgan had not yet been allowed to underwrite or make markets in corporate issues—Goldman Sachs was losing lucrative corporate-bond underwritings from such traditionally important clients as Sears Roebuck and Texaco. Both had sold one billion dollars of bonds through other underwriters. In three years in the early eighties, Goldman Sachs's rank in managed corporate-bond underwriting had dropped from first to third to fifth. Its market share had shrunk over those years from 11 percent to 9.6 percent, while Salomon Brothers's share had risen from 16.2 percent to 25.8 percent. The changes were a serious threat to Goldman Sachs's position as an underwriter. Competitors were using their rich profits in surging new markets like mortgages to cover their losses in corporates, where they were cutting prices to gain market share.

Friedman and Rubin were convinced that the firm could make major money in bonds only by committing in a big way to proprietary trading for the firm's own account, because the bond markets were radically changing. Mortgage-backed securities and an increasing variety of asset-backed and lower-grade, high-yield bonds were exploding in volume and in dealer profits. Smeal continued to favor the traditional, customer-oriented agency business. Friedman feared that if Goldman Sachs stuck with Smeal's suddenly obsolete business strategy for another three years—while Salomon Brothers, Morgan Stanley, Merrill Lynch, and First Boston kept building their risk-embracing business, making big profits as principals, not small profits as service-intensive agents—the firm risked being shoved aside as a major corporate underwriter. Friedman and Rubin recognized the strategic problem; knew Smeal could not discard all he knew from long experience; and decided that the better option was for them to take over leadership of the fixed-income group. Weinberg endorsed the change, partly because it gave his two protégés a challenging opportunity to develop and demonstrate their abilities as coleaders away from their "home bases" of M&A and arbitrage, and partly because the firm's earnings in bonds paled in comparison to the enormous profits Salomon Brothers, First Boston, and a few other bond dealers were making. Weinberg wanted to test the pair with greater managerial responsibilities as he groomed them to be his successors. He expected them to figure out how Goldman Sachs could join in making big profits in the bond business.

A strong dealer position in the secondary bond markets had become essential when competing as a new-issue underwriter, and new-issue bond underwriting

was booming. Not being a leading dealer in bonds was already hurting the firm competitively and, without major change, would become a dominating strategic liability in corporate underwriting. All the other majors were strong in both debt and equity, and no corporation would want to depend on a one-trick underwriter. Moreover, if competitors were making big profits in *any* line of business—like proprietary trading in new kinds of bonds—those profits would surely be used to move in on other lines of business or to pay up in recruiting talented people, including those at Goldman Sachs.

In 1985, at age sixty-seven, Frank Smeal retired. This opened up an opportunity for major change. Steve Friedman recalls, "I couldn't sit on the management committee with Smeal and not know that something was missing—something really important—when he talked about London having lost twelve million dollars on a trade and didn't even know why. They *had* to know why they'd taken such a loss so they could learn from the mistake so it could be prevented the next time. I knew that Tom Saunders at Morgan Stanley had everyone and everything reporting into him on the trading floor, so they had close communication and good coordination. By contrast, we had guys spread across three different floors. Talk about frustration!"

A year later, Bob Rubin called David Ford again: He wanted Ford to relocate to New York and take on sales management again. "You're really asking two different things," Ford responded. "First, will I take the job? Second, will I move to New York? If you can judge my work by the results accomplished and not by how much face time I put in in New York, I'll take it—but only on that basis."

"I'll want to discuss this with Steve. Can I put you on hold?"

"Sure."

Ford was on hold for less than one minute and would never know whether Rubin actually asked Friedman anything before coming back on the line to say, "Done."

To make fixed-income sales effective, Ford knew he would need to offer a service that would enable his salesmen to "sit on the client's side of the desk"—offering solutions to pressing problems—by delivering research that would help clients make better investment decisions. Gary Wenglowski's extensive macroeconomic research—although originally organized to support equity research—was adaptable to fixed-income research and proved helpful. So was the work of

Stanley Diller, who joined Goldman Sachs to build a bond-research department in the late 1970s and was the firm's first "rocket scientist" quantitative analyst. Diller, a professor at Columbia, came to do research on portfolio strategies as a way to differentiate Goldman Sachs and to generate research-based transaction ideas for customers instead of simply risking firm capital buying any bonds that customers wanted to sell. Unfortunately, Diller needed enormous amounts of computer time to run his complex models, and this caused conflicts with others in research. When Diller lost his temper one day and called Lee Cooperman a "Hitler," his career at the firm was suddenly kaput.

Also in the late seventies, Joel Kirschbaum, who had ranked at the top of his class at both Harvard Business School and Harvard Law School before coming to Goldman Sachs, switched from banking to build a mortgage-backed-securities business and catch up with Salomon Brothers, which was making a fortune in mortgages. To trade mortgages, Kirschbaum recruited Robert From, a trader from Blyth, who recognized that when portfolio managers wanted to hedge their portfolios of mortgage-backed bonds against market risk, they were short-selling the bonds' initial maturity strips. (In another of many "product" innovations from Wall Street, mortgage-backed bond issues were sold in strips, divided by maturity like slices in a loaf of bread.) With this simple insight, he would accumulate a big position in those initial maturity strips, buying in the floating supply, and then squeeze the short sellers—hard. As the shorts scrambled to get securities to deliver, they had to pay higher and higher prices. Panicked as prices went up and up, they would bid the price up even faster and even higher. This caused major spikes in market prices that only the former Blyth trader could anticipate because he was the one forcing the shorts to cover. He made huge profits for Goldman Sachs.

Soon Kirschbaum was asking the brightest people he could find one key question: "Who is the one person I most want to have to build a truly great research unit in mortgages?" Some of Professor Richard Roll's UCLA students were at the firm, and they all pointed to Roll. "Joel flew out to Los Angeles, grabbed me by the throat, and just would not let go," recalls Roll. He joined the firm in 1985 and over the next two years built a fifty-five-person research unit specializing in mortgages. "The firm had some of the smartest people I've ever met," says

Roll, and "while the firm, more than any competitor, has used more people with advanced academic training, their regular employees are every bit as talented. Goldman Sachs used academics like me as catalysts to get their own people thinking in more rational and sophisticated ways."

John Weinberg was set appoint Steve Friedman to head fixed income, but Bob Rubin heard about it and quickly convinced Weinberg to appoint him as co-head to be sure trading skills would be at the top of the division. Looking back on Frank Smeal's departure, Friedman recalls: "Our bond business was *really* disturbing. It had the wrong strategy. Frank was going backward, not forward, when recommending a relationship salesman to succeed him as head of the division. We said, 'Over our dead bodies!' " Smeal's candidate was not up on the sophisticated analytics that were becoming central to proprietary trading and were sure to be the main source of profits. "One month after Bob and I got involved, a major crisis hit the markets. The fixed-income division was all stovepipes and fiefdoms, so traders were looking only at one part of the market and paying no attention to how other parts of the market were affecting their own. They had no understanding of the basic mathematics of embedded option values [such as call protection or mortgage-refinancing rights], which were absolutely essential. The top of that division was an intellectual vacuum."

Rubin and Friedman changed the compensation arrangement from straight commission on volume to "managed comp" that could at least include whether the firm *wanted* the business a salesman was doing. "We had guys getting paid on volume when the key to *their* volume was *our* losses in market-making," laments Friedman.

In 1985, convinced that new leadership and new strategy were needed in fixed income, Rubin and Friedman recruited a group of experienced risk-taking bond dealers from Salomon Brothers into Goldman Sachs to force change in the fixed-income division's culture and alter its concept of the business from service-oriented and risk-avoiding over to a bold, risk-embracing, capital-intensive, proprietary business model. Most left Salomon Brothers because they had felt shortchanged, and most subsequently left Goldman Sachs after a few years

because they couldn't adapt to the teamwork culture, but by then they had already helped change the firm's way of doing bond business.[6] By 1986 over one thousand people worked in Fixed Income.

Thinking more rationally and in more sophisticated ways was not limited to tactical changes. The changes that Rubin and Friedman put through were massive—and would help change the character of Goldman Sachs forever. But favorable change did not come swiftly or easily.

As interest rates fell in 1986, dealers with long positions in corporate bonds and mortgage-backed securities were not getting the rising prices they had expected, but their short positions in U.S. Treasuries *were* rising right on schedule—so Goldman Sachs dealers were taking huge, repetitive losses. Arbitrage losses in Fixed Income surged to one hundred million dollars—not a good start for Rubin and Friedman as new coheads of the division.

"What in hell is going *on?*" exclaimed Friedman.

Nobody knew—and nobody knew for days on end—until somebody realized the obvious: As interest rates fell, homeowners were refinancing their mortgages and corporations were refinancing their bonds by exercising call provisions. That explained why the Wall Street dealers' long positions in corporates and mortgages were not rising as rapidly as their short positions in Treasuries, squeezing the spreads that dealers were counting on.

Goldman Sachs needed better models that more accurately reflected the impact of changing interest rates on the different bonds' embedded options. This need surfaced during one of the postmortem review sessions Rubin held each Saturday. He always made sure that each person present had his chance to speak—including in-house guru Fischer Black, the codeveloper of the Black-Scholes formula for valuing stock options, who sat in a corner and was silently listening. Rubin, who respected people who, like himself, knew how to listen, said, "Fischer, you've been pretty quiet. Is there anything you'd like to add?"

Noting that the embedded bond options to refinance were not being valued correctly, Black said that correct valuation of those embedded options could probably be obtained if the quantitative-model builders at the firm went to work on the problem. While the Black-Scholes formula for valuing stock options couldn't work well on bond options, over the next several weeks, working with Emanuel

Derman and Bill Toy, Black developed a practical computer model that incorporated the decisive difference between stocks and bonds.[7] All bonds have an exact value on the exact date when they mature, and this enables analysts to translate each bond's yield curve and price volatility into a consistent pattern of future short-term interest rates and volatilities. And that pattern can be used to price *any* other fixed-income security, including derivatives, in ways that are all internally consistent.[8] This insight revolutionized the bond business at Goldman Sachs and the bond markets all around the world because it integrated futures and cash trading in every market, everywhere. What began with Rubin's habitual question-invitation soon became another transformational revolution.

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FIGURING OUT PRIVATE CLIENT SERVICES

Ray Young and Richard Menschel saw an opportunity in the early seventies to develop a substantial new business by harnessing two established strengths of Goldman Sachs. If executed well, this new business would have high margins, require little or no capital, and be a steady long-term moneymaker. Good execution would depend on an entrepreneur who was ambitious, unusually presentable, and tough—tough enough to cold-call persistently in many different cities over many years.

Except for one crucial distinction, the business opportunity Menschel and Young had in mind was the basic business of Wall Street: retail stockbrokerage. The crucial distinction was focus—focus on wealthy individuals, particularly on individuals who had became wealthy by building businesses and whose wealth had suddenly become liquid because Goldman Sachs or another firm had helped sell their companies. The focus would give Goldman Sachs an important "unfair" competitive advantage. Since the firm already had strong research and trading capabilities in place to serve its institutional accounts, any business with wealthy individuals would be almost entirely incremental, so the profit margins would be high as volume built up.[1]

Through its "seller rep" specialty, Goldman Sachs was the Wall Street leader in helping the owners of small and medium-size companies sell out on favorable terms. After a sale, each of the major shareholders suddenly had money—usually lots of money—and Goldman Sachs knew exactly who they were and how much they each now had to invest, weeks before any other firm. In addition, each of these newly wealthy people would have a quite favorable predisposition toward the firm that had managed the sale of the company. Said Menschel: "You couldn't ask for a better opening opportunity for a securities salesman." If Goldman Sachs managed an IPO and the company's CEO came into millions, a young salesman—also from Goldman Sachs, but often not with the same maturity as the attending investment banker—would call about managing his personal investments.

During the conglomerate era of the sixties and seventies, acquisitions were at an all-time high. For example, U.S. Industries Inc. alone made one hundred acquisitions in half as many months—creating at least one or two, and often as many as a dozen, freshly minted millionaires in each of one hundred selling companies. As Menschel noted, "That's hundreds of prospects from just that one acquisition-active company. And there are bigger deal makers, like Jimmy Ling, the Murchisons, and Derald Ruttenberg, all doing deals and creating big, liquid personal portfolios."

Once a few successful entrepreneurs in a city had become clients and experienced the firm's first-rate service and solid investment results, they would be more than happy to introduce their wealthy friends to Goldman Sachs. This would give the firm an expanding perimeter of competitive advantage in building its individual-investor business. Some of these new customers could also become clients for the firm's seller-rep business—a perpetual virtuous cycle.

Menschel thought he knew the right man for the job of building a significant business on his ideas. Menschel had been assembling the firm's institutional sales force, one person at a time, with great care and high standards, because he recognized that year after year, the firms with the best relationships with institutional investors got paid significantly more than the second- or third-ranking firms serving those same institutions. The key factor in having the best relationships was having the best salesmen. That's why Menschel was exacting in recruiting and training salespeople and supervising their assignments and their

advancement. He concentrated recruiting at Harvard, Stanford, Wharton, and Columbia, and was alert to unconventional candidates who were exceptions that proved the rule—like Roy Zuckerberg, whom he had hired a few years before.

Looking over Zuckerberg's one-page résumé, Menschel, who liked to test candidates to see how they reacted, had said, "I see you didn't go to business school, Roy. We're hiring most of our new salesmen from the very best business schools. Can you tell me why I should hire you when you didn't even go to any business school?"

"No, I didn't go to business school," replied Zuckerberg smoothly. "I studied business in the real world—where you actually do things, not just talk about doing. While the others studied business, I did business."

"So what did you accomplish in your school of hard knocks?"

"I reorganized sales, cut costs, and increased revenues threefold in eight years, and changed the way the business was done. I managed people. I built relationships. I built a business and made it far more profitable. You learn a lot when you do real business."

"And what did you study at . . . was it . . . Lowell Tech?"

"Textile engineering. My father was in the industrial textile business."

Menschel was impressed but still skeptical. Virtually all his hiring was at business schools, particularly Harvard Business School—partly because he'd gone there himself, partly because John Whitehead and John Weinberg both favored HBS graduates strongly, and partly because the training there made his salesmen highly presentable to clients—particularly after an offhand comment like: "Your salesman will be Sam Jones. He went to Harvard Business School, you know." But Lowell Tech, followed by no business school at all—that would never impress anyone. Yet Menschel was intrigued. This guy Zuckerberg had charm, was clearly driven to get ahead, and showed considerable selling skills. He was certainly good at selling himself. More important, L. Jay Tenenbaum, a good judge of people, had recommended him to Menschel. Tenenbaum had been instrumental in bringing into the firm a series of future leaders: Bob Mnuchin, David Silfen, Bob Rubin, Steve Friedman, and Bob Freeman. Tenenbaum had agreed to see Zuckerberg for fifteen minutes because his friend Bruce Mayer had asked Tenenbaum to interview him as a favor. On learning that Zuckerberg was about to take a job in operations at Bear Stearns, Mayer had said, "Oh no, Roy,

you belong in sales," and called Tenenbaum. Busy as he was on the arbitrage desk, Tenenbaum continued the interview for nearly three hours and concluded by saying, "I don't know how, but I'm going to help you get you a job here at Goldman Sachs. I'll introduce you to our heads of sales, Richard Menschel and Roy Young."

Menschel might have been even more intrigued—and more skeptical—if he had known more of the details of young Zuckerberg's education. In high school, Zuckerberg realized that he was very smart because he got high grades without doing any homework. When other kids told him he would be in trouble if he kept skipping homework, he elected the toughest course he could find—math—and bet ten dollars he would get a grade of seventy-five or better without any study. He won the bet with a seventy-eight. He then went to Lowell Tech and then to work at his father's "textile" company. In dry-cleaning women's dresses, the mannequins that take the abuse of heat, pressure, and chemicals have textile covers that must be replaced regularly. Roy's father's textile business was providing those covers—a tough business, but not as tough as Sam Zuckerberg, who announced how his son's first day on the job would begin: "You'll start working tomorrow at five a.m. Be there!"

"Gimme a break, Dad. I've had no vacation since leaving school."

"You've had twenty-two years of vacation! Five a.m.!"

When, after a few years, Roy decided he would have to quit, he went to his father to explain his decision. As soon as Sam Zuckerberg realized what was coming, his eyes narrowed and his voice hardened: "Turn in the keys—now! That's a company car!" The son protested that he needed the car to get home, twelve miles away. The father had no problem with that: "Turn . . . in . . . the . . . keys!"

Zuckerberg started in securities sales at Goldman Sachs in 1967 and in 1972 was also running the sales training program when Menschel said, "Roy, why don't you give up your institutional accounts? We both know that because you came into sales late, you don't have the best list of accounts. You should drop your institutional accounts and go full time into selling securities to wealthy individuals. You do well with the individuals you work with now. You have a good understanding of how to do significant business with individuals, and there are

good individual-investor accounts all over the country, so the opportunity is unlimited—and it's a fast-growing business, particularly if you concentrate on the wealthiest of the newly rich." Menschel had developed a decisively differentiated model of how the individual-investor brokerage business could and should be developed, and now he wanted someone to run it, someone who could develop it into an important business for Goldman Sachs.

"All the newly rich selling shareholders need somebody," Menschel told Zuckerberg. "All you have to do is to make sure that that somebody is Goldman Sachs. You'll have more good business than you can handle, and you can build a significant organization to serve this large and growing market. And Roy, all the business will be incremental, so the profit margin will be very high. This is your great opportunity!"

Zuckerberg started building the individual-investor business in 1972 and ran it for sixteen years. "I traveled extensively to work with our regional people to meet with their clients and prospects," he remembers. When any corporation sold out, with the help of Goldman Sachs or any other firm, Zuckerberg and his team would call on every important stockholder within twenty-four hours of the deal—usually first thing the very next morning. Zuckerberg recalls, "Dick told me the secret—in fact, he insisted on it: 'Go after the very rich. They're only different from everyone else in one single way: They have much more money. It's just as easy to sell to the very rich man as it is to sell to an ordinary account.' "

Soon Menschel had another idea: "You need a name! This business is becoming important, and every important business has a name." The business had simply been called Security Sales–Individual, to separate it from the dominant business, Security Sales–Institutional. Even the order tickets were "institutional"; designed for a cash-on-delivery institutional business, they were so complex that most individual customers found them frustrating. The business's comforting new name became Private Client Services.

In addition to going after more and more new accounts, Menschel and Zuckerberg thought strategically about how to organize and build a strong, scalable business for the firm. Adding clients often required a major educational job because the prospects knew so little about securities or the markets. They were not investors. They were and had always been business managers, and investing in securities was very different both objectively and subjectively. "Night after

night, I'd sit with a legal-size yellow pad and make long lists for myself of what we should do," Zuckerberg recalls.

By the early 1980s, Goldman Sachs was consistently one of the top three underwriters of negotiated municipal-bond issues. This meant PCS clients had plenty to choose from and could buy new bonds at wholesale prices (with sales compensation paid by the issuer). At the same time, strong individual-investor demand from PCS clients was great for the firm's reputation as an underwriter: PCS got broad distribution, and the bonds would often be held to maturity—not get sold back into the market.

In addition, the firm's solid equity research was well suited to the high end of the individual-investor market. Definitive reports on industries and leading companies could intrigue entrepreneurs leading smaller companies in the same business and showed how broad and deep the analysts' knowledge was. PCS salesmen would send research reports to people likely to be interested with a note such as, "Thought you'd be interested in George Owens's research. If you'd like to hear from George directly, we can set up a conference call." Finally, as Zuckerberg and his salesmen would explain to prospective clients, Goldman Sachs did not accept "retail" accounts; it took on personal business only if the account was very large and the individual was "qualified" for admission to what appeared to be a special insiders' club.

Later on, PCS got into real estate, tax-advantaged investments, and then private equity, international, and hedge funds. In private equity, the sales pitch was different: "How would you like to invest side-by-side with the partners of Goldman Sachs? They're the lead investors in this fund and are contributing twenty percent of the total." Adding another 10 percent to 20 percent from individuals was important in the sales process—it helped the firm preempt efforts by large institutions such as state pension funds to get a fee break in exchange for an early commitment. Year after year, the business grew larger and larger. As Zuckerberg recognized, "We had everything going for us."

Building on the process that had brought Zuckerberg in years before, Richard Menschel developed the core strategy that so differentiated PCS from the ordinary retail sales organization. Most stockbrokers were hiring college graduates, training them only to pass the basic New York Stock Exchange Series Seven exam, and then sending them out to sink or swim—with most sinking in a year

or so. Goldman Sachs recruited MBAs from top schools, people who were academically and motivationally equal to those who covered the major institutions as sales people. To achieve consistency in training and instill its culture, the firm took almost no laterals—while most competitors were poaching each other like crazy to bring over books of business. Goldman Sachs generally hired only those for whom PCS was their first serious job.

Hiring involved several rounds of interviews, always including some with partners, and all final interviews were in New York City. By the time a candidate was hired, she or he knew quite a few people and knew what to expect. PCS people received a salary and were given time, training, and a full array of support services.

At Goldman Sachs, training took six to nine months, compared to about ten weeks at other firms, and went from 7:30 a.m. to 7:30 p.m. every day. None of that time was spent on prepping for the Series Seven exam. That was to be done on your own time—on nights and weekends. Research got special emphasis, and each tyro would be given a month to master every aspect of two or three recommendations for presentation at group meetings. Friday night sessions often ran as late as nine thirty. Are you sufficiently dedicated? If you feel the firm is demanding, fine. Get used to it! The moment of truth for a trainee came in a role-playing test: Can you demonstrate that you know more than any other salesperson? This required mastering annual reports and 10-K reports and knowing the directors—all at least as well as an institutional salesperson.

The test of a relationship, the trainees learned, was this: Will the person take your call even when it's really inconvenient? During training, salespeople were advised to develop good relationships with as many internal Goldman Sachs people as possible so they could always call for help and gang-tackle situations.

So there would be no temptation to churn accounts, newly trained salespeople were not put on commission for a year or more—until they had built a large enough book of business to support their draw. Teaming was standard operating procedure—originally in pairs, but with more and more specialties like private equity, municipals, and options and other derivatives, teams of three or four were not unusual. Even for new-business solicitations, teams were used. A group of four specialists who worked well together would make a powerful and differentiating impression on a prospect.

The firm invested in continuing education, including regular two-day research seminars. It was expensive to take people out of sales production, fly them to New York, and put them up at a hotel, but it brought everyone together and generated bonding. (Anyone who missed would get a call.) Also, when firm analysts would visit the regional offices to meet with institutional investors over breakfast and lunch, a few PCS salespeople were invited to listen in.

Zuckerberg recruited people carefully and worked with them closely and individually to train them to be effective business producers. "We trained and trained so everyone knew and understood every product and how to use it. And we built pride and esprit de corps, so we had very low turnover, which meant a lot to the clients. We had great client loyalty to the firm and to the individuals in PCS. And that really helped us build a very solid, steady business on a very large scale."

Managers of regional offices—successful salespeople who showed an interest in management and were potential partners—were taken out of production and relied on Menschel's judgment for their compensation. Their job included recruiting stellar salespeople and helping new joiners develop their skills and their books of business. Managers were also expected to know as many clients as possible, particularly the more active and important clients in their region.

Only "significant" accounts were accepted. As Menschel and Zuckerberg said over and over, the only real difference between the affluent and the very rich is the size of their orders. In the seventies, an account had to have one million dollars in the market. Then it was five million dollars. Then ten million dollars.

Most retail stockbrokers try to cover two hundred or more accounts and assume they'll lose and replace 20 percent of them a year, so they go for major commission-generating turnover in the accounts while they have them. But at PCS, losing an account was like an earthquake, because the strategy was to have only a small number of major accounts—as few as twenty—but to keep all of them forever. The typical brokerage customer who stays with one firm will go through six different representatives in a decade. At PCS, the strategy was to have such capable salespeople that they kept clients so long that they really got to know their hopes, fears, worries, and predilections—and attended their family weddings and bar mitzvahs—with a clear focus on understanding their needs and expectations.

Selling is all about listening, and listening is partly about being quiet and paying close attention and partly about asking good questions to learn the real meaning and feelings behind the words. Good listeners give people the feeling that they are "in it together" and "on the same side of the table" and comfortable with each other. In the seventies partner Gene Fife noted that the developer of Pringles potato chips had just sold his company for eighty million dollars. It was too late for Goldman Sachs to be his seller representative, but the firm could become his investment adviser. So, with one of Zuckerberg's PCS salesmen, he went to Idaho Falls and from there to a remote fishing camp for an afternoon and dinner, an overnight stay, and a hearty breakfast. Conversation ranged over many, many topics, but no business was discussed. Two other New York firms' representatives who were soliciting the business made similar visits. A month later, Fife's telephone rang. "Well, Gene, you've got the business."

"Well, that's just great! Thank you so very much! I'll arrange to have one of our best people come out and take care of the necessary arrangements."

"Don't you want to know why you won?"

"Oh, sure. Why?"

"The missus and I talked it all over. You and the other two groups all talked the same, looked the same, and dressed the same," . . . pause . . . "but after dinner, you pitched in to clean up and wash the dishes. That was different. We felt you were really listening and understanding us as people—so we felt comfortable with you. And that's why you won the business."

Zuckerberg recognized early that the key to success in PCS was being effective not so much in investing assets as in gathering assets—attracting clients. "The secret is that there is no secret," he says. "Show people that you really care. Be sensitive to people's needs and their tolerance for risk. The clients we want are all smart, way too smart for any baloney. And they get lots of calls from all the other firms, so they have lots of choices. They know they'll get pretty smart people at any firm, so they look for something meaningfully special. And that special something is understanding what they really want—and that we care."

He adds: "I made it clear that I would go at any time to any city for a luncheon or a dinner with a prospective client and often would bring along a guest speaker such as Lee Cooperman, our investment strategist, or a top research analyst. And when I say go anywhere, that includes Boise, Topeka, Little Rock,

and Shreveport. For years, I traveled a lot to smaller cities most people have only heard about, and I ate a lot of meals with PCS prospects and clients, building relationships and building our reputation in each of these communities. We built the business the old-fashioned way—one relationship at a time."

The years 1972–73 were a growth period for PCS, but in the severe bear market that followed, Zuckerberg—who took it all very personally—was discouraged. Bob Rubin chose that time to ask how much business volume was being done, and Zuckerberg said, "Six million dollars." Rubin's response was just what Zuckerberg needed to hear: "That's pretty good these days, particularly in a new business." Zuckerberg looks back on that simple exchange and smiles: "Bob's reaction was very important to my staying focused on PCS." With Zuckerberg's focus, PCS grew steadily—up nearly 20 percent a year for more than fifteen years. With over 375 PCS account reps—three hundred in the United States and nearly one hundred overseas—managing seventy-five billion dollars in assets, revenues grew from six million dollars in 1974 to $220 million by 1990. That carried Zuckerberg to the management committee. By 1998, PCS revenues exceeded one billion dollars.

Along with the surging revenues, PCS reported strong profits all the time. With larger and larger balances in clients' margin accounts, PCS earned important profits on the spread between the rate charged to customers and the firm's cost of funding. Another layer of profits came from the stock-loan business. The firm found more and more ways to earn profits from Private Client Services—brokerage commissions, dealer spreads, underwriting fees, private-equity management fees, interest-rate spreads, stock lending, foreign-exchange spreads. And PCS helped the firm's investment bankers by having large amounts of controlled business that could be delivered to "make it happen" on important underwritings. Zuckerberg and his legions kept adding more and more accounts. "I always believed everyone would eventually want to do business with Goldman Sachs," says Zuckerberg.

His efforts to build up the margin-account business had drawn early resistance within the group: Oh no, Roy, if one of our customers can't afford to pay cash for his purchase of shares, then that's not the kind of customer business we

really want to have. Exasperated, Zuckerberg explained that if a customer used margin to double the number of shares purchased, PCS would get double the commissions—with no increase in costs or sales effort—and would also earn extra income through the fees on the margin balance. Later the services developed for PCS would be adapted to service hedge funds and create another stream of profits.

PCS's well-organized, well-managed, almost automated process of business development depended heavily on personal contact through carefully orchestrated dinners. Often the speaker was Cooperman, who was a great "switch hitter": He could give an erudite, statistics-laden disquisition on the economy and portfolio strategy, or he could switch over to hilarious Jewish jokes or do both, as suited the particular audience. Another part of the process was the systematic collection of information so every call built on all prior calls. For every guest, a briefing memo—telling everything anyone could find out—was required. "By reviewing those files before the dinner, we knew what we didn't know and what we should be finding out. After every client and prospect dinner or luncheon meeting, we met to decide how we would follow up on our conversations with each guest and to add any significant new information to our understanding of their situation and interests. If you know what you're looking for, your chances of finding it are pretty good."

After one of those many dinners—this one in Tulsa—Zuckerberg had his team sit down right after the guests had gone home to review each guest so they could add to their notes anything they had learned about that guest's financial situation and interests or concerns and how best to improve PCS's business prospects. When they got to a Mr. Livingstone, Zuckerberg called out his name.

"He didn't come, Roy."

"Any idea why not?"

"This club is restricted."

"How could you possibly have decided to host a Goldman Sachs dinner at a club that's restricted? That's embarrassing! And dumb! Call Mr. Livingstone right now and apologize."

"It's after nine, Roy."

"I don't care. Call him, I want to speak with him and apologize for putting him in such an awful, embarrassing position."

The call was made; Mr. Livingstone came on the line, and Zuckerberg apologized profusely. Mr. Livingstone said not to worry. Zuckerberg said he'd like to meet Mr. Livingstone and apologize in person. Mr. Livingstone said that was not at all necessary—but if Zuckerberg really wanted to come out, he'd be welcome for breakfast. Before accepting, he should know that the Livingstones were early risers and breakfast would be at 7 a.m.

The next morning, Zuckerberg was up very early and made the 7 a.m. breakfast. On the walls were pictures of Mr. Livingstone with Golda Meir, with David Ben-Gurion, and with others—always clearly in Tulsa, the headquarters for LVO Corporation, Mr. Livingstone's company. The breakfast was cordial, and Livingstone eventually became a good client. Zuckerberg's takeaway: "Fix it! Everybody makes mistakes. Whenever you make one, fix it right away."

PCS became a key part of Goldman Sachs's international expansion strategy. Since there are rich and well-connected people in almost every part of the world, each PCS salesperson could make himself profitable on his own initiative. And wealthy people could often provide entrée to promising leads to investment banking opportunities, particularly with the midsize, privately owned companies that are important everywhere. PCS added strength in Europe and was Goldman Sachs's "first mover" in Asia. Joe Sassoon, hired by Zuckerberg in 1979 as he was completing his PhD at Oxford, recruited other good people to PCS in each of Europe's major countries and built a large European private-client business. Sassoon took a philosophical approach: "Wealthy people are difficult to deal with. Most are, of course, older and understandably tend to be defensive, particularly about their personal wealth. They know they cannot live forever and this reality is always on their minds, so they often come across as complainers. And, of course, as wealthy people, they have gotten used to being given lots of attention and rather expect it, particularly in regard to their wealth, which has often become their last focus of attention."

PCS opened in Hong Kong, Tokyo, and Singapore—and in Miami, which linked the firm to accounts in Brazil, Venezuela, and the rest of Latin America. In the early 1990s, it became clear that non-U.S. clients would like having a Swiss bank and numbered accounts, so the firm acquired a bank and two years later got a license to run it as Goldman Sachs Bank.

As a result of Menschel's careful recruiting and the economic advantages of

his business model, PCS continued to have low turnover and high morale. Like all retail brokers, the people in PCS were paid entirely on commission, and they were making real money: On a payout of 30 percent of gross commissions—one of the lowest percentage payouts on Wall Street—personal incomes of two million dollars were not unusual for brokers with no managerial responsibilities, and some earned even more. This did not go unnoticed by the partners, who typically earned two million dollars to five million dollars a year and had to spend time in management and recruiting, activities that were recognized as important for firm building but took them away from making more money.

Complaints began to arise around the firm that the highly paid PCS salesmen were trading off the reputation of Goldman Sachs while their investment results were not always "firm standard" in quality or consistency. So the firm began to monitor account-by-account performance, with particular focus on potential risks and portfolio turnover. The source of the worst investment ideas was soon discovered: Most came directly from the customers.

Goldman Sachs was understandably happy, even a little complacent, about the progress of PCS. In 1989 Bob Rubin asked for an analysis of PCS's profitability. The results were clear: PCS was a money spinner. Profit margins were consistently 22 percent to 23 percent. But in any multidivisional business like Goldman Sachs, with large core costs allocated to revenue-producing units, the profitability of individual operations can be changed a lot by changes in the allocations of those core costs—costs like the multimillions spent on research, which were then allocated to the operating units. After Zuckerberg left the firm in 1998, John McNulty arranged to merge PCS into the still-not-profitable business of Goldman Sachs Asset Management, and allocations of support costs were "revisited." When the allocations to PCS were recalculated, PCS was declared "not really profitable." In another reallocation, profits on bond purchases by PCS clients were shunted away from PCS and over to the dealers making each bond's market. "I don't believe I ever witnessed a larger reduction in business value," was Lloyd Blankfein's summary of the impact of reevaluating PCS.

In 1999–2000, Phil Murphy, the new head of PCS, reorganized compensation to align individual incentives with the firm's objectives. This typically cut pay-

out ratios to brokers from 30 percent to 20 percent. This reduction and realignment caused dozens of PCS salesmen to look at moving to other firms that were trying to break into the wealthy individual investor business. Other firms offered gross commissions as high as 40 percent—in some cases well above the firm's new payout—to attract major producers to leave PCS. While most chose to stay, some of the most productive PCS brokers checked the market for their capabilities and traded themselves to Merrill Lynch, Morgan Stanley, UBS, or Bear Stearns after commanding rich signing bonuses as well as higher commissions. The leaving was often unhappy, even bitter.

With a substantial reduction in its profitability and with both Zuckerberg and his successor Bill Buckley leaving the partnership, it was almost inevitable that the whole concept of PCS would be challenged—and reinvented. McNulty and Murphy led the transformation. "The PCS business model was flawed," said McNulty. "At the end of the year you had to start all over again. We were paid by the number of transaction tickets written—and paid very well for placing IPOs. But that was not an investment-advisory business." The PCS salespeople thought they were asset managers, but they were actually confusing two very different businesses. The first business was based on developing personal trust and personal relationships, which they were good at, but from the firm's perspective, PCS was too dependent on those individuals. The second business was the investment business. PCS was a series of personal proprietorships, but it was not a scalable, manageable business, and the real "owners" of the business were the individual PCS people, not the firm.

As McNulty explained, "The PCS people were not all great portfolio architects or great stock pickers or great investment strategists—and the world of investing was developing skills and expectations of capability and professionalism that were rapidly outpacing them." McNulty and Murphy converted PCS from the entrepreneurial business model developed by Zuckerberg and Menschel into a corporate design in which PCS people were "asset gatherers" and the investing was increasingly done by the firm through GSAM and firm-sponsored funds.

Some very large accounts—particularly those with assets over one hundred million dollars and poor results—were taken away from individual salesmen and made firm accounts. Investment management was shifted away from the individual PCS salesman in two ways: The investment "product" was broadened to include more asset classes and made more consistent—less dependent on the

individual PCS salesman. An "open architecture" approach to product sourcing brought investing capabilities from outside GSAM.[2]

After he retired, Zuckerberg went to the firm's office at 7:45 one morning in 2004 and was surprised to see what was now called the Private Wealth Management area almost empty. "Where is everybody? Where are all the people?" Someone heard him, knew who he was, and understood what he meant: "Roy, it's different now."

And so it is. Now everyone is part of a large organizational effort, and the role of the PCS people is concentrated on bringing in the accounts and servicing them. Other people, chosen because they were professional investment managers, would run the money. Goldman Sachs has a highly profitable, scalable business, PCS people get paid well, and the profits are more predictable. Within the firm, some miss the old PCS hustle, but most believe it's all just as well.

Goldman Sachs has produced two important businesses out of PCS. Private Wealth Management, serving wealthy families and individuals with a wide array of investment products produced both by Goldman Sachs and by an array of outside investment managers, became one of the best among the firm's many businesses when it was expanded globally. And an even better business—if not the best of all businesses that came out of PCS—is prime brokerage.

In the spring of 1983, based on the work being done for one client—Steinhardt, a hedge fund assigned to PCS because it used margin-account borrowing and required special handling—Roy Zuckerberg had an idea. It got him so excited that he felt he had to discuss it with someone—someone who could take it from a mere thought into a really good business. Zuckerberg called Dan Stanton, who was managing the Boston regional office, a proven business builder and good with people.[3] "Dan, if you were presented with the right opportunity, would you be willing to make a change?" Stanton said he liked what he was doing, but yes, he would move for the right opportunity. Zuckerberg said, "I'm coming up to Boston to see you. Let's meet in the Café at the Ritz-Carlton tomorrow morning." That next morning, the two men were in deep conversation, with Zuckerberg drawing squares and lines on a paper napkin to make his points.

"We do a lot with Mike Steinhardt. We could do the same, and more, for

other hedge funds if we package it properly, deliver the service properly, and price it properly." Morgan Stanley was already doing what Zuckerberg had in mind—coordinating the many specialized financial services that hedge funds require—for Julian Robertson at Tiger Fund and for George Soros. Bear Stearns was doing part of it, but its business model was based on its clearing brokerage business for the smaller regional firms and wasn't really right for the hedge funds. Zuckerberg was enthusiastic: "This is going to be big because hedge funds are going to be big. More hedge funds are being organized all the time, and they are going to keep growing because the compensation economics are so compelling." Stanton was at least as interested as Zuckerberg.

Hedge funds manage their assets very intensively, so they need accurate reports on their positions every day and accurate, swift clearance of all their trades, many of which are complex. Margin lending is important for all hedge funds because they use leverage boldly, and margin-lending brokers need to know exactly how much good collateral each hedge fund has to support its borrowing. It makes no sense for a hedge fund to work with twenty or thirty different brokers and try to consolidate all their reports into one database when all that work can be done by one "prime" broker who can keep accurate daily records for the hedge fund of what it is doing with all its separate brokers. Because hedge funds trade so actively in all sorts of securities, serving as a prime broker is operationally exacting and depends on sophisticated computer capabilities—capabilities that can easily cost one hundred million dollars every year. Developing the capacity to find and deliver securities that the hedge fund is selling short is essential. Easy in concept, this can be hard in day-to-day practice. "We travel the world to develop supply and make an unrelenting drive for superb relationships with the master trustee custodians who supervise most securities assets," explains Stanton. Short-term cash balances—both credit and debit—stay with the custodian broker, who earns some interest income on the funds every day, including Saturdays and Sundays. The prime-brokerage business has grown almost as rapidly as the hedge-fund business. In the seven years from 1993 to 2001, total hedge-fund assets multiplied six times from one hundred billion dollars to six hundred billion dollars; they will probably triple again by 2010. The funds' record-keeping computers are integrated with the firm's computers so the work can be done machine to machine. Securities lending is the key product in the prime-brokerage

business. Since borrowing hard-to-find securities could also be critical to the firm's proprietary-trading desks, their heads didn't want the prime-brokerage operation to lend securities to the hedge funds. Others argued that preventing this would be a subsidy to the "prop" desks. As one proprietary trader said, "If we really need a subsidy, we shouldn't be in this business." Prime Brokerage kept the right to lend securities.

"Every real business has a name," said partner David Silfen, like Dick Menschel before him. "So you should come up with a good name for your business, Dan." Stanton thought for a while and proposed "Global Securities Services," or "GSS." Since "GS" often stood for "Goldman Sachs," many people thought the name must be Goldman Sachs Services. "There was a lot of confusion about the name, but no confusion about the business of making money for Goldman Sachs."

Stanton and his group were making bigger and bigger profits, but nobody in senior management seemed to know or care. Ed Spiegel, a leader in equity sales, proudly introduced his partner: "This is Dan Stanton. He runs our back office." Almost nobody came down from the executive offices on the twenty-eighth or twenty-ninth floor to visit GSS on the seventh floor. Among the partners, John Thain got it. Hank Paulson knew he should have had more of an understanding but felt he never had the time. Yet even as the profitability and the compensation in Equities kept getting squeezed, the profitability of GSS kept rising over the years. By the millennium, the status of being in GSS was equal to that of being in Equities, if not higher. For a while, it was disconcerting for many at the firm to know that GSS people without MBAs were making more money than Harvard MBAs in other divisions, but profits always drive power and status in the firm. Today being in GSS is clearly high status, so talented, ambitious people are migrating there.

"Being underappreciated and ignored by the top brass, who really didn't understand our business, was a real benefit—because they left us alone," says Stanton. "Even during the '94 cost cutting—or should I say, cost slashing—we refused to ease off on our commitment to recruit the very best people and deliver the very best service. And we never backed off on our absolute commitment to information technology—never, even when everyone else was taking a blowtorch to IT." That commitment has really paid off in building Goldman Sachs

a great business. When Thain and John Thornton, serving as co-COOs, conducted a "Q&Q" study in 2000, to measure the quantity and quality of earnings in every business of the firm, two lines of business stood out: M&A and GSS.

GSS is a Warren Buffett dream come true—a simple, great business with a wide, impenetrable protective moat around it. GSS has it all: rapid, steady annual growth of nearly 40 percent, compounded; high—very high—profit margins; and few competitors and tall barriers to competitive entry because the huge computer costs make a large scale of operations essential to be cost-competitive. Even more important, the service is absolutely necessary to the customer, the cost to the customer is tiny compared to the value delivered, and the service and how it's delivered are opaque, so there's almost no pressure to reduce fees. That's why it would make no sense for the market leaders—Goldman Sachs and Morgan Stanley—to compete with each other aggressively on price. Even as volume has multiplied many, many times, prices have eased down only 20 percent since the late nineties. Finally, the extensive network of working relationships is crucial in the all-important core of the business, securities lending. As Stanton says, "It can't get any better than this."

15

J. ARON

UGLY DUCKLING

Bob Rubin looked up slowly from the business plan he held in his hand and, as usual, spoke softly: "Mark, you'll have to set your sights higher—a *lot* higher."

Two years before, Rubin had put Mark Winkelman in charge of the commodities firm J. Aron, Goldman Sachs's first important acquisition in half a century. After years of increasingly lush profits before the acquisition, J. Aron had faltered badly. It lost money in its first year as part of Goldman Sachs, and with lots of work and many changes had just barely climbed back into the black with a five-million-dollar profit. In his business plan for the coming year, Winkelman had been aiming to stay in the black—and *double* profits to ten million dollars.

Smiling sympathetically, Rubin handed Winkelman's business plan back to him. "Mark, ten million dollars is *not* why we bought J. Aron. Tell us what we need to do to make profits of a hundred million *this* year!"

"What?"

Mark Winkelman was brilliant, but he had no idea what Rubin might be thinking. He was dumbfounded. Even with his extraordinary respect for Rubin's

judgment, he couldn't believe Rubin was really serious. But the look in Rubin's eyes said he was very serious.

Winkelman had gotten to his new position circuitously. Born in the Netherlands, he studied economics at Rotterdam and then went to Wharton in 1971, having persuaded a Dutch company to pay his way in exchange for a ten-year commitment to work for the company after graduation. Before taking up that offer, however, he got a scholarship at Wharton, so he was able to cover his own costs. What's more, he recalls, "Even more fortunately for me, I met a girl in a very short skirt on my second day—and we are now married." After Wharton, Winkelman worked briefly for a small firm in Cambridge, Massachusetts, on bond-arbitrage software and then at the World Bank in the innovative finance unit run by Gene Rothberg.

Frank Smeal brought Winkelman—described by colleagues as brainy, rigorous, fair, and very Dutch—from the World Bank in 1977 to start a Goldman Sachs operation in interest-rate-futures arbitrage, a fast-changing business.[1] The key to success in the bond business had switched from service to disciplined risk taking, and each dealer had to figure out for himself how profoundly the markets had changed with derivatives and globalization. Winkelman's mission was to install and develop an options and arbitrage capability for the bond business and to work with the traders.

Five years later, "my switch into commodities looked like a fairly dumb move to most people," acknowledges Winkelman. Bonds were booming, and the big positive market trends seemed sure to continue. In contrast, gold—which was crucial to J. Aron's business—had peaked briefly at $850 an ounce when Russia invaded Afghanistan, the global political world seemed out of control, and Jimmy Carter seemed out of his depth. Fed chairman Paul Volcker's clampdown on inflation propelled interest rates and money-market volatility to record levels. Then, as calm returned to the markets, the price of gold came down—plunging to three hundred dollars. Gold's price volatility dropped even more than the price, evaporating almost all opportunity to profit from trading against changes in prices.

Because it was so obviously a career-risking move, Winkelman was advised by peers: "I wouldn't switch if I were you." But Winkelman had a private reason to switch: The competition between him and Jon Corzine in fixed income had

become too intense. Winkelman's success was a persistent problem for Corzine, and their working relationship was increasingly strained. "At first, we were like two young bulls, pawing the ground and looking for ways to dominate," Winkelman recalls, though he adds that over time they made their differences mesh pretty well and became successfully interdependent.

Commodities were not entirely new to Goldman Sachs. In the late seventies, the commodities industry was enjoying the best and final years of a long-term cyclical boom in coffee, grains, silver, gold, and particularly oil, where prices were way up due to OPEC, while the securities business had been slowly going downhill for years; the Dow stood at 1,000 in both 1966 and 1982, sixteen years later. As an industry expert[2] observed, "Everybody saw opportunities in commodities." In 1980, Rubin hired Dan Amstutz, a grain trader, to develop a small agricultural commodities business within the arbitrage department, reflecting Rubin's considerable curiosity about how different money businesses worked.

Winkelman had been developing another small commodities-trading business at Goldman Sachs as one of Bob Rubin's R&D initiatives when he heard the November 1981 announcement of the firm's acquisition of J. Aron. He resolved to quit. How could he hope to make his career now, with six J. Aron people, all deeply experienced in commodities, suddenly being made Goldman Sachs partners and one even going onto the management committee? With that many partners competing with him, Winkelman saw his career as hopelessly stuck in a big traffic jam.

"Mark, don't be foolish," counseled John Whitehead. "You'll be part of the biggest and best commodities business in the world. Commodities are far more international than securities, and this whole firm is going international. You'll have a superb international perspective. J. Aron is a great platform for a rising young star like you, and this is a major strategic thrust for the firm, so you'll soon see we are doing you a favor. You can ride this big wave to great things. So roll up your sleeves and get to work."

John Weinberg was even more direct: "Don't be stupid! I understand that you're angry about this sudden change, and I can see why. We're not sure just how yet, but we're going to make something important out of this business."

"Sit tight. Let's wait and see," was Bob Rubin's noncommittal but encouraging advice. "The next election of partners is in just one year. How bad can it be to wait a year to see?" Winkelman decided to stay.

Then the Two Johns, Weinberg and Whitehead, made everything perfectly clear: J. Aron was an important opportunity—for Winkelman and for the firm. "You will go to J. Aron." Somewhat intimidated and yet pleased to be given this responsibility, Winkelman dove into every salient aspect of the operation. Two years later, he developed the budget he thought appropriately bold, the one that drew Rubin's astonishing response: "Tell us what we need to do to make a profit of a hundred million *this* year!"

"Bob Rubin had a very soft touch with words and as a manager, usually making his quiet suggestions by asking questions," recalls Winkelman. "His approach worked best with people who were personally modest, intellectually open, and comfortable with genuine doubt. If you weren't this kind of person—and many traders weren't even close—Bob would simply move on until he found someone he could really work with." Rubin set the right tone of understatement to make his challenge clear and compelling to Winkelman.

In his revised business plan, Winkelman took J. Aron aggressively into currency trading with the firm's capital at risk. With this change, the unit's profits in its third year as part of Goldman Sachs were actually well *over* one hundred million dollars—and a few years later, were well over one billion, no less than one-third of Goldman Sachs's total profits—with only three hundred employees in a firm of six thousand.*

The firm's eventual success in commodities was certainly not created by the acquisition of J. Aron. Success was achieved only through massive changes in every important dimension of the business *after* the acquisition. Most of the people and all the business leaders were changed, and the basic risk-controlled financial arbitrage business model was changed into a capital-at-risk proprietary business model. However, as disappointing and painful as the first few years' financial results were, the acquisition did bring to Goldman Sachs a cadre of traders and a trading culture that would become dominant in the firm—and the man who would become its CEO.

* J. Aron contributed an estimated 40 percent of firm earnings in 1990, roughly one-third in 1991, and 35 percent in 1992, primarily from foreign-exchange and petroleum trading. Though 1990 was a poor profit year in the securities industry, with the help of J. Aron, Goldman Sachs earned record profits. *Wall Street Journal*, November 9, 1992.

Still, the path from here to there would have to be figured out and major changes made. Over the next several years, even the markets in which J. Aron operated were changed as J. Aron moved boldly into foreign exchange and oil trading. These changes required reinventing the business and the business concepts. Profit opportunity in the gold-trading business was basically a function of bullion's price volatility and financial-markets arbitrage, so J. Aron had needed little capital and enjoyed a high rate of return on the capital it did invest.

As a matter of policy, J. Aron seldom went long or short on gold bullion or tried to profit on an inventory position. Profits were made principally by arbitraging the changing spread between the London bullion market and the new futures markets. Growth in these profits came from increasing market volatility and trading volume.

In a typical day as an independent firm, J. Aron had done one thousand trades in the morning and three thousand trades in the afternoon—carefully matching its long and short positions within *seconds* to be sure the firm was never much exposed to market risk. "Our plan of operation called for being long or short up to a maximum of twenty seconds," explained Jack Aron. If ever there was any serious doubt—once or twice a year—the whole firm would stop doing any business with a command like, "Okay, everybody! Shut off the phones immediately! We're doing a one-hundred-percent books-to-cards check to be *sure* we have absolutely no net positions." The complete analysis could take until nine or ten at night.

J. Aron began as a coffee trader in New Orleans in 1898 with ten thousand dollars in capital, prospered, and moved to New York in 1910. Jack Aron and Gus Levy were distant relatives who became friends in their early days in both New Orleans and New York City, and both were leaders at Mount Sinai Hospital and in the Jewish community. Their two firms did occasional business together, so Levy had been interested when Aron called on him in the late sixties to say, "Gus, I'm getting old. My two sons have no real interest in the business. Our two firms are both private. So if you'd like to buy, I'd like to sell."

After some discussions, a large tax liability on an unrealized gain at J. Aron got in the way, and Levy's interest in a deal quickly faded. Later, when Jack Aron took another tentative Goldman Sachs offer to his partners, the deal was voted down by the younger J. Aron partners in a move led by Herb Coyne. Coyne was shrewd, consistently pragmatic, and never sentimental, famously saying, "Hon-

esty is *one* of the best policies" and leaving it to his listeners to guess which policies he might think were equally good. Coyne was an astute strategist focused on the goal of maximizing wealth. By then Aron was in his seventies and had moved away from the business to concentrate on his charitable foundation, so it was not hard for the two men to agree on an internal management buyout and arrange the sale of the firm to Coyne, his brother Marty, and twelve other shareholders.

George Doty had gotten to know J. Aron partners when he was working with them to create low-cost income-tax deferrals for Goldman Sachs partners based on "straddles" in commodities futures. He became a strong proponent of acquiring a commodities firm because he believed Goldman Sachs should get into the business, yet he didn't believe it had the necessary perseverance as a partnership: One group of partners would have had to make the several years of costly investment spending and building that would be needed to get established, knowing that any returns on those investments would go mostly to their successors. In any case, Doty would never have favored a "build our own" entry strategy because it would entail, as he exclaimed several times, "too much risk!"

In what must have seemed like a very lucky break, Herb Coyne approached Goldman Sachs just two years after the J. Aron partners had bought out Jack Aron and his two sons, and asked the firm to try to find a buyer. Before almost anyone else, Coyne had figured out the probable impact of the new futures markets on both the gold-bullion and the foreign-exchange markets. Almost simultaneously, another fortunate coincidence developed: In September 1981, Engelhard Minerals proposed—through Goldman Sachs—an acquisition of J. Aron, but the controlling partners of J. Aron refused. They were not interested in signing long-term employment contracts or being part of a public company.

J. Aron partners were unwilling to give up their cherished privacy—particularly when profits were spectacularly large. To avoid attracting competition, Coyne imposed specific rules of secrecy: "Don't tell *anyone* where you're going, who you're seeing, or what you've heard—ever!" His partners all agreed: "Never tell anyone how much money you make—just smile as you walk to the bank." As one J. Aron partner readily conceded, "The way we made money was so simple, anyone could do it—so we were sworn to secrecy."

J. Aron had expanded in the late sixties from coffee into precious-metals trading and began growing rapidly and very profitably. After a recapitalization

shrank the partnership capital to four hundred thousand dollars, profits mushroomed through the seventies and lifted the partnership capital to one hundred million dollars by 1981. That year, J. Aron made profits of sixty million dollars on its capital of one hundred million dollars—similar in ratio to Goldman Sachs's profits that year of $150 million on partners' capital of $272 million—but Goldman Sachs had earned its profits by taking much greater market and credit risks than J. Aron had taken.

The two firms were vastly different in style and culture. Coyne had recently begun hiring "top of their class" lawyers because the business had become so complex that only the most astute analysts could stay ahead of the markets through creativity, but J. Aron had for many past years promoted clerks with only high school education—including Herb Coyne's former driver—*not* Harvard MBAs. If they were smart, tough, and ambitious, lack of education didn't matter. J. Aron remained an autocratic, hierarchical pecking order, with recent hires ordered to fetch lunch for slightly more senior people. In contrast, Goldman Sachs was all about teamwork in a relatively flat organization that believed in at least fifteen preemployment interviews and thought graduate degrees from top-tier schools were essential. Goldman Sachs prized modesty, even humility. At J. Aron, the consensus was totally different: "We were convinced we were the smartest people in the universe because we were making all that money," recalls a former partner. "There was a hubris that just infected the place." Goldman Sachs investment bankers prized deferential client service and were always polite, but at J. Aron traders spoke just as crudely as traders always have about customers. While the larger accounts were accorded deferential respect, small accounts were assigned to juniors who could get them little more than price quotes and transactions.

J. Aron was in three different businesses, and acquisition advocates at Goldman Sachs saw opportunities in all three: first, gold, silver, platinum, and palladium, plus a range of small positions in other commodities; second, a small business in foreign exchange; and third, coffee, where it clearly ranked number one in the world as an importer of unroasted green coffee. As Whitehead recalls: "J. Aron was a unique opportunity with unusual attractions. In gold, J. Aron was a world leader. Gold trades in more daily volume than anything else—more than General Electric stock or General Motors stock, for example—particularly in the Arab world."

There were opportunities to expand in other agricultural commodities such

as cocoa, corn, and other grains, building on J. Aron's strength in coffee, where it acted as selling agent for coffee growers and as buying agent for General Foods and Folgers, among others. And there were opportunities to develop the profitability of the business by engaging in directly associated activities such as shipping, insurance, and warehousing in Brazil and New York City—all without taking on price risk. As Whitehead saw it, "We could control the whole process—and if someone tried to compete on price in any one function, we could simply bring our pricing down below his for that particular function and move our profit making to another part of the chain. We would have complete control. And by selling to roasters at the same time we bought from the growers, we would have no price risk."

Interbank foreign-exchange dealing was another opportunity, but Doty had no interest: "Leave it to the commercial banks! They'll do FX for *nothing*. You'll never be able to make any real money in a business they'll always dominate." But J. Aron was already active in the fledgling currency-futures markets, which commercial banks were ignoring, and in arbitraging the fluctuating spreads between futures and the cash market.

During their two years of ownership, Herb Coyne and his group had built up the metals business and made three particularly clever moves. First, as an ever-curious intellectual who loved to figure things out, Coyne learned that the central banks of many nations kept their currency reserves in gold bars stored in the vaults of the Bank of England in London or the New York Federal Reserve Bank. Taken together, all this great wealth of nations had what Coyne saw as one fascinating characteristic: It earned zero return. It just sat in the vaults. But Coyne knew that the time value of money *always* figured into any futures contract and that the forward markets in commodities always reflected implicit interest rates, so he called on the central bankers in one country after another and made what appeared to be a generous and innovative offer: "Lend me your sterile bars of gold bullion and I'll pay you a fee of half of one percent every year!"

The banks were familiar with J. Aron's large business in gold and its reputation for absolute integrity and meticulous care, so they saw J. Aron as a no-risk counterparty and the 0.5 percent fee as found money. Even a small country would have two hundred million dollars in gold reserves, so Coyne's deal would take that country's annual income on its gold bars up from zero to one million dollars. The central bank of Austria, after a long series of meetings at which each aspect

of the arrangement was carefully explained and pondered, finally signed up.[3] It was soon followed by the central banks of Hungary and Mexico. Others, like Portugal, followed later.*

Coyne knew what the central bankers did not know: J. Aron could create a near-perfect hedge by selling short the borrowed gold and buying gold futures (which incorporated the high interest rates of those years) for an annualized profit as high as 8 percent on the matched book.[4] That was 8 percent on a risk-free matched book that required almost no equity capital, so it produced a nearly infinite rate of return. J. Aron's strong relationships with many central banks were the keys to this magic kingdom of profits, because the central banks had virtually unlimited reservoirs of gold-bullion reserves and could keep supplying the market to match any volume of demand.

In a second clever innovation, J. Aron created and ran a highly profitable sideline business selling gold coins minted in Mexico, Russia, Canada, and South Africa—for which it sold over one million Krugerrands. The margins were not large, but J. Aron acted only as an agent: The governments owned and stored the inventory; there was no competition and virtually no costs of operation. Again, the return on capital was nearly infinite.

Coyne's third business strategy was particularly astute and venturesome. Driven by Herbert and Bunker Hunt's remarkable speculative efforts to corner the world silver market, silver bullion was selling at record prices in 1980, and people everywhere were responding by trying to melt down the family silver to make tradable bullion bars and capture the unusual spread in prices between silver in flatware and pure silver bars. But to do this required refining. Anticipating that demand for silver refining capacity would continue to rise, Coyne contacted major smelters, including Europe's largest,[5] and asked for price quotes on future capacity. Given a set price and anticipating strong demand, he signed binding contracts for virtually all the refiners' worldwide future capacity. This was a brilliant stroke and a masterful speculation on a grand scale. Since J. Aron had already prebooked the refineries, everyone had to come to it and pay a big premium to get scrap silver refined. J. Aron made another killing.

The profits from letting speculators pay up to buy scarce refining capacity

* An alternative arrangement for these central banks was to give them dollars—for ninety days—equal to the value of the gold turned over to J. Aron so they could invest those dollars as they wished.

and the profits from borrowing gold-bullion bars from central banks were rich, but that could not and would not continue forever, as Coyne fully understood. The short-run bonanza masked the major problem that was rapidly developing in J. Aron's basic business. Commercial banks were becoming increasingly active competitors in commodities, and they instinctively swept cash balances automatically every day to invest them at the prevailing 10 percent–plus interest rates. Most corporate and individual customers had instead let cash balances build up, allowing J. Aron to invest those cash balances in the money market and keep the interest earned for itself. At the same time, improved worldwide communications were taking the information-processing time required to complete a trade down from an hour for a cabled instruction to just one second for electronics—reducing uncertainties and squeezing core profitability. In addition, Paul Volcker's determined drive against inflation had pushed interest rates up to record levels, provoking a recession, which in turn calmed the market volatility in gold prices that had been so profitable for traders like J. Aron.

"The Coyne brothers knew their business was in trouble, but they could not see a way out. They didn't have a clue—not a clue—about how to get out of the trap they'd put themselves into," says Winkelman. "The profits of the physicals-versus-futures [arbitrage] business were evaporating. That's the only business they really knew. They had no understanding of how to shape their firm into a major risk-taking, capital-based business—and that had become the only way to go."

Coyne had seen other firms like his take capital risks and get wiped out. He knew his organization didn't have the ability to run an aggressive risk-based business; he and his senior partners were not up to date with new instruments, like currency options, that were just starting to trade and were major potential profit makers. So it was a good time for him to cash in, become part of a much larger business organization, and hope to find ways then to make even more money.

Coyne made his most important strategic move when he reinitiated merger discussions with George Doty at Goldman Sachs—just when Salomon Brothers was combining with the commodities giant Phillips Brothers, known as Phibro.[6] Through his work with Doty on tax shelters for Goldman Sachs partners, Coyne knew how very profitable the firm was. And he succeeded in selling J. Aron to Goldman Sachs at the absolute peak of its earnings.

Strong opposition to making the acquisition came from Goldman Sachs

partners: "That's *not* our business"; "Commodities aren't securities"; "If they want to sell, why should we be their buyer? We'll just be patsies." But as debate within the partnership kept postponing the decision—and risking J. Aron's doing a deal with some other organization—the recognition of the moderate risk of loss if things went wrong became increasingly persuasive. With the agreed purchase price of $135 million offset by book value of one hundred million dollars—almost all in cash and cash equivalents—serious risk seemed small. "Since risky trading positions were minimized because traders simultaneously matched buy and sell interests," explains Whitehead, "the operation was virtually risk-free." Whitehead's strategic interest in internationalizing Goldman Sachs kept his focus on a macro vision—and away from the rigorous operational analysis for which he was well known. "Gold trading involves every country in the world, so it's the most *international* of businesses, and at Goldman Sachs we were expanding internationally." Whitehead was determined to acquire J. Aron as one part of internationalizing the firm and as a signature transaction that would permanently change Goldman Sachs.

"We had a terrible time getting the acquisition approved by our own people," recalls Whitehead, "so I assigned Steve Friedman and Ken Brody to study the merits of the acquisition, believing that since Steve worked for me and was ambitious to advance, his report would make a solid, positive case for making the acquisition. But he surprised me by recommending against acquiring J. Aron." But it really didn't matter what others said or thought, because Doty and Whitehead were determined, and they drove it through the all-powerful management committee in October 1981.

"I was never in favor of buying a business," says Friedman. "From my M&A experience, I knew that mergers are always hard and often don't work out. It's not that they actually fail financially, but they underperform and disappoint relative to expectations because the organizational cultures don't fit together. Conflicts and tensions are so easy to have and cultures are so very hard to integrate, and Goldman Sachs has a very strong, very different culture. We would always be better off building our own because the key to success is always people and we have the best people—*lots* of best people."* Ironically, given Friedman's observation, after the acquisition only one person—Mark Winkelman—was transferred from Goldman

* After the problems with J. Aron showed how difficult acquisitions could be, John Weinberg decided against acquiring any investment managers and said, "We'll build the investment business ourselves."

Sachs into J. Aron, while several J. Aron people would become leaders in Goldman Sachs and one, Lloyd Blankfein, would eventually become the firm's CEO.

A few weeks after the acquisition—while Goldman Sachs was striving to make the J. Aron people feel part of the family—J. Aron's CFO, Charles Griffith, went to see Doty to say, "George, I'm going to resign—unless I can become a partner." Doty and Whitehead quickly agreed that he would have to be made a partner. That certainly did not go down easily with all those who had been competing for years to earn a Goldman Sachs partnership—particularly after seeing six other J. Aron people made partners as part of the deal. One of the cardinal firm rules was that nobody should *ever* threaten to leave if not taken into the partnership. Partners were made only by the firm and only when the firm was ready.

These postmerger problems were disturbing, but certainly not as disconcerting as the core problems with the J. Aron business. Even though the deal was done, as more and more difficulties developed, opponents within Goldman Sachs were convinced that the acquisition of J. Aron was based on a collection of mistakes in both strategy and tactics. Some of the erupting difficulties were due to errors, even serious errors, but some were due to unexpected external problems. Most partners didn't bother to sort out the two kinds of trouble; the whole experience was too painful. As one partner lamented, "We made every mistake in this merger that we always worried clients would make in their mergers."

One mistake was to react to a competitor's move and impute a threatening reason for that move. Although some had seen Salomon Brothers's link with Phibro as a strategic master stroke, in fact that merger had not been driven by any grand strategy: It was really just a great trade—a chance for the partners of Salomon Brothers, a private firm, to sell out and get 100 percent liquid at a high price. Another mistake was for innocent observers to develop an almost romantic vision of another firm's having both low business risk and unlimited opportunity while seeing commodities as a hedge against the adversities inflation might impose on the securities business. Another was to assume that Gus Levy's interest in the J. Aron deal had been strategic when it was really closer to opportunistic. Another was not knowing how and where the profits were really being made and not realizing how serious the misunderstandings based on this innocence could be. The two firms' cultures, styles, and values were not only different; they would be in open conflict and would make integration difficult.

Mistakes would include losing key executives early on; not having a clear strategy for increasing profits after the deal was done; paying up front rather than obligating the sellers to an earn-out; and tying up precious capital and management time. The classic mistake was not understanding the true motivation of the sellers and not remembering that most "acquisitions" are not *purchases* driven by the interests of the buyer, but are *sales* driven by seller motivations that the buyers learn about only long after the deal is done. Misreadings were also important at J. Aron, where Coyne had somehow expected to become the leader of the combined J. Aron–Goldman Sachs organization and to have his partners in major leadership roles.

Goldman Sachs did not really understand the J. Aron business, but the sellers certainly did. As one J. Aron partner later observed, "It would have been a very difficult time if we had not sold the business."[7]

In less than a year, J. Aron's record profits were cut in half, and a year later there were losses. With tens of millions of dollars of Goldman Sachs partners' capital locked up in this one acquisition, the added opportunity cost of not using that money in the firm's own highly profitable proprietary trading businesses was over thirty million dollars a year.

Opposition to the acquisition was fanned back into flames. In addition to a major capital commitment, many Goldman Sachs partners had thought the nonfinancial cost of the acquisition was way too high: Many insiders resented Marvin Schur, who headed the coffee business, being made a member of the management committee and five "outsiders" suddenly being made full partners. It certainly didn't help that after a year of experience, as others soon found out, John Weinberg didn't much like the J. Aron guys. And they didn't like Goldman Sachs. One of J. Aron's seniors was explicit: "I don't really *want* to be your partner." He was being honest, but what a way to try combining two organizations! Then profits suddenly plunged because "soft" commodities like coffee were cyclical and commercial banks and other securities dealers moved into the hard-commodities business of gold and precious-metals trading just when market volatility dropped, taking margins down from 0.5 percent to just $^{1}/_{32}$ of 1 percent.

When Doty retired, responsibility for supervision of J. Aron passed to Bob Rubin, who made just one change in the J. Aron organization: He replaced Ron Tauber with Mark Winkelman as CEO. Rubin and Winkelman soon decided that

J. Aron's COO, a lawyer, had to go and that overhead was way too large because many people who had appeared to be profit makers when gold volatility was high were not moneymakers in more normal markets. With help from the internal leaders they identified at J. Aron, Rubin and Winkelman cleared out the last of J. Aron's old guard—Aron's younger stars saw that as a breath of fresh air—and cut the staff by 50 percent. "J. Aron was in real trouble," recalls Winkelman. "Costs had to be cut back sharply, and cutting costs meant cutting people—something Goldman Sachs traditionally did not do." To control the pain, it was agreed to do all the terminations on one day—to get it over quickly instead of stretching it out—and that each person would be privately informed by his direct supervisor unless that supervisor was also being fired. "Because George Doty and the Two Johns were in a different building and J. Aron was still a separate organization, doing all these terminations was considered okay. We were fighting for our very existence and we had to cleanse the culture from a bootlicking family-run business," recalls Winkelman. "After half a dozen years at J. Aron, I still was known as the smart-ass that knows how to fire people."

While he was terminating many, many people—ultimately 130 of J. Aron's 230 employees were identified as redundant—Winkelman made one eventually crucial decision to go the other way and keep a young man who had already been turned away by Goldman Sachs. Lloyd Blankfein—son of a postal clerk, who went through Harvard College and Harvard Law School on scholarships—had been hired as a personal assistant by Herb Coyne in the summer of 1982. "The place was lousy with lawyers," recalls a J. Aron colleague. "Lloyd was hired because lawyers know how to work hard and could explain to clients new instruments like options and complex trading strategies. Lloyd was and is funny—one of the most naturally funny people in the world—warm and real. We all knew Lloyd was the guy, and Mark Winkelman soon had that figured out."

There were more departures. In less than a year, Marvin Schur and Herb Coyne both discovered—not at all surprisingly to skeptics within Goldman Sachs—that they had serious health problems. The day after the merger was completed, Coyne had complained of a pain in his chest. Within a year, Schur was not feeling well either. Soon both men retired. As Goldman Sachs partner Lee Cooperman says sardonically, "With chest pains and forty million dollars apiece in the bank, who wouldn't?"

Within J. Aron, which had had only six major owners, it had been understood for some years that share ownership was going to be redistributed so everyone in management would be an owner. But young, brainy natural leaders who were well trained and would become the real leaders of J. Aron under Winkelman—and ten senior people who had been promised a stake—were not included in the sale of the firm. Bitter people know little loyalty. People who were counting on that "share the wealth" proposition felt badly jerked around when the Coyne brothers sold the firm out from under them. A week after the deal, two key J. Aron employees left for Drexel Burnham Lambert and took with them their business—the business of renting gold bars from Central and Eastern European, African, and Latin American central banks—determined to compete for the business aggressively in every way, including price. This quickly clobbered J. Aron's lush profits in the "gold loan" business.

Expectations of repetitive thirty- to thirty-five-million-dollar annual risk-free profits from J. Aron now seemed a chimera. "Internally the traditional J. Aron business was going through the wringer," recalls Winkelman, "and it looked as though profits would *never* come back." The prices of gold and silver came down and kept falling. Competitors like Drexel Burnham cut into the central-bank gold-bar lending business by offering to pay higher interest rates and taking market share. As volatility subsided, commercial banks got into gold trading and cut the profit margins on that business. The pressure was really on.

The Two Johns made a very visible and personal pledge to the partnership: "We'll take care of this situation." They met every week with Winkelman, not to discuss trading but to explore possible business strategies and management decisions. "At first, I thought it would be difficult—a real punishment," recalls Winkelman, "but soon I realized that it was a golden opportunity. First, I saw what a great strategic vision John Whitehead had and how important that was. Second, we got a lot of exposure to the firm's real leaders. They got personally involved to be *sure* we would eventually solve the many problems at J. Aron—and there were *lots* of problems." With low volume and narrow spreads, the real question was whether a commodities business needed the big overheads of a large organization or whether it could operate with a small group of skillful traders.

During that difficult period, the naysayers within the firm were having a field day. Not only, they told management, have you—apparently just to keep

up with the Joneses at Salomon-Phibro—bought a business we don't understand and really don't need, and lost a pile of money and tied up a lot of capital, you now want to send good money after bad to build up a trading business by making markets almost none of us know anything about with customers we know very little about—and care less about. It's the wrong business, at the wrong price, done for the wrong reason at the wrong time. And now you want to build up an even larger risk exposure and capital commitment to do a bad business with the wrong accounts!

Whitehead and Weinberg understood what had to be done: a complete redesign of every aspect of the old business model. "In foreign exchange, J. Aron's business model was modest and deliberately cautious. This was all wrong for the market as it was developing, and we realized we had to start over," recalls Winkelman, who began asking himself a series of fundamental questions, including the one that led to a breakthrough: "What if we risk our capital and work as *dealers?*" Rubin and Winkelman agreed on that strategic imperative: The firm would have to commit substantial capital to the business and switch to boldly embracing risk in a capital-intensive, risk-taking principal business on a global scale. To make serious money, the firm would have to take serious risks, trading commodities for its own account.

When acquired, J. Aron was described as "a leading gold and commodity trading firm";[8] by the time, less than a decade later, that J. Aron was contributing one-third of Goldman Sachs's profits, it was making most of its money not in gold and general commodities, but in foreign exchange and oil trading. After twenty years—admittedly twenty long years—coffee trading also worked out well.

After Coyne left at the end of 1982, Blankfein was suddenly without a specific job. "But he was quite promising and wasn't paid all that much," recalls Winkelman, "so we moved him into sales in metals to see if he might work out. He was clearly bright and energetic, even dynamic and passionate." Blankfein demonstrated good sales talents in metals, so Winkelman gave him more responsibility in 1984 by putting him in charge of the six salesmen in foreign exchange. Winkelman had been advocating a sales effort to try building an advice-based business with corporations. Later he also put Blankfein in charge of foreign-exchange trading.

Winkelman was advised against that move. "Mark," cautioned Bob Rubin,

"that's probably not the right thing to do. We've never seen it work to put salespeople in charge of trading in other areas of the firm. Are you pretty sure of your analysis?"

"Really appreciate your experience, Bob, but I think he'll do all right. Lloyd's driven, and he is a very smart guy with a very inquiring mind, so I have some confidence."

What Winkelman didn't know was that Blankfein was an occasional visitor to gambling casinos, fascinated by the discipline of poker and very used to winning. Blankfein was determined to learn all he could and surrounded himself with traders and economists. As Winkelman had advised him, he practiced by taking small trading positions to develop his skills in timing and his feel for the markets while working to learn, learn, and learn.

"Fortunately, the global commodities business was growing rapidly in volume, and strategic changes are always easier to make in a growth situation," recalls Winkelman. Not only the scale, but also the very nature of the commodities business was changing as derivatives kept displacing physicals and thousands of new participants came into the markets.

We should do oil," announced Bob Rubin one morning in the eighties, having noticed Phibro's volume in crude oil and oil futures. The same sort of change was coming to oil trading that had come to foreign exchange in the seventies, as long-term fixed-rate contracts were displaced by markets in options and futures. "Phibro is big in oil, so let's look there for good people." But after looking over a few Phibro oil traders and deciding they'd never fit into Goldman Sachs, Rubin decided to focus recruiting on traders working at major nonfinancial companies and hired John Drury, head oil-products trader at Cargill's European subsidiary. While he couldn't fit in culturally and was soon eased out of Goldman Sachs, before he left, Drury set up an effective organization, hired some good people, and brought others over to oil trading from the declining metals business.

Oil is not completely fungible, like wheat or gold, so it can't be swapped or exchanged in the same way. Oil trading is operationally intensive because each forward contract is a specific link in a long chain of transactions involving one

specific tanker load. Each contract is unique and has to be cleared, step by step, through that same entire chain. "We went into oil trading in 1983–84 with all the market-making and operational difficulties you might imagine," recalls Winkelman, "but we did better that year—instead of another loss of six million dollars, we made a profit of eighteen million. I was feeling pretty proud and confident in the future of the business and felt good about the approach we were taking. But I was only a second-year partner, so in preparing for the annual planning meeting of the partners in December, I turned to Bob Rubin for help, and he laid out his vision for the business and his expectations for the coming year or two."

Currency-options trading was just getting started on the International Monetary Market. With his early understanding of the equity-options market, Rubin pressed for more and more commitment to developing new currency-options instruments and making markets in them. He understood that while "early stages" volume would be light, margins would be wide and that the best time to establish Goldman Sachs as a major market maker was early—at the creation of the markets. Currency-options trading was still too small for the big commercial banks, and they had not participated in equity options and had no related business experience, so they stayed away, while Winkelman's J. Aron made ten million dollars in this niche business in 1984 and twenty million dollars in 1985. Winkelman wasn't satisfied. While it was fine to make six million dollars trading on the 1985 Plaza Accord, an agreement by the G5 industrial nations to stop the dollar's increasing in value against the yen and the German mark, he recognized that the firm could have made—and, he thought, should have made—sixty million dollars.

The metals-trading business model was also changing substantially, but it didn't really matter because overall market volume was way down, and, as Winkelman says, "It's hard to make large profits in a dying business."

After replacing eighty percent to ninety percent of management, J. Aron is in a very different business than the one we acquired," says a continuing skeptic. "The partners of Goldman Sachs would not say the acquisition itself was a good deal."

Whitehead takes a different view: "We never would have ventured into any of those highly profitable businesses without the J. Aron acquisition, and

the worldwide nature of the commodities businesses contributed importantly to the firm's going global." Others go further and say it was the best acquisition the firm ever made—partly because of the profits, partly because of the people who became firm leaders, and partly for the firmwide commitment to proprietary trading and to an entrepreneurial trading style that blossomed under Winkelman, Rubin, and Blankfein. As pension funds expanded their investment in international stocks and bonds and became major buyers and sellers of currencies, as major changes in exchange rates wrenched the money markets, as oil prices and trading volume surged, as commodities moved to record prices on record volumes, each created a bonanza for J. Aron and Goldman Sachs.

Lloyd Blankfein came to believe that as the profitability of the traditional agency business faded away, the DNA of commercial instincts essential to risk-taking principal trading that were first spawned at J. Aron became vital to Goldman Sachs as it reinvented itself as a profit-creating, risk-taking global financial intermediary.

16

TENDER DEFENSE, A MAGIC CARPET

Call me as soon as possible—no matter how late—Bob Hurst."

When Steve Friedman got back to his apartment after a long dinner in 1974, he got the message and called Hurst, who had just joined the firm.[1] "Steve, opportunity is knocking if we act very quickly. When I was at Merrill Lynch before coming over to the firm, I covered Electric Storage Battery Corporation in Philadelphia and got to know their people and their business pretty well. They're being raided—by International Nickel. And get this: Inco's being advised by Morgan Stanley!"

"Are they asking for help?"

"No. Nobody's called us. They may not know it yet, but ESB is in real trouble, and they are going to need a lot of help from somebody. So let's make that somebody *us*. I called on their CEO just two days ago and warned him pretty bluntly that if he were in the UK instead of the U.S. he would get raided because his stock is selling at such a cheap price relative to liquid assets. Steve, I think we should be at ESB's office first thing tomorrow morning so we'll be the first to *offer* help. They may not realize it yet, but they do need us—and will soon recognize their need. Can you go with me?"

"What time does the first morning train leave Penn Station?"

Friedman and Hurst were on that train and spent most of the next week in Philadelphia working with Electric Storage Battery, trying to find the best way out—and each day buying new sets of shirts, shorts, and socks at a nearby Brooks Brothers. "We couldn't protect ESB's independence," says Friedman, "but we could and did get them a much higher price and a friendly merger with a white knight."

The combination of many components into a new kind of business may look obvious in retrospect. And as the parts are actually coming together, the combination may look like just good luck. But for people with an entrepreneurial mind-set, putting different pieces together to gain a competitive advantage can become a habitual way of thinking. For Goldman Sachs, what became known as tender defense—and proved to be a major vehicle for the firm's strategic advancement in investment banking—combined several components: Whitehead's Investment Banking Services organization had become fully operational with a large, aggressive, and increasingly experienced sales force hungry for products and services to offer its clients and hundreds of prospective clients; the phenomenon of large corporations' repetitively acquiring other companies was accelerating and would become a major force in the nation's capital markets; institutional investors were ready to respond swiftly with large blocks of stock to attractive takeover offers; arbitrageurs were increasingly large, active, and forceful market participants; Goldman Sachs, thanks to the recent work of partners Corbin Day, Steve Friedman, and Geoff Boisi, was developing a credible reputation in mergers and acquisitions; and because of its long-standing policy against advising on hostile takeovers, Goldman Sachs had been building its skills, experience, and reputation for integrity as the one Wall Street firm that was always on management's side.

"Goldman Sachs's policy on no hostiles was based on the simple proposition that, in most cases, they just don't work," explains Whitehead. "The very act of a hostile takeover will alienate the management of the acquired company: Many will be embittered and will quit. Those that stay on will have gone through an unhappy, adversarial confrontation—in public, with real damage done. It

usually begins with a meeting that comes as an unwelcome surprise. The target company's shares are almost always in a slump, usually selling for less than book value. The intended acquirer opens the initial meeting with a general observation that a combination of the two companies would surely be quite favorable for everyone and then proceeds to propose several specific actions to realize the fine opportunities for synergy and to increase profits. But of course, none of these actions or ideas appeals to the target company's management, so they decline the invitation to merge and the meeting breaks up."

But not for long. As Whitehead recounts it, "The very next day, in an obviously *previously* well-planned attack that is in clear contrast to the assertions of friendly cooperation made the day before, large advertisements appear in all the newspapers delineating the gross incompetence, strategic blunders, and persistent errors of the present management and offering to rescue shareholders with a bid some 20 percent over the current market price. Various judgmental comments are made in private and in public about the obvious inadequacies of incumbent management. Then the target's management responds in similar tones or worse—and the fight is on. And it gets worse and worse as time goes on. If the target company resists, the acquisitor will step up the pressure, usually disparaging the current management and its past record, sometimes quite forcefully and publicly. Vitriol comes easily. Things are said under pressure, some quite bitter and hurtful, that are very hard to forget later on."

After all that, what are the real chances of the two managements working well together? "Not very great," Whitehead says. "So most hostile takeovers do eventually fail. The act of taking over often does real damage. So we decided against being involved in hostile takeovers—partly as a matter of business ethics, but primarily as a matter of business judgment. And over the years, we earned a reputation as a firm that could truly be trusted and couldn't be bought and was, perhaps, more focused on ethics and judgment. So companies increasingly often came to us on their own initiative, seeking our advice and assistance. And quite a few chose to retain Goldman Sachs to advise them on the ways they could prevent, or at least greatly impede, a hostile attempt at takeover. Overall, it did work out very well: Goldman Sachs prospered commercially, and our reputation grew as a good firm to do business with."

The firm got paid its full retainer each year whether or not the client got

raided. For a giant corporation, while a hostile takeover was clearly unlikely, the annual fee seemed so small and the subject so new and important that signing on was an easy "why not?" matter. As Fred Weintz recalls, "This business fit in with our image as a firm and our desire to be seen always on the same side of the table as our client, and it fit with the firm's long history of seller representation—helping owners whose companies were ready for sale decide whether to have a public offering or merge into a larger company." Friedman summarizes: "And it worked well as a business."

But not at the beginning. Even the name wasn't clear. Friedman favored—and still does—the more explicit and graphic term "raid defense," and others preferred "takeover defense," but Whitehead, ever the statesman in public, decided on using the softer, more mellow euphemism: "tender defense." At first Friedman argued that the firm could work on both sides, but Whitehead said no. Some were cautious at first because the mechanics could get pretty complex pretty fast and nobody in IBS wanted to be embarrassed by not fully understanding the complexities. But IBS guys loved to sell it. The fee was low and known up front. Every prospective client welcomed the offer. Many were scared that they might be next.

The firm's no-hostiles policy fit perfectly with its increasing emphasis on "exclusive seller representation," a business Whitehead had innovated and advocated as far superior to conventional business brokerage—both in business decorum and, even better, in profit to the firm—because it was not competitive and was fee-based, and because success could earn significant incentive fees. "Seller rep" was particularly well suited to Goldman Sachs's extensive relationships, created by its increasingly effective IBS business developers, with smaller and mid-size companies, often privately owned or dominated by an owner-manager. When leadership succession or business strategy problems were serious difficulties, it was not unusual for an owner to solve his business problem by selling. Goldman Sachs conscientiously developed a premier reputation for getting a higher than expected price—which the IBS organization would be sure to recount to its many future prospects. So Goldman Sachs was unusually well positioned to take advantage of opportunity when it came as a result of change in federal antitrust policy.

For Wall Street, the business of advising on mergers and acquisitions—"M&A" in the patois of the financial markets—for a large fee had begun to bloom

at a very specific time: the day in 1981 when a Stanford Law School professor, William Baxter, told Ronald Reagan's recruiters, "I'll take the job as assistant attorney general, but only if I can change the basic framing of antitrust policy." His proposition was accepted, and six months later he put out entirely new policy guidelines on how markets and market dominance should be defined—guidelines that were much more tolerant of mergers. Then, in industry after industry, one company tried making an acquisition and then, when the Antitrust Division did not complain or intervene, another company would make an acquisition—and soon it seemed that everyone got into acquiring and merging. This led to giant fees for Wall Street for advising on mergers and acquisitions—and then to Wall Street's taking the initiative and proposing acquisitions and mergers to expansionist companies in one industry after another.

Serving too few of the nation's largest corporations had for years been a major frustration for Sidney Weinberg, whose strategic objective had always been to build Goldman Sachs into a leading investment bank—which ipso facto meant serving the largest and leading corporations. But Morgan Stanley, First Boston, Dillon Read, and Lehman Brothers were almost unassailable in their positions as investment bankers to most of the major blue-chip corporations, so Goldman Sachs would have to build most of its business with medium-size and smaller companies, and these companies were a lot more likely to be takeover *targets*. But now, with tender defense, what had been a problem suddenly became an opportunity. Since Goldman Sachs's clients were much more likely to be targets needing help with their defenses, the firm was much less likely than others to face conflicts of interest when offering advice on defense, because most of its clients were too small to be the attacking raiders. Goldman Sachs could make a virtue out of its competitive weakness and decided to make a major push in tender defense. Friedman says, "We had a bloodlust to go up in front of boards of directors."

The pathway leading to Bob Hurst's "call me as soon as possible" message began a few months before with a surprise. The Ronson lighter company, a well-established Goldman Sachs client, suddenly became the target of an unwanted takeover bid by a European conglomerate. This was a new kind of experience: new to Ronson, new to America, and new to Goldman Sachs. Scrambling

to find a possible white knight that might outbid the European predator, one of the companies the firm decided to call on was Electric Storage Battery. As Hurst recalls, "My first call for Goldman Sachs was on Electric Storage Battery, one of my old Merrill Lynch clients: a sleepy midsize company with several fine products, including Ray-O-Vac and Duracell batteries, and a stock price selling below net current assets. My main purpose in calling on ESB was to see if they might be interested in buying Ronson, but during that visit, I warned CEO Fred Port that his own company was vulnerable to a potential takeover because the share price was so very low."

Three months later, on a Thursday, International Nickel, one of Canada's most respected companies, with a fine credit rating, made a takeover bid for ESB through Morgan Stanley. This was America's first hostile takeover bid advised by a major "blue blood" investment banking firm. And coming as it did from Morgan Stanley, then *the* prestige firm in the business, it threw out the old rule book, which had said that respectable investment bankers simply did not conduct hostile raids on other companies. If Morgan Stanley could and would do a raid, all the old assumptions against raids were over and the gloves were off. From then on, any investment banker could advise any corporate client on anything and, with perfect impunity, *everybody* could do a raid.

In the mid-seventies, by law, a cash tender offer had to be accepted or rejected by the target company's board of directors in no more than eight days. This made time-urgency a major factor for both the raider and the target company. The laws would be changed, but in 1974 time pressure was very real, particularly for the unprepared—which is why cash tenders were called Saturday night specials.

"ESB was totally unprepared—and I was totally unprepared," recalls Hurst. "I'd been on vacation on Cape Cod in a little cottage with no electricity and no phone. On Thursday, I decided to walk into town, in shorts and barefoot, to mail a letter and call the office. By the end of that day, I was in Manhattan waiting for Steve to return my call." And early the next morning, Hurst was in Philadelphia with Friedman. They were closeted with the ESB people, trying to figure out ways to block Inco. Friedman recalls: "Blocking Inco meant blocking Bob Greenhill of Morgan Stanley and Joe Flom of Skadden Arps, two of the best talents in the business. We didn't know what to do. Inventing and improvising, we made it up as we went along. But we were committed, smart, and determined.

Fortunately for us and for ESB, as unprepared as we were, nobody else really knew what to do either, so there were no rules of the road."

Inco's initial offer was twenty-seven dollars a share. United Technologies—then still called United Aircraft—was brought in by Goldman Sachs as the white knight, and a deal was finally done. Inco prevailed but paid forty-one dollars, more than 50 percent above its initial "generous" offer. As Friedman says, "We may have 'lost'—although, ironically, that acquisition later turned out to be a real turkey for Inco—but our client won a major improvement in price and we got great press coverage for all the good work we'd done, plus a nice fee. And smart people in the marketplace got the crucial message: Goldman Sachs is a good firm to have in your corner when the going gets really tough."

A few weeks later, Houston's Apache Oil Company got raided. Friedman phoned: "Can we help?" "No need for any help, thank you. We'll be okay on our own." Wait a day and call again: "Can we help?" "No need, thank you." Then wait another day and call *again*. After being told "No, thanks" twenty times, the reply became, "Okay, come on over." Back to Brooks Brothers again—and again.

Friedman, Whitehead, and partner Jim Gorter were all sensing that a pattern was starting to emerge, and just possibly a new line of business could be developed. Sangamo Electric was an early tender-defense client. Arthur Highland, Jim Gorter's near neighbor, was son-in-law to Sangamo's major owner and president of the company—an ideal combination for getting the business. As Highland got off his plane one day, a raider handed him an envelope with the takeover "offer" inside. Highland called Gorter, explained the situation, said, "We've got one hell of a problem," and asked the obvious question: "What'll we do?" "Lots!" came the immediate and confident reply. Years later, Gorter reflects, "He was quick to see Goldman Sachs in the role of his defender. And we were ready to help. It was perfect."

Friedman flew to Chicago's O'Hare Airport and drove to Gorter's home on the North Shore. The two men sat by the pool to talk out what the real business opportunity might be and how Goldman Sachs could take full advantage of it. Could the firm develop a significant, profitable business? How could it best be done? "Strategically, we soon realized that we were seeing what could be the first robin of a major transformational change," recalls Friedman. "The game and all

its rules were changing, maybe forever. We could tell that there would be more hostile takeovers bids—maybe *lots* more. So we knew we should get involved in a major way."

The two men began sketching out a business proposition, asking themselves: If a company has no ties to Wall Street, and management gets the call from a raider some Friday night, whom are they going to call? If they call their banker or lawyer and ask for a recommendation, whom will they suggest? Gorter and Friedman answered their own questions: If we're seen to be on the side of the angels, we'll get *all* those calls. As Whitehead later said, "Lawyers for a threatened company would certainly be encouraged to say, 'Why not retain Goldman Sachs—just for this one special service? They can be trusted.' So we got lots of mandates—often from companies we didn't know particularly well—and tender defense fit in with the firm's overall position of 'no conflicts with management' and the reality of Goldman Sachs's clients typically being smaller companies—and therefore acquisition targets. Tender defense worked out quite well as a business for Goldman Sachs. And our reputation grew as a firm that could truly be trusted and as a good firm with which to do business."

Late one night, Friedman and Boisi were at Joe Flom's law offices at Skadden Arps talking shop when an associate came in with an early copy of the next day's *New York Times* to show Flom a full-page advertisement they had placed on behalf of a client that was about to raid Garlock Paper of Rochester. As the lawyers talked excitedly about their ad and the deal, Friedman whispered to Boisi to call the IBS man who covered Rochester for Goldman Sachs: "Tell him to call Garlock and tell them two things: They will be raided tomorrow morning, and we are ready to help."

Geoff Boisi recalls the way the firm continued taking the initiative. From then on, he says, "at ten p.m. we'd jump in a cab and drive up Broadway to Nathan's Famous—not for hot dogs, but for the next day's *New York Times,* because we'd learned that a neighboring newsstand was the first place in the city to have tomorrow's *New York Times* for sale—and would quickly look for advertisements of tender offers. Then we'd call our IBS guy, any directors we might know, and the CEO. I remember calling the CEO of Hydro Metals in Houston—a company Goldman Sachs had never before called on—to tell him we would be in his office the very next morning to help him defend against a hostile takeover. He

was stunned: He hadn't heard a peep about being in danger. Our call was the first he heard that he was in a crisis. He didn't know any of us, but he sure treated us like long-lost friends when we arrived in Houston that next morning. In a raid defense situation like this, we'd take one secretary and one associate and *live* with our new client."

In 1974 interest rates were at record highs and stock prices were seriously depressed, so the middle-market companies Goldman Sachs had specialized in serving were unusually vulnerable to takeovers. With the Antitrust Division taking a much more laissez-faire approach to mergers, most public companies were unprepared for anything like a hostile raid. "They hadn't even reviewed their own bylaws," says Friedman. "They didn't know the differences in the takeover laws and regulations or the judicial decision histories between Delaware and New York. There were no poison-pill provisions. Companies—even likely takeover targets—had no plans for their own defense." To Friedman, "For acquisition-hungry predator corporations, it was like being the fox in the hen coop."

It worked well for Goldman Sachs too. When the balloon went up—a hostile takeover, launched in a dawn raid—and the battle began, directors wouldn't have the slightest idea what to do, so they would call their lawyers, and soon realize that the local lawyers had no good ideas about what to do—other than scrambling around, looking busy. Recalls Friedman, "We organized all the best ideas for action we could come up with and enlisted the two best lawyers in the field—Joe Flom and Marty Lipton—and went around the country from one board meeting to another explaining what we knew was going on. It was just like Chautauqua."

After Electric Storage Battery, hostile takeovers went from being rare to being normal and frequent. Takeovers could be proposed at any time by any investment banker, accelerated by institutional investors, and decided by arbitrageurs. Goldman Sachs was in close and regular contact with all three groups and understood their motivations and their capabilities. And Goldman Sachs's no-hostiles policy positioned the firm perfectly to be the knight in shining armor rushing to defend the frightened target company from the hostile aggressor's sneak attack.

"We couldn't recruit outstanding people or attract top guys from other areas of the firm until we launched Tender Defense in the early 1970s and it took our

M&A unit from being a small, arcane backwater to being the number one profit contributor in investment banking," recalls Friedman. "Still, we got a lot of resistance from inside the firm. The IBS guys, having had to overcome lots of 'new idea resistance' themselves just a few years before, might have reached out to help us launch Tender Defense but were instead major resisters, protesting: 'How can you expect me to go to my client and scare him to death about being taken over and losing his job?' We wanted a fee structure that had no incentives for us to sell the company, so we worked out a way to win in any of three outcomes. First, we'd win if we beat the raider off. Second, we could win by getting the raider to pay a higher price. And we would win if the target company got sold to another company—a white knight. Sometimes, of course, we soft-pedaled Tender Defense, preferring to get in on the arbitrage business instead." Goldman Sachs's arbitrageurs, led by Bob Rubin, often gave important help with market intelligence on the risks of a raid's developing and how it might develop.

An important part of Goldman Sachs's arsenal was its skill and bold strategies in negotiating the terms—particularly the price—of final deals. Friedman was particularly effective in takeover negotiations—always working to maximize the client's interests, particularly when the client was being too cautious. The management of Chicago's LaSalle Bank had decided to sell and had agreed internally on their number—the share price at which they would sell. ABN-Amro, a high-grade Dutch bank, got interested in buying a U.S. bank and entered into negotiations with LaSalle, and everything was soon agreed—except a price.

The Dutch came in with a nice price: thirty-two dollars a share, more than two dollars over LaSalle's management's "number." Management was more than pleased and about to say yes when Friedman said, "No, there's more here." "But thirty-two dollars is higher than our target number. Let's not risk losing the deal at thirty-two dollars." Gorter recalls the situation: "Steve was as cool as could be, saying, 'There's more in it for you.' And sure enough, after some intense negotiation with the Dutch, that's just what happened: Steve got them even more."

When a raid began, if the firm wasn't already involved, it would decide, based on the profit potential for Goldman Sachs, whether to concentrate on the arbitrage opportunities or to get involved as an adviser on defense—advising management on ways to monitor purchases by potentially hostile investors, knowing how to react and respond to a hostile bid, and recommending that the target company

retain as special counsel on takeovers either Skadden Arps or Wachtell Lipton. This, of course, did not go unnoticed by those two major law firms, so it was no surprise when they repeatedly recommended Goldman Sachs as the investment bank to use for this specialized service. The business soon began to pour in.

Goldman Sachs's offer to give a tender-defense presentation to a board of directors was easy for the management to accept. Declining was hard. Companies that worried about being raided and taken over were a lot more numerous than the companies that were actually raided, so with IBS advocating "at least give our experts one hearing" the tender-defense business expanded rapidly. Engaging the firm was made easy by the decision to price this new service at a modest annual fee of forty thousand to eighty thousand dollars. "We decided to charge a nominal annual retainer fee," recalls Whitehead. "We considered both twenty-five thousand and fifty thousand, but doubted we could get fifty thousand, so we went with forty thousand. And that's what the law firms charged, too. With fifty corporations as clients, we soon had a nice little business." The business required zero capital and little senior-banker time. With more than two hundred clients and annual revenues well over ten million dollars, the business was highly profitable.

Most directors of most corporations had little or no knowledge of any of the complex actions and possibilities for action that come together in a major corporate takeover. That might have seemed like bad news for Goldman Sachs—it meant the firm could have a fairly hard time explaining what it could do to help. But in fact it was great news, because Goldman Sachs would have every opportunity to be—and be perceived to be—real and compelling experts. Since hostile takeover raids were truly a life-and-death threat to executives' and directors' jobs, Goldman Sachs always got their absolute attention as it explained that any company with assets that were not carrying their own weight by generating adequate earnings was at real and very visible risk because a raider could sell off those very assets to raise money and pay a significant part of his purchase price with the target company's own assets. Several aggressive, change-minded CEOs had a special reason for inviting the firm to make presentations. They realized they could use the threat of a takeover to force through structural changes.

"Whenever senior management introduced us to a company's board of directors, either Marty Lipton or Joe Flom would present along with us," recalls

Friedman. "It was great. This was a subject on which we were suddenly experts, and it was a matter of actual life or death for the company. So we were in an ideal situation: Seen as experts on a crucial matter, we were clearly on the company's side, and we were talking to all the right people in each company. This automatically put us in the ideal pole position to compete for any future investment banking business and to develop a strong long-term relationship with that company. For investment bankers, it just doesn't get any better."

Goldman Sachs not only got paid its annual retainer fee for advising on tender defense, it won numerous mandates from its new clients to execute specific transactions because the best defense was often preemptive: Take the actions a raider might take *after* gaining control—such as selling off unrelated or unnecessary businesses—but do it *before* the raider made his first bid. If the value of a division was not reflected in the company's total market value, and a raider would probably sell it to raise money to help pay for the takeover, why wait? Sell that division *now*. The operations being divested were usually the result of a prior management's ad hoc or nonstrategic acquisitions, so selling was often painless. Of course, for every seller, there had to be a buyer, so many of these "clear the decks" divestitures earned the firm not one, but two fees—and often opened the door to another new corporate client relationship. M&A quickly went from being only incidental to a major investment banking relationship to being crucial. Geoff Boisi recalls, "Our total investment banking fees went up nearly a thousand times—from three million dollars to nearly two *billion*."

Over the next few years, Goldman Sachs enjoyed a decisive competitive advantage in developing new business relationships. With its refusal to take hostile takeover assignments—while its major competitors had all joined in that highly profitable business—Goldman Sachs repositioned itself as the trustworthy friend of corporations and management and established investment banking relationships with more and more of America's largest and most prestigious corporations. While competitors divided the lush fees for advising on individual hostile takeovers, Goldman Sachs was dominant in tender defense, developing relationships that would produce large fees for many years to come and would lift the firm to market leadership in investment banking. And that was not the end of it.

Inside Goldman Sachs, another major change was brought about by the tender-defense business. To organize and develop a proper defense for a corpo-

rate client, Goldman Sachs's tender-defense advisers drew on the expertise of sometimes as many as seven or eight different and previously quite separate and separately managed divisions of the firm: Arbitrage, Equity Research, Institutional Sales, Commercial Paper, Block Trading, Bonds, Options, Private Client Services. This kind of intense, multiunit cooperation in doing business was fairly new to the firm. In the past, each division had run its own business in its own way, reporting only final results to the management committee. How you ran your business was strictly your own business. Now, for the first time, teamwork within the silos would become teamwork across the silos, because tender defense called for and rewarded coordinated efforts across the several divisions. "Up until this time," says Friedman, "firmwide teamwork was honored more in the concept than in reality. As we struggled to gain recognition and competitive position, we built a tremendous internal team spirit, centered in M&A and fanning out to all areas of the firm. We called for help, insisted on getting it, and rewarded every part of the firm for helping us dominate the market. The time-urgency of tender defense forced us to work well together and rewarded working well together by our winning more often and getting paid more—and it was exciting, fun work. We realized we could be—and so we were absolutely determined to be—more expert, more experienced, and more effective than anyone else. When others were good, we drove ourselves to be better—and faster, more creative, and more hard-hitting. Just as Gus Levy wanted *every* block trade, our team wanted to be in on and win in *every* takeover."

Tender defense came at the perfect time for Goldman Sachs. The firm was ready to expand and upgrade its business from commercial paper and seller representation for middle-market companies. IBS was well organized and working effectively but was hungry for more product. Arbitrage and block trading were humming. Research was improving. If the firm hadn't made a bold and clever strategic move, it would have seen its mostly small and medium-size clients disappearing—one at a time, but steadily disappearing—but if it did make a bold and clever move, it could expand quite rapidly and profitably. When Goldman Sachs put together a "holistic" program of defensive tactics and strategies and went out on the road, tender defense became the firm's strategic magic carpet in investment banking—and eventually lifted Goldman Sachs above Morgan Stanley, First Boston, and Lehman Brothers. Part of the surge in competitive strength

came from the effectiveness of Whitehead's IBS organization. Part came as a result of vigorous recruiting. Part came from the emphasis on teamwork. Part came from Goldman Sachs's new commitment to entrepreneurial innovation, and part came because so many companies had reason to be afraid of being taken over by a hostile raider.

Being in the flow and active in one deal after another proved crucial to the firm's rapid expansion in tender defense because it gave Goldman Sachs the chance to be in on all the details of recent transactions, and that gave the firm great credibility. Having done the latest merger in an industry and being able to tell the specific details of each losing bidder's tactics and how it all played out gave the firm a big advantage when competing for the next deal in the same industry. And if there were a third deal in the same industry, the momentum could be unstoppable. "In pitching for business," recalls Friedman, "we also learned to be careful not to be dumb—like asking a forest-products company what a cruise [an inspection to estimate a tract's lumber potential] was or not understanding the lingo of the oil industry and innocently asking a *really* dumb question—which I did during an eight-course dinner at Antoine's in New Orleans. And when we came out, I was hit on the head by a huge bird-dropping from an overhead pigeon. It was so symbolic."

17

THE USES AND ABUSES OF RESEARCH

The research operation whose strategy Gus Levy later redirected began informally in the fifties. It was a sideline for one man who occasionally helped salesmen and a few customers with the important financial information he packed into the pages in his midsize, three-ring black notebook—information on the companies where Sidney Weinberg was a director. Nat Bowen never gave anyone his little black book to read, but he would use it to check the facts before offering "guidance" on current developments at the three dozen companies he tracked very carefully. Having all the facts on those companies was essential to Bowen; his job as assistant to Sidney Weinberg was to keep all the important data on Weinberg's companies in one place for quick reference so he could brief "Mr. Director" on financial and operating details just before each of his many board meetings. Bowen's briefings helped Weinberg greatly as he built his reputation for being the best-informed director at the many companies he served.

For salesmen Bowen considered sufficiently serious, he was willing to answer questions and to meet occasionally with their more thoughtful clients. Of course, in today's more regulated market Bowen would have been doling out prohibited

"insider information," but in the fifties the boundary lines were not only much less clearly defined, they were further apart on the behavior allowed. "Nat Bowen was a great help," remembers partner Bob Menschel. "We'd arrange quiet lunches with Nat and key accounts. While he wouldn't give away his little black book, he would consult the data he had packed inside and give broad indications of how a company was doing. Nat had all the facts, and the accounts knew it. So even though he said little, he knew his stuff and clients appreciated his perspective."[1]

Later in the fifties, the link between statisticians and sales began to be regularized, with George Boyer, a statistician, talking to the salesmen about companies and stocks in the late afternoon when there was no real business to be done because the stock market had closed for the day. Goldman Sachs still had very little franchise in underwriting or in research, so salesmen were always looking for an entry point with each institutional account. Superior research gave Goldman Sachs analysts and salesmen preferential access to the institutional analysts and portfolio managers who were making the decisions, and knowing in advance what stocks might be bought or sold helped Goldman Sachs increase its share of trading volume. Trading was where the profits were.

Research as a specific function at Goldman Sachs—and in Wall Street—developed slowly until the sixties. Security analysts—still called statisticians, many still wearing green eyeshades, and all relying on slide rules—were hired to provide useful data for investment banking and arbitrage. In the early sixties, as a series of research-boutique firms were formed to go after the rapidly expanding institutional stockbrokerage business, Bob Danforth agreed to organize a research department to provide research for institutional investors—but primarily to uncover attractive investment ideas for Goldman Sachs partners' personal accounts.* "The firm had only six or eight people in research," recalls Menschel. "Danforth covered paper, Nick Petrillo covered rails, and Lou Weston covered financials. We put out one four-page report each month: one page on rails, one on industrials, one on utilities, and one on financials." Since Danforth was far more interested in finding attractive personal investments for himself and the firm's

* Danforth was a canny stock picker who turned down a partnership invitation because he wanted to be free to invest his own account and use margin for leverage, which partners weren't allowed to do. After the boom years of the seventies and eighties, when Goldman Sachs was earning its reputation as Wall Street's most profitable firm, he acknowledged that the firm had done almost as well as he'd done on his own.

partners than in building and managing a business serving institutional investors, he concentrated on small, emerging growth stocks.

Promising as the potential price appreciation for these stocks might be, the big business of Goldman Sachs was not in *investing* in stocks. The firm's big and fast-growing business was in Gus Levy's business of *trading* stocks for clients and collecting commissions. Goldman Sachs could make much more money using its capital to finance a large, high-margin stockbrokerage business than it could ever hope to make through investing that capital in public stocks as a mere passive investor. (Similarly, the people who typically make the most money in the goldfields are not the miners, but the purveyors of blankets, food and drink, or mining tools.)

In 1967 a mathematician and computer whiz named Leslie Peck was hired to develop a mathematical model to predict corporate earnings. Peck had been head of operations research at Arthur D. Little, with tours at Los Alamos and the Institute for Advanced Study at Princeton, and had proved that most of the "technical" analysis then popular on Wall Street was useless hogwash. But building the model proved far too complicated, and the effort was given up. However, Peck did develop a simple computer model to predict changes in the prices of utility stocks based on a few standard measures of financial strength, such as the trend of earnings growth and a stock's customary dividend yield compared to all other utility stocks'. The reason his model worked was not rocket science but social science. In those days, new information in this slow-moving sector could take two or three years to be fully reflected in the stock prices, but the direction of change and an approximation of the magnitude of change were fairly easy to estimate because investors' evaluations were, eventually, consistent over time and across five dozen highly comparable regulated utilities.

The most effective research may have been done by Rudy Stanish, a Goldman Sachs dining room employee who, as a masterful crepes chef, was a welcome presence at all sorts of firm receptions and parties, preparing customized crepes for the mighty of finance and silently absorbing the names of specific stocks that smart, hardworking analysts and portfolio managers from all the leading institutions were most excited about. While waiting in line for Stanish to finish preparing their favorite crepes and omelets, investment experts from leading institutions, in

an understandable effort to impress their friends, would describe to one another their favorite stocks. If you had served an average of a hundred crepes and omelets a day for thirty years, while listening to the nation's best investors; bought and sold stocks with the smart consensus; and acted on a few tips partners might pass along to a loyal retainer who was always respectfully appreciative and discreet, you too might have accumulated a personal portfolio worth over ten million dollars—while preparing crepes and omelets actually as a sideline.

Responding to insistent demands from his largest block-trading accounts in the early seventies, Gus Levy called for a firmwide refocusing from midsize companies and "small-cap" stocks to extensive research coverage of the nation's larger companies, the companies that dominated institutional investors' portfolios and their trading—the area where Goldman Sachs was the disproportionate leader. As usual, Levy was impatient to see results.

The partners of Goldman Sachs were divided as to the best strategy for building up a research department to cover large companies. Some wanted to acquire a research-boutique firm, while others wanted to hire away the research department of another major firm. Both groups worried that hiring a full team of analysts one at a time would be too slow. Others argued that with intensive, one-at-a-time recruiting of people who would fit well with Goldman Sachs's culture and organization, the firm could create an all-star research department and avoid the we-they conflicts that so often afflict firms after a major merger. They pointed out that securities firms are remarkably "tribal" and most mergers go through a costly tribal "fight to the death" until one culture or tribe eventually dominates—usually at great cost to the organization. Goldman Sachs decided to recruit individual analysts who could fit into the firm's culture and concentrated on hiring young analysts with rapidly developing "franchise reputations" for expertise in specific industries. Once the core group was established, the firm would revert to the "grow our own" policy that characterized Goldman Sachs.

In retrospect, even though the securities business was under heavy pressure in the early seventies, the strategic buildup in research came at an ideal time. Covering large-cap stocks in research protected Levy's block-trading profit cornucopia, and research was key to IBS's refocus on major companies. Moreover, the firm's

steadily increasing profitability during the seventies—particularly in investment banking—made a major research organization affordable. "It was planned," insists Whitehead. "In a time of unsettled conditions on Wall Street, while others were economizing, we saw an opportunity to upgrade the quality of our research department. Our research was soon costing us about six million dollars a year, but we kept telling ourselves that our customers would find a way to pay us for it."

Deciding to hire franchise analysts and build the firm's own research department was one thing; actually doing it was another. Analysts are professional doubters and are particularly cautious about their own careers. The firm soon found that prospective recruits were asking skeptical questions about Goldman Sachs's true commitment to an institutional business—blunt questions like "Why should I trust you?" They pointed to other firms that had made large promises while hiring during favorable markets and had then fired all their newly hired analysts when the stock market and trading volume turned down and profits got squeezed. This concern was particularly strong when analysts were considering joining a firm that was, like Goldman Sachs, dominated by investment banking or trading, rather than agency brokerage. Analysts would have had their fears confirmed if they had heard George Doty say sardonically, "Research is like a parking lot for a movie theater. You have to have one, but it's not the business you're in."

Having decided that Goldman Sachs should have the best research on Wall Street, the firm's leaders gave partner Lee Cooperman the classic mandate: Do it! Cooperman, joined later by partner Bill Kealy, drove to get strong, independent thinkers and produce strong, independent research.

Partner Mike Armellino recalls, "With rising earnings, Goldman Sachs could and did stay with all its commitments to research, and fulfilled all its promises with regular actions." Each analyst was challenged to develop an innovative strategy that would make him or her distinctive—a "must" source of ideas and information. "The firm has always provided all the resources you need as an analyst," Armellino says. "Once each year, each analyst would meet with management and work out a compact. You'd explain what support resources you needed and why—and what your plan was for contributing to the success of the firm." Goldman Sachs encouraged each of the firm's research analysts to develop his or her own franchise and accepted that the resulting differences in style and content would lack the firm's traditional consistency and cohesiveness. "We told our

analysts: Figure out your particular comparative advantage versus the competition, seize on it, and make your unique service truly *addictive* for clients," says Armellino. "Only *you* can identify what will distinguish you and your work. Find it, excel at it—and grow!"

Each analyst was expected and challenged to be an entrepreneur. For example, Joe Ellis made himself the leading retailing analyst on Wall Street. "We began the idea of conducting field trips for institutional analysts to visit retailers back in 1984," recalls Ellis. "Now other firms do similar things. So we've gone on to other things—like our annual conference on international retailing, where I give a slide show of pictures I've taken to show the best merchandising being done around the world."

As partner Steven Einhorn recalls, "Comparative advantage differed from analyst to analyst, but the firm also wanted enough consistency to create an overall brand for its research. Part of this was visual. So that Goldman Sachs research would stand out, research reports always had three sections: the investment conclusion, the reasons, and any risks. With this format, there were no structural surprises and the serious reader knew what to expect. The firm also used a consistent approach to valuation and identified the drivers in each sector. Professional editors were brought in to increase the clarity and consistency of the analysts' writing in research reports. "It was essential to find the balance between *individualization* to maximize the different strengths of different individuals and *teamwork* so we would collectively develop a 'bigger than any one of us' franchise. One thing was a certainty: We didn't want to homogenize creativity and entrepreneurial drive into 'blah.' "

The stylistic and analytical differences between analysts' coverage of their different industries were offset by a strong commitment to "framing" capabilities in macroeconomics and portfolio strategy. Both Lee Cooperman and Gary Wenglowski became partners because their work in portfolio strategy and economics was so strong and so well accepted by institutional investors all over the country. This acceptance did not come easily. Both men were highly visible on the institutional investor circuit—New York, Hartford, Boston, Philadelphia, Chicago, Minneapolis, Denver, San Francisco, Los Angeles, Houston, Dallas, Atlanta. They were on the road almost half their days and nights, with the local salesmen in each city running them through meeting after meeting, from an early breakfast

right through dinner, and then a late flight on to the next city—and another series of meetings.

The research sales organization developed by Richard Menschel capitalized effectively on the rapidly developing research product and established Goldman Sachs as the most important provider of research services to the most institutional investors, developing a strong stream of revenues and earnings and the relationship network for success in underwriting. Another strength behind the firm's rapid buildup in research was economic: The department didn't have to rely entirely on institutional stockbrokerage to absorb costs. Investment banking helped in a major way. "We were the first firm to have banking pay for research," recalls Cooperman. "They paid fifty percent of the total cost because the relationship managers in banking were all generalists and they knew they needed to have research to have a competitive edge when making their calls on companies."

An obvious question was how the firm should handle conflicts when an analyst was negative about a major investment banking client. Would professional integrity or "he who pays the piper calls the tune" prevail? The answer to that question was clear from the beginning: "Goldman Sachs has always been first-class on integrity in research," says Joe Ellis.[2] "If you've done your homework and formed a judgment, you'll be supported in your decision. For example, Sears has always been a very important client of the firm. Back in 1974, after writing a positive report in 1972, I recognized that things were becoming terribly wrong in the way Sears was being managed and the way it was headed—and I became quite negative on the stock as an investment. While we didn't publish a formal negative report, everyone knew I was negative and they knew why. Even so, our firm's management was very supportive."

An analyst's career begins with mastering an industry, its major companies, and financial analysis. Then, if he or she has managed to develop a strong franchise with institutional investors, the analyst becomes a top-ranked "name" institutional analyst with a support team helping with client service and covering more companies in the industry. That industry expertise is then linked to investment banking. Working on deals with senior corporate management gives the industry analyst an opportunity to demonstrate knowledge of the industry and the major competitors and gives the analyst in-depth exposure to the operational realities of the firm's business, which helps professional growth. Says Ellis, "My

advice to young analysts is always: Dedicate yourself to being number one in your research specialty and, if you're not number one, examine why you're not yet and what you must do to get there."

The analyst's job is hard and requires many different skills. As Ellis says, "You have to be very good on financial analysis *and* on interviewing *and* on business judgment and market judgment *and* able to work effectively with institutional investors and the sales force *and* with corporate executives *and* investment bankers. It's complicated. And it's very hard to serve all of them really well." Ellis worries that the firm missed an opportunity to be even more effective by developing one branding for Goldman Sachs rather than each analyst's developing his or her own brand.

Analysts initiate, develop, and maintain relationships with institutional analysts and portfolio managers through visits, phone calls, e-mails, and formal research reports, all of which are supported by salespeople who also call and visit, telling the latest news from the analyst. Merchandising an analyst's expertise as well as specific recommendations is nearly as important as research rigor in establishing an analyst's franchise with institutional investors.

By the eighties, the research organization had over seven hundred people—of whom half were line analysts—collectively covering sixty industries in every major country and doing macro research in every major nation on economics, currencies, and commodities. The total research staff would peak at nine hundred at the millennium. "Of our worldwide research department, fifty percent were in the U.S. and they probably produced eighty percent of the total global firepower," says Einhorn, who was research director.[3] "The number of analysts needed to cover all the major companies in all the world's stock markets became a managerial problem because it was so hard to integrate so many people into a coordinated whole that would make all their capabilities fully and consistently available to all clients."

The firm's successful drive to develop homegrown research talents made Goldman Sachs an obvious target for others seeking to recruit experienced analysts. In the nineties, a major problem developed at the top end of the spectrum: The most effective analyst-entrepreneurs started moving to hedge funds. Hedge funds could pay remarkably high compensation and free the individual from the structures of a large organization and, more important, the need to spend lots of time selling and servicing customers.

. . .

In the mid-nineties, Goldman Sachs's research budget was over $175 million, with analysts producing over 3,500 reports each year covering nearly two thousand companies in sixty-eight industries plus all the world's major economies, currencies, and commodities. Managing research on such a scale so integrity is always ensured is challenging. In 1999 an analyst named J. D. Miller was fired for plagiarism less than a month after he joined Goldman Sachs. In an eighteen-page report, he copied passages verbatim and misspelled names exactly as had a report from the Putnam Lovell investment bank, which protested after being tipped off by an institutional investor. Miller was summoned to a meeting in the personnel department for immediate dismissal and told, "Take your jacket with you."[4]

"Steve Einhorn was a superb professional to work with in the boom years when investment banking wanted to use economics as a tool," says partner Gavyn Davies. "He agreed that we would only publish what we knew to be true. Since Steve left, this rule has been less clear. Now it's a bare-knuckle fight."

In 2003 Goldman Sachs would be fined $110 million for violating rules of the National Association of Securities Dealers, the industry's self-regulatory organization, and of the New York Stock Exchange in an action brought before Judge William H. Pauley in U.S. District Court. The essential issue was that research analysts, at Goldman Sachs and elsewhere, while presenting their work as objective and unbiased, were in fact distorting their recommendations to help the firm win investment banking business during the dot-com bubble of 1999–2001.

The court found that the firm knew about the conflicts but failed to establish policies and procedures to detect and prevent the conflicts. In their individual plans, analysts had been expected to tell how they planned to support investment banking. Analysts were asked to identify companies where their relationship with senior management was stronger or better than the firm's investment banking relationship and how that could be used to enhance the firm's business opportunities.

In retrospect, the step-by-step process by which Goldman Sachs and others moved almost inexorably into misbehavior seems almost predestined. By the mid-seventies, investment bankers knew that superior research coverage of a client company was good for business. Corporations wanted to be covered

and to be recommended by leading analysts, because that improved the market for their shares with institutional investors. Without research coverage by their firm, investment bankers would be seriously handicapped in developing a strong and profitable relationship. Since bankers wanted first-rate coverage of more companies, it made sense for investment banking to help pay the cost of research. Goldman Sachs was one of the first to do this: Banking agreed to pay half. Corporate executives enjoyed in-depth discussions with the leading analysts covering their industry, getting an objective, informed, outside view of their company as well as candid appraisals of key competitors. And analysts enjoyed the chance to test their thinking with industry leaders. Everybody saw benefits. By the early eighties, the best analysts knew that working with investment bankers and their clients on corporate financings and acquisitions helped make them accepted as experts by their colleagues in banking and by the institutional investors they worked with.

Naturally, if banking was paying half the cost of research, investment bankers wanted a say in how that money was spent: which industries and companies would be covered; which analysts were hired; and how analysts were rewarded. By the late eighties, leading analysts were earning substantial annual bonuses—sometimes in the millions—for decisive contributions to their firm's banking business. In the nineties, investment bankers were increasingly insisting that if they were paying more than half of analysts' total compensation, they had a right to expect favorable coverage of their clients—and certainly not negative coverage.

In the worst cases, highly favorable research reports were sent out to clients recommending stocks that informal internal e-mails proved were simultaneously being knocked as junk. The conflicts of interests were blatant when uncovered by New York State attorney general Eliot Spitzer and the SEC, with help from whistle-blowers and access to e-mails. There were alarming violations of NASD and NYSE rules against "acts or practices contrary to fair dealing."

During the first half of 2000, Goldman Sachs research analysts were involved in thirty-one mergers involving fifty-six billion dollars and financings for 209 companies totaling eighty-three billion dollars, and analysts helped solicit 328 separate transactions. Analysts' coverage was a regular item in "pitch books" seeking to win banking business. The combination of opportunity and motivation created

an organizational risk that individual analysts would go too far, and soon analysts certainly did:

According to court findings, an analyst defined the three most important goals for 2000 as: "1. Get more investment banking revenue. 2. Get more investment banking revenue. 3. Get more investment banking revenue." An analyst decided not to lower a company's earnings estimates solely because it was too close in time to an IPO. Analysts published "recommendations and/or ratings that were exaggerated or unwarranted, and/or contained opinions for which there was no reasonable basis."

In April 2001 an analyst wrote to a supervising analyst, "In light of the fact that [the company] is worth 0, do you think we should adjust our rating on price target?" and got this reply: "Changing the rating now is probably not a good idea. . . ." In May 2001, WorldCom had the firm's highest rating when the senior U.S. analyst told his European counterpart, "Would have loved to have cut ratings long ago. Unfortunately, we can't cut [AT&T], because we're essentially restricted there. And without cutting [AT&T], there is no consistency in cutting WCOM [WorldCom]." WorldCom stayed on the firm's recommended list until July, but in April, when a hedge fund asked the research leader for telecom whether to buy, sell, or hold at twenty dollars per share, the reply was "sell."

Just *before* an important downgrade of Exodus Technology Corporation from "recommended" to "market outperformer," the analyst met with an institutional client and subsequently received grateful e-mails. One said, in part, "Fortunately, we were able to get out . . . and avoid the recent earnings in the shares." In a survey of the sales force about this analyst, one respondent commented: "His investment recommendations have been abysmal and while I understand he communicates what he really thinks to a sele[c]t few, his public ratings have been an embarrassment to the firm."

Goldman Sachs and the nine other defendants were required by the consent decree to separate research and banking into different organizational units with separate reporting lines; to prevent any input from banking about analysts' compensation; to prevent analysts from participating in new-business solicitations; to erect "firewalls" to prevent communication between research and banking about potential business; and to prohibit analysts' participating in road shows prior to an underwriting. The decree required a set of standardized disclosures of a firm's

economic interests in each company being evaluated, and required each defendant firm to pay for and provide to its investor clients third-party research from at least three independent firms, to provide tracking measures of past research by each of the firm's published analysts, and to pay for an independent monitor to ensure compliance.[5]

Judge Pauley found, "In several instances Goldman Sachs issued certain research reports for companies that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about these companies, and/or contained opinions for which there was no reasonable basis."

Goldman Sachs and other firms were ordered to pay large civil penalties. It was clear that the penalties would be large. The question was how large, and the most important part of "large" was relative—relative to the other major firms that were major competitors. The most important competitor was Morgan Stanley, particularly in reputation, but also in research and in investment banking.

Chairman Hank Paulson called in Bob Steel, vice chairman and head of the equities division. "Bob, your job is to get a settlement that makes Goldman Sachs look okay—okay compared to Morgan Stanley. It may well be that our analysts did worse things than theirs did, so your job is clear: Make sure our firm [fares] no worse than their firm."

Steel "won." He got a fine of $110 million for Goldman Sachs, while Morgan Stanley paid $125 million.

Goldman Sachs had put itself in position to get relatively favorable treatment by taking remedial action in early 2002. It appointed new coheads of research, separating research from investment banking and from sales and trading operations to demonstrate that "research is a stand-alone independent operation." To clarify the independence, research analysts were prohibited from owning stocks in companies in the sectors they covered.[6]

While prohibiting the most egregious misbehavior by the small minority of analysts who were the worst offenders, the settlement cast a pall over investment research and created a field day in the realm of unintended consequences. Analysts' compensation—which had risen to highly attractive levels—fell off. Firms

cut back their research organizations to save on costs. Bureaucratic requirements like having a chaperone sit in on conversations between bankers and analysts slowed down internal communication, only a small part of which, after all, had migrated into being "inappropriate."

Conforming to the series of organizational requirements imposed on the defendant firms, Goldman Sachs has codified the separation between research and banking. Analysts are encouraged to call it as they see it on earnings estimates and research recommendations. Every research report carries a declaration by the analyst that it is his or her work and believed objective and valid, and each report includes a statistical distribution of the firm's buy, hold, or sell recommendations. The firm requires all incoming analysts to take and pass the all-day professional examinations given over three years by the CFA Institute and provides time and resources for preparation.

Nevertheless, the consequences of the settlement were and continue to be disturbing. The firm still talks about the importance of research. "Research has always been important at Goldman Sachs," says partner Abby Joseph Cohen. "Clients are increasingly looking for new ways to look at investments, how to use options and other derivatives, environmental sensitivity, and other creative ways to develop insight. Our emphasis is increasingly on long-term thematic research." Yet at Goldman Sachs and other major firms, research has been damaged. The career trajectory of an industry analyst had once been viewed as a high-speed escalator to financial independence and professional stature. Bright, articulate, and numerate analysts willing to work hard analyzing companies and servicing institutional investors could earn upward of five hundred thousand dollars a year—sometimes even one million dollars—within five years, a much faster acceleration than in almost any other line of professional work. For the self-reliant and highly motivated, this opportunity rang all the right bells. But after the settlement, analysts' compensation fell by half or more. Many left the major firms and went to hedge funds, where creativity was treasured, there was no bureaucracy, and pay was high.

Institutional stockbrokerage as a business continued to suffer a grinding squeeze on profit margins, because mutual funds and pension funds, two major groups of customers, pressured stockbrokers for lower and lower fees. Low-cost brokers and electronic exchanges both gained increasing shares of the total

business. For full-service stockbrokers like Goldman Sachs, profitability was drained away. Institutional stockbrokerage was no longer the rich business it had been since Gus Levy's triumphs. Cost discipline and cost reduction became important, changing the role of research and the career opportunities for research analysts. When combined with the changes imposed by the settlement, the change in the environment was profound. Research reverted from being a leading-edge part of the firm and its business to being only a necessary service accommodation. Capable, diligent professional analysts were needed, but their roles, like aging movie stars', shifted from romantic leads to supporting characters.

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JOHN WEINBERG

With his abrupt, disarming candor, people of all sorts quickly learned to trust and like John L. Weinberg, the son of Sidney Weinberg and half of the Two Johns. Consistently unpretentious and surprisingly approachable for a Wall Streeter with nearly fifty years as a leading frontline investment banker and fourteen years as cochairman or chairman of Goldman Sachs, Weinberg would chuckle, "I'm here to help people. If they want somebody with gray hairs and scars, I'm their guy."

Weinberg's affable manner partly explains how he was able to contribute so substantially to the successful resolution of the tense, potentially confrontational situation in which Seagram and DuPont found themselves in 1995. Seagram was the unwanted largest—and potentially dominant—shareholder in DuPont, and had been since DuPont's "white knight" acquisition of Conoco for $7.8 billion in 1981. The confrontation was resolved when DuPont repurchased 156 million shares—over 24 percent—of its own common stock for an astounding $8.8 billion, by far the largest such transaction ever effected.

The scale of the deal was exceptional, but its successful execution was typical of the man: Both sides trusted John Weinberg. Those closest to the deal appreciated

the sophistication of the technique used in the execution. Using derivatives, the transaction kept Seagram's *percentage* shareholding constant because while it sold 156 million DuPont shares, part of what it got in payment was an equal number of warrants to buy shares. While those warrants were deliberately priced high enough that they would never be exercised, their existence meant that the transaction between DuPont and Seagram qualified under IRS guidelines as an intercorporate dividend, taxable at just 7 percent, rather than as a capital gain at a tax rate of 35 percent.[1] The press release from Seagram specifically acknowledged "the contribution of Goldman Sachs and the unique role of John L. Weinberg."

Weinberg was the central playmaker. But in typical fashion, he credited others—particularly, in this case, the attorneys at Simpson Thacher & Bartlett—for doing an outstanding job in structuring the complex transaction and providing what he cheerfully recognized as "a lot of room for negotiating agreement." This may be one of the few billion-dollar understatements in financial history. In the terms on which they finally agreed, DuPont and Seagram effectively split a tax saving of nearly $1.5 billion.*

To appreciate Weinberg's performance in DuPont's massive repurchase, it helps to understand the background of the complex situation so decisively resolved. A bidding war for Conoco began in 1981 when Dome Petroleum bid for no fewer than fourteen million and no more than twenty-two million shares of Conoco at sixty-five dollars a share—30 percent above the market. Dome was intending to swap the acquired shares later for Conoco's 52.9 percent interest in Hudson Bay Oil & Gas, like Dome a Canadian company, saving Conoco the capital-gains tax it would have incurred in a cash sale. However, Dome's offer was fatally flawed because Dome's shares were owned by a subsidiary, not by Dome itself.

Meanwhile, Seagram had $2.3 billion in cash it had received from selling a large oil holding to Sun Company and wanted to invest this money. Learning in 1981 that 52 percent of Conoco's shares had been tendered—well over the 22 percent Dome had sought, and leaving 30 percent of the Conoco shares "unspoken for"—Edgar Bronfman Sr. called in Weinberg, a longtime friend, adviser to the

* The directors of DuPont did not expect their chairman, Edgar Bronfman Jr., to get IRS approval for his tax deal, even though he was a major political campaign contributor. His father and uncle both preferred to hold on to DuPont—whose stock price nearly doubled in the next few years under the rationalizing leadership of Edward Jefferson Jr.—but Bronfman wanted to try harder to do better by buying MCA.

Bronfmans, and a director of Seagram. A tentative accord was soon set: Seagram would buy 35 percent of Conoco and agree to a standstill agreement at that percentage. Soon thereafter, the situation was made much more complex by DuPont's white-knight purchase of Conoco for $7.8 billion. This left Seagram with over 24 percent of DuPont's shares, enough to be DuPont's controlling shareholder.

For more than a decade, DuPont management, understandably uncomfortable with Seagram's powerful position and the potential for future confrontation, wanted to buy out Seagram. Again, Weinberg would be the principal negotiator, this time working with DuPont's senior management. "Edgar and I courted our wives together," offered Weinberg as a typically matter-of-fact explanation of how he'd gotten to know the Bronfman family, the key to his ability forty-five years later to orchestrate the largest share repurchase in history.

Like every successful deal maker, Weinberg always looked for the "bond in common" and often found it on a personal level. DuPont's very British CEO, Edward Jefferson, seemed stiff and aloof—far removed from John Weinberg's gregarious, earthy informality. But Weinberg knew that Jefferson had also served in combat, and out of that common experience he quickly developed a friendly relationship and a channel of communication that facilitated a major transaction between distant and different organizations. As Weinberg later explained, "Back in 1981, when the Bronfmans bought their position, we had worked out a standstill agreement, including how many seats the Seagram group had on the DuPont board and on each of the key committees. So we got to know everybody pretty well over the years."

Typically, Weinberg left out any explanation of how he earned the respect and trust of both parties in a situation that just a few years before had offered little hope of an amicable resolution. "I just do my job," he said. Making no mention of the twenty-five-million-dollar fee he earned, Weinberg added that, while the high price DuPont had paid for Conoco back in 1981 may have looked like the top dollar paid at the top of the oil market, "when run *by* DuPont and *for* DuPont, it has been a big contributor." Nor did Weinberg mention that Goldman Sachs's policy of not representing a buyer in a hostile bid for a company had obliged him to resign from advising Seagram—and to pass up an eleven-million-dollar fee for managing Seagram's original hostile bid for Conoco. Weinberg was demonstrating the true test of a policy: You follow that policy through even when it's costing you real money. Goldman Sachs was the only major investment banking house

in New York City that did not take in millions of dollars in payments during the Conoco fight as deal manager, arbitrageur, or adviser.[2] By the time the dust settled, Texaco, Mobil, and Cities Service, as well as Seagram and DuPont, had each been involved in what was then the largest takeover in history.

Over his many years, Weinberg, who was born in 1925, performed key roles in many other major transactions, including GE's acquisition of RCA, where Weinberg advised GE's Jack Welch on negotiations with RCA's top brass, and U.S. Steel's purchase of Marathon Oil, then the second largest acquisition in American history. One part of Weinberg's effectiveness was his ability to stay out of the newspapers and to work effectively within the Goldman Sachs organization. "The best work I do is anonymous," he observed. The *New York Times* noted that he had "achieved a privacy that would make any head of the Central Intelligence Agency jealous."[3]

Weinberg never took himself too seriously. "The boss needs to lose arguments—not all arguments, but enough to keep everybody honest and responsible for clear thinking. You can't micromanage this business from headquarters." About innovative ideas, of which there were a great many, he tended to be conservative. But if the young bucks were pressing hard, he liked to give way, saying, "I'm just an old guy, so I don't know all the ins and outs of this new stuff, so if you're sure it's right, let's go!" He could then observe with a knowing smile, "I can't lose now. If I *was* right, they'll soon be saying, 'Jesus, maybe the old guy knows the score,' and if *they* are right, they'll feel really good about themselves—and will work even harder."

Genially self-mocking in manner, Weinberg knew his business and knew how to get paid fully for his and his firm's services. "In 1986, after the RCA deal, he felt strongly that he and his firm had earned a fee of six million dollars," recalls Jack Welch. "Being always cheap, I thought that was too high. So John drove up to my home in Connecticut over the weekend and we argued for a while and then we had a heart-to-heart and then I agreed to pay the full six million dollars."

Welch adds: "At the final stages, we were absolutely divided. Felix Rohatyn was insisting on sixty-seven dollars a share for RCA, and I was adamant for sixty-five dollars. We were each in a separate room at the Waldorf. John asked for a few minutes alone and said, 'Everybody wants a victory. You'll be thrilled with all you can do with and for RCA, and RCA people will be with you for a long long

time. Leave 'em with dignity, with a victory.' Final offer: sixty-six fifty. I never dealt with Goldman Sachs—I always dealt with John. It was a very personal relationship with John Weinberg. John was as good inside as they make 'em."*

Weinberg's major business responsibility at Goldman Sachs was doing large transactions for large clients, continuing to build up the client relationships Sidney Weinberg had developed over many prior years and adding important new clients. He adhered to his father's advice to leave internal management of the firm to others. "Delegate *everything* to others and keep close tabs on what they are doing," Sidney Weinberg had insisted, "but don't do any managing yourself. You may not be able to delegate everything, but remember: If you're really any good, the best work you'll do for the firm will *not* be in management."

John Weinberg's focus on transactions for clients goes back to the fifties. Howard Morgans, Procter & Gamble's CEO, was working in the early hours of a morning on the final negotiations in P&G's 1957 acquisition of Clorox, a relatively minor transaction. Weinberg recalled, "We learned that three Teamsters at a P&G plant in Oregon were about to go on strike. If they went on strike, all the other Teamsters in the P&G system, following the 'hot cargo' clause in their contract, would have to strike too." Morgans turned to Weinberg and said, "Procter & Gamble cannot take a strike now just because three guys in Oregon are up in arms. The only quick and sure way out of this mess is to have somebody else own that unit." And then he continued, "So here's what we're going to do: We are selling that plant to . . . you!"

Weinberg protested that Goldman Sachs couldn't just buy a food-processing business. Morgans insisted. "And pretty soon," recalls Weinberg, "I'm signing a one-page agreement to buy the Oregon business unit for $460,000. P&G never bought or sold *anything* without complete documentation, but here I am signing for nearly half a million bucks on a single sheet of paper! Next day, I arrive back at the office on the red-eye and, naturally, march right over to Pop's office, where I tell him the acquisition is all set—and then I own up that we had a little difficulty at the end and explain the Oregon business and that I signed the papers and that we bought the unit. Pop's reaction was fast: 'All right, shithead, you are fired!'

* When Jack Welch divorced his wife to marry a much younger woman after retiring from GE, Weinberg disapproved. Despite their long personal and business relationship, the two men saw much less of each other. "He and Sue and my former wife and I used to play golf together, but it's been difficult since my divorce," said Welch.

And then Pop launches into a ninety-minute reaming of me and my capabilities and my judgment, and *everything*. It was an amazing exit interview. It took two weeks before he would hire me back into the firm."

In what must be a governance record, John Weinberg's thirty-four years of service as a director of B.F. Goodrich and twenty-six years at National Dairy (today's Kraft) extended Sidney Weinberg's previous service of thirty-two years with each of these corporations to exceed half a century.[4] Weinberg also continued his father's custom of buying the products of the companies he served as a director: Ford cars, GE refrigerators, Goodrich tires. "I was brought up that way. My father always did it, and I got in the habit of doing it." Weinberg kept a plaque inherited from his father that enumerated the many setbacks suffered by Abraham Lincoln on his way to becoming a great president, with the message that enormous success does not come without setbacks. As part of training John to lead the firm, Sidney Weinberg had made a point of taking his son to observe and meet business leaders.[5] (Similarly, John Weinberg took weekly weekend walks with *his* son John to advise on how to do well at the firm.) Very much his own man, John Weinberg was proud to be his father's son but frank about Sidney's toughness. "He peeled you when you made a mistake. He was a great father, a great banker, a good teacher, but a very tough guy and very demanding, who said, 'I don't care how far you go, but you damn well better try *hard*.' . . . I first heard about Goldman Sachs in the womb! I grew up on it. My first job at the firm was in the summer of forty-seven. After three and a half years in the Marines, my plan for that summer was to relax and have some fun. 'The hell you are!' said Pops. 'You're going to work.' So I spent the summer with the old-timers in the cage, learning how operations really worked."[6]

John Weinberg was quite purposefully self-deprecating. He drove an old Ford, wore short socks with his calf showing, would casually scratch his shins, wore short-sleeved shirts in the summer, and described his cigars as "El Rope-O No. 2" in a *New York Times* interview, adding, "I don't let my ego get in the way."[7] Unlike any other prominent executive of his time, he was so very natural that he really didn't care about appearances. He never mentioned his membership in Augusta National or his service on the governing boards of all three of the prestigious

schools he had attended: Deerfield, Princeton, and Harvard Business School. In contrast, he spoke about his service in the U.S. Marines hundreds of times.

"He knew exactly what he was doing," said an admiring partner.

Sometimes he got tested. "Rent a Royal" was a high-profile opportunity to entertain clients in London. The arrangement was simple. All members of the royal family are patrons of various arts organizations, so for a £25,000 contribution to "their" charity, Charles and Diana would mingle with Goldman Sachs's guests for a cocktail reception *and* again at the intermission *and* for a farewell reception at the evening's end. Goldman Sachs signed up for an evening with the royals at the London Philharmonic.

Weinberg was in London on business, so he sat in the royal box with Charles and Diana. Though as always he wore short socks, he was on his best behavior and keen to master the first rule of etiquette with the future king and queen: Never initiate conversation; wait until spoken to. Princess Diana, lovely in her green silk dress, was soon enjoying a conversation she initiated with Weinberg, but she had a problem—and that problem quickly became a test of Weinberg's resourcefulness. "Mr. Weinberg, my back itches—way up high. Could you do me a favor and scratch my back?" The royal box is in clear view of the entire audience. People were, of course, always looking. What to do? Fortunately, just then the house lights dimmed, Weinberg quickly scratched gently—and Diana gave him her warm smile of royal gratitude.

At the other end of the spectrum, Weinberg's capacity for folksy contact with "the troops" had many illustrations over his long years at Goldman Sachs. He was in his office on the eleventh floor at 55 Broad Street when one of several summer associates saw him and thought, *Why not introduce myself?* Weinberg was glad to chat with a new associate and wanted to know: "Where are you from? Where are you working? Where are you in school? Are you enjoying New York? Are we keeping you busy? Helping you with your questions?" Busy as he surely was, Weinberg was never too busy for individuals who worked at the firm. The associate, who stayed with the firm for a decade, recalled with appreciation, "I *still* got Christmas cards from John—twenty years after I'd left the firm."

Intent on protecting the firm's culture from emerging arrogance among young partners, Weinberg was consistently tough as he told offenders, "Knock it off or else"—clearly implying they might have to leave the firm. In fact, Weinberg didn't much like the term "culture," which he considered highfalutin, but he

believed deeply in the concept, the commitment to shared values: "It's the glue that holds the firm together so we can all work together." More than any other firm on Wall Street, Goldman Sachs forged a set of shared values and beliefs: an emphasis on both entrepreneurial aggressiveness and self-effacing teamwork; never disparaging a competitor; having clear ground rules on the sorts of business it would and wouldn't do; having a strong preference for developing its own talent (almost all partners spent their entire careers with the firm), a tendency to insularity, and a strong, expressed determination to put clients' interest first.

Weinberg came into his own in the six years he was sole senior partner, the era in which heavy investment spending converted the concepts Whitehead had articulated in his vision of Goldman Sachs as "the first global firm" into substantial on-the-ground reality with experienced Europeans leading the business in each of Europe's major countries.

Weinberg would see the firm's commitment to those policies tested again and again in ways large and small. Fred Krimendahl, an exceptionally capable leader within Goldman Sachs, developed the corporate-finance unit into one of the best in the business. Bob Rubin and Krimendahl sponsored the launch of the Water Street Corporate Recovery Fund. Operationally, it was co-led by Alfred Eckert III and Mikael Salovaara, both partners of Goldman Sachs. Water Street was funded with $750 million, partly partners' capital and partly clients'. Water Street's strategy was to buy up controlling blocks of distressed high-yield junk bonds that could put the fund in position to control the terms of any subsequent refinancing. The bonds were often being sold at prices significantly below fair market value by institutional investors who did not want to get into all the work, time, and effort of negotiating an adversarial workout and did want to get the bonds off their books when reporting to clients. Buying those bonds from "highly motivated sellers" at very low prices, fighting the fights and forcing solutions, promised to be very profitable for Water Street and for Goldman Sachs.

The "vulture" business, as it was called in slang-prone Wall Street, is and was capable of forcing companies to accept harsh refinancing terms. It can be a rough business of confrontational power plays and often quite bitter fights in court and in the market. Executives at companies involved in fights over particular bond issues were soon getting squeezed by Water Street. Several complained to John Weinberg that Water Street's rough dealings were in direct conflict with

the firm's vaunted no-raids policy and its carefully crafted franchise for having high "client integrity." Weinberg saw the conflict and promptly closed down the highly profitable fund. Later Eckert and Salovaara separated and got into prolonged, bitter arguments and more than a decade of angry litigation. Years later, Fred Eckert, who went on to establish a successful firm of his own, said, "I agreed then and now with [Weinberg's] decision. I had an impossible partner. Since that closing, no investment bank has tried the same sort of fund."

Weinberg also said no to bridge loans when they were a hot new product. In a bridge loan, investment banks lend as much as one billion dollars of their own capital to an acquiring company so it can finance a takeover, on the assumption—not always valid—that a public bond offering can soon be underwritten to pay off the loan. This stratagem was used only by borrowers with poor credit, and several bridge-loan financings collapsed before the investment banks' loans were refinanced—with obviously painful consequences to the firms. Partners admired Weinberg's ability to make such difficult decisions. (Years later, the firm returned to bridge loans and developed a large business.)

Some of Weinberg's judgment calls were on much more personal matters. Sex and sexuality have always been part of the scene on Wall Street, just as they are in Washington and Hollywood. The people attracted to all three need to connect with other people; they all live lives that are detached from reality, and they are constantly engaged in one way or another in seducing other people. Many are young, live "gee whiz" lives, and have money to spend. Flirting comes easily. So does going further. For those engaged in the excitement of the experience, knowing where the invisible boundary lines are is not a priority.

In the January 8, 1990, issue of *New York* magazine, a seven-page article described the events leading up to an unusually brief memorandum to the whole firm from John L. Weinberg announcing that a rapidly rising partner was resigning.[8] Weinberg had a clear code of moral behavior based squarely on all-American core values. He'd been around and was realistic about how other people—in the Marines, at Princeton, and in Manhattan or on the road—were behaving. But there were boundaries and limits. As he would say to a large group at the firm, "You can, if you want, do every sheep in Central Park . . . but leave our girls alone!"

In August 1989, two New York City policemen in uniform had gone to the twenty-ninth floor at 85 Broad Street to serve partner Lew Eisenberg with a criminal harassment complaint filed by Kathy Abramowitz, his former assistant. Called on the carpet by Weinberg, Eisenberg told Weinberg that Abramowitz and her boyfriend, an NYPD cop, were blowing an old affair all out of proportion, and that he had even considered going to a lawyer to charge Abramowitz and the boyfriend with extortion, but that since it was in the past, he had relented. There was nothing to her accusations of abuse or pressure: The relationship had always been entirely consensual—and it was over; there was no truth to the rumors. Weinberg accepted what his partner said. That's what partners and Marines do. What Eisenberg didn't say was that he and Abramowitz were still going regularly to a nearby hotel at the World Trade Center and watching blue movies in bed.

Anyone who has ever made a serious mistake knows how easy it is to keep pretending it hasn't really happened. It's hard to stop at the moment of confrontation and say, "What you're saying is accurate. I've made a terrible mistake and done something wrong. I'm truly sorry and am stopping *now*." Eisenberg didn't tell Weinberg everything.

Then, on a business trip, Weinberg read the real story in the newspapers—particularly the *New York Post*—and blew his top. Eisenberg was immediately banished from the firm. The dismissal was so absolute that nobody would even mention his name. Weinberg could have accepted the affair, even when parts of it made the papers, but he would not accept anything short of the whole truth when any situation required his asking questions.[9] Believing that the maxim "Much is expected of those to whom much has been given" applied directly to partners of Goldman Sachs, when Weinberg was told less than the 100 percent truth he always required, the partner had to go. Later Weinberg told his partners that if anyone entered into an affair with a subordinate, one or the other must request a transfer so the partner would not be supervising a lover.

Weinberg's own adventures were in the corporate world with his many clients. When Sir James Goldsmith made his massive twenty-billion-dollar raid on the United Kingdom's British American Tobacco Company in 1989, it was the largest hostile bid in European history. An urgent call went out from

CEO Patrick Sheehy in London to John Weinberg in New York—at least in part because Goldman Sachs, under Weinberg's direction, had three years previously defended Goodyear Tire & Rubber from a prior Goldsmith raid. Weinberg took the next flight to London to lead the successful defense, helping establish Goldman Sachs as one of the principal investment banks to British industry.

Weinberg clearly took pleasure in helping to work things out. In 1993 he was an adviser to Eastman Kodak's board of directors and to the committee of the board in charge of the search for a new CEO for the company. He and Coca-Cola CEO Roberto Goizueta had agreed that the right man to take the helm at Kodak was George Fisher of Motorola. They went to see Fisher together and, as planned, hit him with both barrels. First, they argued that a great American corporation was floundering, and Fisher, with his leadership qualities and his understanding of technology, was uniquely qualified to be CEO and to accomplish something of great importance for this major company and for America. Second, they laid out an incentive package that would make Fisher a wealthy man if he succeeded.

The two men were playing to win. But they were not making much progress and certainly were not getting to the close. During a lull, Weinberg was alone with Fisher, who said, "John, it's a great job and a wonderful offer. I know that. But I'm not going to accept it—even from Roberto and you—and I want to tell you why. My wife, Anne, has been wonderful to me, and I owe her the time and the fun she's clearly entitled to, but she would lose out on this if I took the job and embarked on a major new challenge at Eastman Kodak. I'm just not going to do that to Anne."

Weinberg replied warmly, "That's wonderful, George, truly wonderful."[10] Then he asked gently, "Would you mind if I were to give Anne a call?" With Fisher's assent, Weinberg was on the phone in a few minutes, explaining the Kodak opportunity and its importance and saying, "But, Anne, George won't take the job at Eastman Kodak." Asked why, he explained with innocent appreciation, "Because he loves *you*." Anne Fisher asked for twenty-four hours, and well within the time limit, George Fisher was on the phone to John Weinberg. He and Anne had discussed it all and had agreed he should move to Kodak. Once again, Weinberg had done his job for a client.

He also did his job for Goldman Sachs—sometimes parlaying a lucky break into a significant advance. During the 1980s, the major investment banks needed huge amounts of long-term capital to finance global expansion and, particularly,

the enormous increases in their dealer inventories as they made markets in debt and equity securities all around the world, often in tremendous amounts. Goldman Sachs continued its tough capital-retention policies and arranged a series of private-placement debt financings with major insurance companies, but these were not enough to meet the firm's mushrooming need for equity capital—the same need that was driving competitor firms to merge into major commercial banks or go public and lose the cachet of being private partnerships.

Morgan Stanley had gone public. Salomon Brothers had gone public by merging with Phibro, and DLJ was public through an IPO and might combine at any time with a major underwriter. Bear Stearns was public and building out its banking business. In a major report he prepared for Rubin and Friedman, partner Don Gant explained the problem with the partnership. Sure, the firm had much more capital than it had ever had before—nearly $1.8 billion—but six hundred million dollars of that belonged to the retired or limited partners and was scheduled to be paid out to them over the next several years. The other two-thirds belonged to the active general partners, but those with the largest percentages were almost certain to be retiring over the next few years, and each would be taking half his capital out of the firm on the day he went limited. Realistic projections showed that just when the firm needed much more capital to support its expanding and increasingly capital-intensive business activities, it was almost certain to have less equity capital on its balance sheet.

All the big commercial banks were not only public, they were armed with potent balance sheets, many corporate relationships, and strong international networks. They were trying to expand into investment banking and securities underwriting. Several banks had bought into securities dealers in London. The big banks all had ambitions to expand into securities dealing, and it was clear they were prepared to extend large loans and cut prices to gain market share in the investment banking business. The consensus among Wall Street's leaders was clear: *Those big, dumb banks will ruin our business!*

To get more capital, Goldman Sachs identified four possible solutions: Lock in partners' capital when they went limited—a major change in the partnership compact that the major partners and all limiteds were sure to oppose; go public—which the newer partners would clearly oppose; somehow increase the firm's profitability—a lot; or find some sugar daddy who wanted to make a large equity investment in the firm despite all the competitive uncertainties.

Of the four choices, Friedman and Rubin, widely recognized as the firm's next generation of leaders, championed an IPO. Having permanent capital and access to the public markets fit with their strategic interests, which would all require capital: investing firm capital in much more proprietary trading, investing in private equity and real estate, and expanding internationally. The management committee—dominated by senior partners who would soon be retiring and would, individually, be the major beneficiaries of an IPO—agreed unanimously to go along, and John Weinberg acceded to the consensus. At the next partners' meeting, Friedman and Rubin presented the case for an IPO but somehow did not project real conviction. Moreover, the partners had not been prepared in advance for such a profound change in the basic nature of their firm. The slide presentation showed what each partner would take home and, emphasizing how stretched for capital the firm was already, explained how and why the needs for capital would increase steadily as the firm took advantage of its growth opportunities. Then, turning from carrots to sticks, they reminded the group that any one or two severe problems—like Penn Central, a large, sudden trading loss, or any of the many different kinds of trouble that could easily be imagined or conjured up—could suddenly do great harm to the firm and its partners.

The presentation was unconvincing. To some, it seemed inconsistent in several ways. The thirty-seven new partners would have none of it: An IPO did almost nothing for them and would preclude their building up their capital positions over the next several years. They had not begun to build up their capital accounts, so even though partnership accounts were valued at three times book value, three times zero was still zero. Partnership decisions were not weighted by shares of partnership capital—they were one partner, one vote—and all the new and most of the nearly new partners were opposed. That meant that while Rubin and Friedman could bring it up again, the idea of an IPO was pushed off for at least a year.

Then, on February 13, 1987, partner Bob Freeman was arrested in the office and charged with multiple counts of trading on inside information. In all the emotional and legal confusion, one thing was clear: There would be no IPO for Goldman Sachs. But the firm still needed capital, particularly since major competitors had gone public and now had substantial permanent capital. Goldman Sachs was competing in fast-changing markets with one hand tied behind its back.

Happily, the problem was solved in a most unusual way that began with a most unusual visit to John Weinberg. Earthy John Weinberg was no dreamer; he never expected to come up with big new ideas. But all of a sudden, in 1987, the least likely solution to Goldman Sachs's need for a large capital infusion presented itself to Weinberg. The solution would be a huge investment in Goldman Sachs by one of the world's largest banks—a gigantic Japanese bank with no prior experience in investment banking. The president of Sumitomo Bank, Koh Komatsu, arrived at Weinberg's office wearing dark glasses so he would not be recognized, having traveled by a deliberately circuitous, deceptive route: Osaka to Seattle, Seattle to Washington, DC, and then the shuttle to New York City. "I had to tell him," said Weinberg, chortling, "that taking the shuttle from Washington National to LaGuardia was no way to hide. Those planes are full of guys from Wall Street—and reporters!"

Komatsu-san, accompanied by Akira Kondoh,[11] explained that Sumitomo Bank, Japan's most profitable commercial bank and the third largest in the world, with nearly $150 billion in assets, had a strategic interest in developing its capabilities as an investment bank and had retained McKinsey & Company to advise on the best way forward. During the postwar occupation of Japan, Douglas MacArthur had mandated a separation of commercial and investment banking along the lines of Glass-Steagall, but that law had been changed recently to allow Japan's commercial banks to provide investment banking services through subsidiaries. McKinsey had recommended a major capital commitment to one of the foremost American investment banks and suggested Goldman Sachs as the industry leader. Felix Rohatyn of Lazard Freres had been chosen to act as an intermediary to make the initial contact with Goldman Sachs. Sumitomo wanted to send two dozen young officers to the firm's New York office for training and indoctrination in the American ways of corporate finance.

Sumitomo's proposition seemed almost too good to be true: It wanted to invest up to five hundred million dollars in cash for an equity interest in the firm. While open to negotiating terms, Komatsu explained that if Goldman Sachs would not agree to the five-hundred-million-dollar amount, the proposition would really not be worth pursuing. As negotiations would later determine, Sumitomo acquired a one-eighth interest in the firm that valued Goldman Sachs at a multiple of 3⅜ times book value—four billion dollars.[12] After generations

of Goldman Sachs partners had patiently built up the firm's capital over nearly a hundred years, Sumitomo's proposition would, remarkably, increase the capital overnight by 38 percent.

The firm's need for more capital—long-term, permanent equity capital—had been the most important argument for an IPO. But when the IPO had been scuttled in 1986, Weinberg had certainly not been unhappy. He believed strongly in the partnership, just as he believed in its client relationships, and he knew his father would have opposed public ownership. He also believed in Goldman Sachs becoming the leading firm on Wall Street and knew that was going to require more capital than the partners could retain out of current profits. Weinberg could barely contain himself, because Komatsu's visit was so improbable and could be so important. "You won't believe this—not in a million years—but I've just had the most amazing visit!" he exclaimed over the phone to Don Gant.

Gant and Weinberg had first met at the firm twenty years before and had always hit it off. Gant is taciturn and tight-lipped and can be trusted with anything. In maintaining the Ford Motor Company relationship, working under Gus Levy, Gant had proved that he could handle matters that were complex and sensitive and required on-the-spot good judgment. In addition, he had done all the detailed financial analysis and documentation for the recently failed proposal for an IPO, so he knew all the numbers. Weinberg, cautious and deliberate, wanted to check out every aspect of Sumitomo's amazing proposition, which is why he turned to Gant. "Don, this may be nothing, but if it does work out, it could be very, very big. Come over to my office right away so I can fill you in. We've got work to do!"

When Gant arrived at his office, Weinberg was grinning widely. "Felix Rohatyn came in this morning with two Japanese guys wearing dark glasses. One guy speaks only Japanese, but is obviously very senior. The other is his translator. The senior guy explains that he doesn't want to be recognized by any newspaper reporters or Wall Streeters, which is why he was wearing dark glasses and why he had come by such a screwball route." Weinberg laughed over the memories of the human foibles as much as over the strategic triumph the opportunity presented. In an industry where equity capital can be leveraged fifty times over by firms with high credit ratings, half a billion dollars of fresh equity capital could be a mighty powerful infusion. Still laughing, Weinberg, as usual, got quickly to the point with Gant: "Don, give Felix Rohatyn a call right away to see how serious

this guy is about what he said to me—that Sumitomo Bank wants to be a partner in Goldman Sachs. See if they're really serious." Then, chuckling, Weinberg said, "Who knows? We may soon be Goldman Sake!"

Gant knew Rohatyn from working together on deals with 3M, so they talked candidly. Gant then reported back to Weinberg: "John, Rohatyn says Sumitomo is absolutely for real on this. We can't just dismiss it. They have the money and want to be a silent partner. If we negotiate this the right way, Rohatyn says we can write our own ticket."

"Are you ready to take the lead on the negotiation, Don? Knowing the Japanese, it could take a *lot* of time!"

"I'll be okay."[13]

"Lucky they didn't come when Gus was still here," observed Weinberg years later. "He hated the Japs. And didn't like the French much either. Never had any interest in international—not even for five seconds."

At first, the Federal Reserve Board of Governors rejected the application for Sumitomo to invest. Institutionally, this made Sumitomo very unhappy; the bank felt "set up." On a personal level, this rebuff hurt the career of Sumitomo's key man in the negotiations because in Japan, anything so important would have been carefully precleared with the Ministry of Finance to prevent just such surprises.

When Sumitomo Bank was attempting to make its huge investment in Goldman Sachs, there was a lot of easy talk in the United States about the Japanese buying up America, and there were specific concerns about any foreign commercial bank owning a piece of a major American investment bank. To head off political interference, partner Bob Downey arranged a meeting between John Weinberg and Representative John Dingell, chairman of the House Energy and Finance Committee, to fill the congressman in. As Downey recalls, "John Weinberg was quite ready to explain that Sumitomo had paid three and a half times book value and that they wouldn't have a voting interest in the firm and all that, but he seemed quite reluctant when I suggested he mention to the congressman that he had had experience with the Japanese all the way back to the 1940s. That's why I was so surprised when John started right off with saying, 'Congressman, don't ever forget that in the war, we fought those bastards.' Dingell cut in: 'Now, John'—but the point on our protecting our independence had already been made for certain. We had no trouble with Congress after that."

After months of discussions and three formal hearings, the Federal Reserve agreed to consider the application but set strict limits to protect Glass-Steagall: Sumitomo couldn't own more than 24.9 percent of Goldman Sachs, and its partnership interest must be nonvoting.[14] The agreement was limited, at Goldman Sachs's initiative, to a five-year term, with either party free to opt out at the end of five years if notification was given at the end of four years. If Goldman Sachs should ever go public, Sumitomo's partnership interest would convert to 12.5 percent of the common stock.[15]

Insisting on secrecy, Sumitomo Bank sent a team of eighteen executives to conduct the negotiations. They all expected to remain in New York City for several months while working with Lazard Freres. (One member of the Sumitomo team met a Japanese woman who was living in New York City and married her—with Gant escorting the bride in the wedding ceremony.) Gant soon understood that Goldman Sachs was in a strong negotiating position.[16] In Japan, Sumitomo Bank was known for being a maverick and boldly innovative—and proudly from Osaka. With a successful resolution of negotiations, Sumitomo would win great prestige, but failure would mean a serious loss of face. Understanding this, Gant was able, whenever necessary, to unwind potential deal breakers simply by assuring his counterparts that a particular demand simply would never be acceptable to Goldman Sachs's management committee.

Initially, Sumitomo thought it would want to have all sorts of trainees at the firm, but Weinberg and Gant explained that to "protect your investment" it would be important to avoid the perception that Goldman Sachs was too close to the Sumitomo Group. The Fed decided that Sumitomo could send two—not two dozen—interns, and they could not remain in New York City for more than twelve months before rotating home. Sumitomo was not at all comfortable with these restrictions, so negotiations continued to be, as Gant later recalled, "touch and go." One problem for Gant was finding partners willing to train a Sumitomo intern, knowing he would not be staying more than a year.

Sumitomo would just be a silent partner and not have a vote. Again, Weinberg explained, "It was to protect their investment." In fact, it was the best investment Sumitomo ever made, because the bank could fund its whole commitment in the Euromarkets at a net cost of just 1 percent. With characteristic genial understatement, Weinberg observed, "It's worked out well for everyone."

As background to the Sumitomo story, Weinberg would later explain that he had lots of close friends in Japan, saying, "I've been going there for twenty-five years." He was diplomatic in understating the reality that he'd actually been going for more than *fifty* years. His first mission was as a Marine, to liberate POW camps in the early stages of the U.S. occupation. As he said, "I'd seen a lot and heard a lot about POW camps—but nothing like what I saw in Japan."[17]

To get into the Marine Corps, Weinberg had lied about his age: He was only seventeen. Since no good deed goes unpunished, nearly a decade later he was called back for a second combat tour, as a platoon leader in Korea.[18]

He would regale friends with stories about events of the war and postwar years—like the day his life was threatened by a Marine captain who accompanied him on a work party at a former kamikaze launching station in Kyushu to reorganize a brothel the Japanese army had maintained for the young pilots going out on their "final mission." The group's assignment was to clean out the facility before reopening it so the same tough White Russian women—who knew how and when to use their fists to maintain order—could service the GIs. The captain called it a "recreational facility." He didn't want young Weinberg telling tales that might tarnish his promising back-home career in medicine, so he made himself menacingly clear: "If anybody *anywhere ever* hears about what we're doing here, I'll find you and I *will* kill you!"

In the year Weinberg received the Harvard Business School's prestigious Alumni Achievement Award, Bristol-Meyers CEO Richard Gelb, Weinberg's HBS classmate, good-naturedly referred obliquely to Weinberg's occupation experience converting the brothel. Gelb noted slyly that Weinberg's assignment had "presented unusual challenges" but provided "rich experience in retailing" that was "characterized by being labor-intensive with a high cash flow." Weinberg's friends and classmates in the audience of dignitaries loved the mercifully cryptic remarks because they knew the real story.

In the few years after Sumitomo's investment, Goldman Sachs's profits increased substantially, and the firm could readily have bought out Sumitomo's stake at the already agreed rate of one hundred million dollars a year over five successive years but didn't, because the capital was employed so profitably. During John Weinberg's fourteen years as managing partner, Goldman Sachs's earnings multiplied ten times and equity capital soared from sixty million dollars to

$2.3 billion. With the IPO, Sumitomo's return on its investment was astronomical. Ironically, however, Sumitomo did not achieve its strategic objective, which was to develop and use a new expertise. It never did investment banking business in Japan.

As an intense competitor against other Wall Street firms, Weinberg placed an urgent call to Fred Frank at Lehman Brothers about an underwriting Lehman Brothers was about to do without Goldman Sachs. "We brought that company public, so it would be a great embarrassment to our firm—and to me personally—if we aren't involved as a major underwriter in this offering. So, Fred, I'm asking you." Frank arranged to have Goldman Sachs reinstated, simply saying to the client: "You can't drop Goldman Sachs—because it's such a strong firm that everyone on Wall Street will think *they* dropped *you*."

A few years later, on a different topic, Frank was back on the phone with Weinberg, describing overly aggressive behavior by a Goldman Sachs banker. "Gee, Fred, that's awful," commiserated Weinberg, asking for time to look into the situation and promising to call back. Frank expected Weinberg's contrition to result in a satisfying business change. So when he next spoke with Weinberg, he asked: "Well, then, John, will you be able to take care of this and put a stop to it?"

"Oh. No, Fred, certainly not," came the surprising reply. "That would be micromanaging." Always an unrelenting competitor, Weinberg was not about to squelch his aggressive colleague. As Frank observed, "For Goldman Sachs, it's not just that they must win—but also *you* must fail."

Long-term relationships were particularly important to Weinberg, and he clearly felt most comfortable where the loyalty went both ways and was equally strong. Loyalty up, loyalty down, say the U.S. Marines. When a relationship was not working, he would work hard to get it right—as illustrated by his work with General Electric. Weinberg explained: "My father had been a longtime director of GE, and we were all disappointed that after his death Goldman Sachs was not invited to continue the relationship as co–investment banker for GE, a traditional relationship the firm had enjoyed." GE turned to Morgan Stanley to serve as its lead investment banker.

Weinberg decided to see what could be done and made a point of showing up at GE's corporate offices in Fairfield, Connecticut, every month over twelve long years, meeting with people, particularly the new people being brought into the senior management group.[19] "I've always gotten along pretty well with regular working people, so one day I'm there and it's pretty quiet, and one of the secretaries I knew—she typed all the superconfidential executive-performance evaluations—said to me, 'There's a new executive you should see,' and in another minute, she ushers me into the office of this guy I'd never heard of before: Jack Welch."

Welch had never heard of Weinberg either, so he asked, "What's on your mind?" Weinberg had to admit, "I really don't have anything particularly on my mind," and asked Welch what his responsibilities would be at GE. Welch grinned and made a sarcastic observation about the value of really doing your homework before calling on busy people and then explained he was now sector executive for several business units, including GE Credit. Weinberg asked how Goldman Sachs could help, and Welch grinned again, commenting about the importance of coming prepared with specific, documented proposals and action recommendations, and asked, "Don't you *ever* do *any* homework?" As Weinberg perceived, however, "Somehow we were actually getting along pretty well on a personal level, and the next thing I know, he's saying how he hopes to become GE's CEO one day and asks me how Goldman Sachs can help him do a great job for the corporation. We talked about various things, and pretty soon things seemed to come together for us both."

Over the next several years, despite starting out so awkwardly, the two men worked together in many ways. For example, the steel industry needed huge investment in continuous-casting equipment, and the IRS allowed a transfer of the investment tax credit if the equipment was leased—and that's where GE Credit could come in. Since the steel companies had little or no profits and few taxes against which to take the tax credit, Weinberg worked out a way for GE Credit to buy the equipment, take the tax credit, and then lease the equipment to the steel companies. Weinberg's summary: "Naturally, everybody was happy."

His engaged, no-pretenses manner left Weinberg open to good-natured ribbing from his many friends—sometimes in public, sometimes in private one-on-one fun. When Jack Welch called his friend several years later to divulge

something big happening at General Electric, he began the conversation in a personally affectionate way that anyone on Wall Street would die for: "You're dumb. You're ugly. And . . . you're oh so very lucky!" And then he continued, "I'm about to be asked to go into the boardroom. When I come out, I'll be CEO—and you and Goldman Sachs will again be our lead investment banker."

Weinberg was not in his office. He was in Midtown taking his turn at a series of physical examinations at the Life Extension Institute. As Weinberg liked to tell the story, he was sitting in the waiting area with Morgan Stanley's then managing partner, Robert Baldwin, who was waiting to be called—for a proctoscopic exam. Grinning, Weinberg would end the story by explaining that just when General Electric's outgoing CEO, Reginald Jones, called Baldwin to explain that Morgan Stanley would no longer be GE's lead investment banker, the attendant came to say it was time for Baldwin's examination.

During the late seventies, those equipment-leasing arrangements helped Welch's GE Credit bring in nearly 75 percent of GE's total reported earnings, making it the earnings engine for GE as a whole. "Over the years, Jack and I developed a good understanding and a lot of respect for each other," said Weinberg. "We became great friends and saw a lot of each other. He's an extraordinary human being." Welch reciprocates: "I could talk for a week about him. I'm really a fan. John was wise, practical, and unpretentious, with extraordinary common sense. He had a great nose for value and never depended on all those spreadsheets other guys insisted on. He was a great judge of character and represented Goldman Sachs at its best. The thing that distinguished John was that he was not just a deal maker for the deal's sake. He was interested in what was right for both parties. He cared about his clients and his own people in as sensitive a way as anybody in business."

While most of his time was spent outside the firm with clients, Weinberg made sure his clients regularly got the very best talents of the firm working on their deals. He also took major roles inside Goldman Sachs. In 1990 the *Economist* credited Weinberg for his leadership: "His mix of warmth and toughness has guided Goldman Sachs though an unparalleled expansion and to higher profits over the past fourteen years. His cautiousness kept the firm from making bridge loans, from putting its own capital into takeovers, or from buying the junk bonds that have so tripped up rivals. 'We watch our eggs very carefully. Because they are our eggs—and everything we have.' "[20]

Weinberg combined deliberately abrupt and unpolished personal ways with quick recall of names, dates, and other details. He was always ready to deal directly with problems and almost instinctively recognized what was right for each person in a difficult situation. This combination enabled him to move directly to pragmatic resolution of matters large and small to the repeated satisfaction of clients and colleagues, and often vaporized the inherent conflicts within Goldman Sachs between talented, hard-charging individuals with different objectives and different perspectives. Weinberg's self-imposed mission was to achieve harmony between two goals that others often found contradictory: cooperative teamwork and aggressive individual initiative—and to do so quickly, decisively, and fairly, with no hard feelings.

Within the firm, Weinberg's approach was simple, direct, and effective. He would take the antagonists aside and, moving up very close and lowering his voice, would lay out exactly how the problem would be resolved: "Now, I'm going to decide this thing once and for all—by noon tomorrow. So each of you should think very carefully about what you really want most included in my final decision and then tell me the exact decision you'd like me to make—a decision you can and you will live with. Make it just as fair as you can to the other guy because he'll be giving me his best and fairest final decision too. I'm going to pick just one of those recommendations and that will be that—and then we'll all get back to work."

Weinberg's strength with the people of Goldman Sachs was matched by his strength with clients, old and new. Always the Marine, he was aggressive and kept moving up, was never a "showboat"—and was loved because he lived and breathed the core values of Goldman Sachs. "I really love this place," he explained quite openly and naturally. "You want people to feel good about themselves and about the firm." His sincerely innocent assumption was that what was so naturally obvious to him must surely be equally self-evident to others. It often *was*—once he'd put it into words. "People want to be treated well, and I don't see any reason not to," he said. On the other hand, Weinberg quickly deflated others' self-importance, observing from experience, "After they get promotions, some people really grow, but others just swell."

Weinberg was direct. Advising a young partner who was bringing a proposal to the management committee, he said: "I want you to have a very success-

ful meeting, and I'll want to contribute directly to your success. So, just as I tell everyone else, I want to have *all* the materials to be discussed forty-eight hours before the meeting. I *will* read it, and so will everyone else. The meeting will begin with questions—and I will ask the first question."

In the decade following his retirement as a partner, Weinberg continued to be a busy man, laughing, "I've been bringing in more business than when I was there." Deals included Chemical Bank's takeover of Manufacturers Hanover Bank and GCA Corporation's $2.3 billion merger with Columbia Healthcare and their combination into Hospital Corporation of America. At seventy-five, as a Goldman Sachs adviser, Weinberg received a huge raise: five million dollars annually under a new two-year contract, up from two million dollars a year under his previous contract. According to a letter from Hank Paulson, Weinberg would receive an additional five million dollars when his contract expired or was terminated. The contract stayed in force until Weinberg's death at eighty-one on August 7, 2006.

While Weinberg was best known for his success in managing major corporate client relationships, that was not his highest priority. "John's greatest pride was not in recovering the GE relationship or taking over as successfully as he did Sidney Weinberg's many major corporate relationships—the backbone of the firm," says his brother Jim, who had a closer relationship with John Weinberg—three fathoms down—than most people realized. "These and other achievements were all *external*. What John cared most about were the many ways the firm was strengthened internally." Weinberg worried that Goldman Sachs's culture, a primal strength in America, would be in conflict with the cultures of other countries. He was delighted to see that the values and work ethic he believed in seemed universal. As one partner observed for everyone: "He was the soul of the firm."

19

INNOCENTS ABROAD

Getting out of a London taxi he and a partner had taken from the City of London out to Heathrow—which in the early sixties was a ten-pound fare—Ray Young, head of securities sales, gave the driver a tip of one hundred pounds. At the prevailing exchange rate of $2.80 to the pound, that was $280. Young's startled Goldman Sachs companion was aghast: "Ray! You can't *do* that. It's *wrong*."

"Why? That's what I always do wherever I go: a hundred lire in Italy, a hundred yen in Tokyo, a hundred francs in France—always a hundred, whatever the local currency."

Young had no thought of the substantial differences from one currency to another and no idea that he had just tipped his cab driver more than the average worker in England earned in six *weeks*—or that in Rome, his standard hundred-lire tip was worth about sixteen cents. Goldman Sachs had a lot to learn before it would become the leading investment banking and securities firm in Europe and Asia.

Urbane Stanley Miller had been in Wall Street before the war. He came to Goldman Sachs from the State Department because Sidney Weinberg knew him; he was recruited to develop international business—not in invest-

ment banking, but in trading. To cultivate opportunities for block trading, he would travel twice a year to call on institutions in Europe. Back in New York City, he supervised a few elderly European stockbrokers who sold to wealthy individuals, a Belgian arbitrageur, and a few young Yanks who covered institutional investors in American shares. To make an overseas telephone call, the caller had to get Miller's permission, partly because calls were expensive and partly to protect against innocents' forgetting the five- or six-hour time differences and calling customers at a boorishly inappropriate hour of the night. Miller was shocked to find the firm served neither wine nor aperitifs at luncheons in the office. He knew better: He had come to build an international business, and international visitors would surely expect a "libation" at such luncheons; if nothing was served, prospective clients simply would stop coming. But at Goldman Sachs, there was no drinking—period. It took several days to find a compromise: Miller could offer sherry, but only in his lunchroom. Later, luncheon guests at the firm would generally be offered sherry, but the people of Goldman Sachs would *always* pass, and the rumor held that one bottle of sherry lasted for many years.

International business at Goldman Sachs can be traced back to 1897, when a profit of four thousand dollars was recorded. Profits increased to $250,000 in 1903 and peaked in 1906 at just over five hundred thousand dollars. But during the Depression and the Second World War, most American investment banks, Goldman Sachs included, dropped their international business and closed any overseas offices. After the war, major firms like Morgan Stanley, First Boston, Lehman Brothers, and Kuhn Loeb took the lead on international financings for the European Coal and Steel Community, the Japanese government, and other major organizations in a series of large and prestigious financings. Goldman Sachs, still stigmatized by the failure of Goldman Sachs Trading Corporation, was not included. Its overseas offices stayed closed.

Goldman Sachs's modern international expansion began—slowly—after the Korean War. As Whitehead explains, "Other firms were well ahead of us with what were then called foreign offices. Goldman Sachs had no international offices and really no interest. If a Goldman Sachs client made an acquisition overseas, it would use another firm—usually one in that foreign country, but sometimes an American competitor like First Boston or Morgan Stanley. To protect our client

business, we knew we had to get into the international side of the business, but our first attempts, particularly looking back from today's position, were pretty feeble."

Charles Saltzman, who had been a vice president of the New York Stock Exchange before becoming deputy secretary of state under George Marshall, joined the firm as a partner and was interested in Japan, so he took an annual trip to Tokyo. "He was well respected, but he never asked for an order," observes Whitehead. In 1974 Bill Brown came over from McKinsey, where he had run a one-man office in Tokyo, and did the same for Goldman Sachs for a decade.[1] "He didn't know much about investment banking, but he did know Japan," recalls Whitehead, who notes the defensive roles governments then played effectively against outside financial firms: "The Japanese Ministry of Finance had always blocked us in Japan. They were just as tough and just as effective as we and our Federal Reserve were at blocking them in America. And in the United Kingdom, the Bank of England was clearly our major problem. They were *very* slow to approve the things we wanted to do—just as our government was very slow to approve the initiatives our European competitors wanted to take in America."

International efforts began to accelerate slightly in 1969 when Sidney Weinberg and Gus Levy brought in Lyndon Johnson's secretary of the Treasury (and Roy Smith's father-in-law), Henry Fowler, as a partner and chairman of Goldman Sachs International Corporation. Fowler, careful not to overwork his government-initiated relationships, described his international role as "less that of a director and more that of an ambassador."

The firm's buildup in Asia began with a small thread of opportunity. In 1969 a trainee from Nikko Securities arrived and sat near Roy Smith. Partner Fred Krimendahl had worked with Nikko on an issue a few years before and had stayed in fairly close communication, so when Nikko wanted to ask if Goldman Sachs could take on an associate to get some experience, the request went to Krimendahl and he made the arrangements. After a few months of licking envelopes, the associate walked to Smith's desk and said, "So sorry, but I have something to say, please."

"What's that?"

"Our firm believes your firm doesn't do enough to promote Japanese securities business, but all your competitors do."

"Why do you tell *me?*"

"Can't tell Mr. Krimendahl. He's too senior. You must tell him."

"But I don't know much about Japan or why we should do more business there. And what's more, Fred knows all this about me."

Nikko's man understood Smith's problem—and had a solution. "We will prepare a written report for you to give to Mr. Krimendahl."

The report was produced, and after going back and forth with Nikko's people several times to get it right, Smith took it to Krimendahl, saying, "Nikko prepared this report on why they think we should be promoting more business in Japan and asked me to bring it to your attention—so you would decide to read it."

The report made an impression. A few months later, Krimendahl called Smith into his office to say that "because of your strong interest in Japan"—which was all news to Smith—"the management committee has decided you should go to Japan for a while to see if we should be doing any business there. Henry Fowler and Charlie Saltzman will go with you to open doors."

As Smith recalls, "At first, it was *my* trip with them coming along to help me, but soon it reversed and became me accompanying them on *their* trip. We spent three weeks in Japan during that 1969 trip and saw a hundred different companies. Not much investment banking or securities business was being done in Japan in those days, but the firm's major competitors were all active in anticipation of business somehow opening up—business that might be done, of course, by Goldman Sachs if it did all the right things." Shortly after returning from this initial trip, Smith was told, "Because of your great interest *and* your great skills and expertise in Japan, we want you to be our man in Japan, but don't spend more than a quarter of your time on this important responsibility."

For the next several years, Smith made five two- to three-week trips a year to Japan. His major work continued to be in New York, serving John Weinberg's clients. In Japan his "office" was his hotel room, and he called on companies, banks, and securities firms—without a translator. "Most firms had either native speakers or translators, but we had neither, which limited the substantive content of our meetings." The Big Four Japanese securities firms controlled all the business, so all the foreign firms beat a path to their doors." Smith recalls, "It was *very* competitive."

One day John Weinberg, believing Smith was either spending too much or

too little time in Japan, told him as bluntly as usual, "Shit or get off the pot." So in 1971, Smith went full time in the international business, concentrating on Japan.

Competitor firms all relied on the relationships they'd begun by getting an introduction through a Japanese securities firm, but Smith understood that these introductions often result in pointless meetings with "face men." "I believed it was better to be known as the smart people from New York with good ideas that would be interesting to the Japanese, so they would see me and then I could play, 'Who do you know,' making reference over and over again to Henry Fowler." Smith made appointments with senior executives through those earlier contacts whenever he could, and, as he recalls, "sent a lot of letters."

Those early days were never easy, and some of the difficulties were quite remarkable. For example, there usually were no street numbers on Tokyo buildings, and any numbers that were there were not in numerical sequence along a street, as in the West, but in the chronological order in which the buildings had been constructed. So to keep from getting lost, Smith had to get a taxi with a driver who spoke some English. Language was a persistent problem. During an initial sales call, Smith might say, "Thank you for seeing me. I am from Goldman Sachs"—without knowing that "zachs" in Japanese is the word for condom.

Smith decided not to live in Japan, believing that the business-development effort would collapse if he wasn't based in the New York office, networking and lobbying with partners and then going back to Japan with the newest and freshest ideas. "If I'd been in Tokyo and out of touch with key people in the firm, we'd never have gotten Japanese business accepted by the management committee in New York, where everyone seemed to think that Japanese business was really just junk-bond business."

Issuing commercial paper for Mitsui—a three-hundred-year-old company where Henry Fowler had a friend from his time as treasury secretary—promised to be the firm's first breakthrough in Japan. But the U.S. commercial-paper market wouldn't accept Japanese paper. Smith's solution was to arrange a U.S. bank letter of credit as backup, an innovation that reassured investors about the credit quality. Once Mitsui's paper had been accepted in the U.S. market, Smith went to every major Japanese company he could identify, "marketing the pants off the idea of issuing commercial paper as a low-cost way to raise money," and got several other Japanese companies to issue U.S. commercial paper. "It was an oppor-

tunistic time," he remembers, "and we would try anything that worked." A year later, Goldman Sachs did a convertible bond for Mitsui, and this significantly increased the firm's stature in Japan.

An early Japanese equity offering by Goldman Sachs was for Wacoal, a brassiere maker. Smith pointed out that Wacoal made more bras than anyone else in the world. This was a surprise to the New Yorkers, since Japanese women were not as "endowed" as American women.

"Who are you going to sell this to?" asked John Weinberg.

"Institutions," replied Smith.

"You'll have a lot of explaining to do," said Weinberg with a grin.

Wacoal wanted to be certain the shares would get the firm's support in the aftermarket. As Smith later explained, "Before we could get the assignment, we had to promise we would do the underwriting successfully, and then, after we got the mandate, we had to study the data to see if and how we could actually do the underwriting." The deal was successful and made a nice profit.

Goldman Sachs's first office in London was opened on Wood Street in early 1970 by Powell Cabot, a son of Sidney Weinberg's great friend Paul Cabot. He was succeeded for a while by Sape Stheeman, a Dutchman hired from S.G. Warburg who built the staff to two dozen. In 1970 Michael Cowles, who had just become a partner and was trying to pull all the international business together, was sent to London to run the office.[2] "Nobody told us what to do," recalls Smith. "Nobody supervised our work. We were out of sight, out of mind, and free to figure it out for ourselves. I called on an awful lot of people to introduce myself and to talk about the firm."

Goldman Sachs was virtually unknown in corporate London, so it had to have a demonstrably superior "wedge" product to break into the market. "Fortunately, we had just such a product in commercial paper," recalls Whitehead. "Our unique product gave us an effective way to get started." Commercial paper was almost unknown in London, and there was no commercial-paper market on the Continent. As the leading commercial-paper dealer in America, the firm had a clearly deliverable and clearly differentiating product. With commercial paper, it could raise working capital for a major corporation at significantly lower interest

rates than the British banks were charging on commercial loans. As Whitehead explains, "The big breakthrough for commercial-paper business in Europe came when Electricité de France became a major issuer [through Goldman Sachs] in the early 1970s."

Whitehead tried to provide leadership to the fledgling international effort. "I'd go to London two or three times a year," he recalls, "and travel around Europe, committing one full day with each man on our investment banking team, which included Ted Botts, Jean-Charles Charpentier, and Bob Hamburger. Naturally, they made sure that these days were as fully packed and productive as possible. I wasn't just looking for mandates to sell commercial paper. I was always looking for some other things we could sell."

A decade later, Roy Smith was sent to cover Europe while continuing his work in Japan, where Gene Atkinson had become head of the Tokyo office. One week each month for three years, Smith was in London, where the firm had a staff of sixty—mostly securities salespeople—in a building on Queen Victoria Street that also housed a representative office of Chicago's Continental Illinois National Bank.[3] The Bank of England, the principal regulatory authority, insisted that all significant banks and brokers locate inside the City of London financial district and thus within easy walking distance, but the firm was not considered important enough to be required to get space within the Square Mile.

With exchange controls—until Margaret Thatcher abolished them in 1979—British investors were particularly cautious about investing in American stocks, and trading volume was low. Indeed, investors had four levels of uncertainty when they purchased American stocks:

- How would the company do as a business?
- How would the stock price do on the NYSE?
- How would the dollar-pound exchange rate change? There had been some devaluation. And . . .
- How would the "dollar premium" change? Because British subjects and institutions could not convert pounds into dollars and so had to buy dollars to invest from other Britons, dollars were sold in London at a premium that fluctuated around 30 percent and was subject to sudden and significant change.

These multiple uncertainties greatly limited American-share activity and Goldman Sachs business in London, as did the prospect of exchange controls being abolished and the 30 percent premium being eliminated. The firm's small brokerage business was unimportant to London and unimportant to Goldman Sachs. It had also been doing a minor export business in investment banking, helping British companies buy American companies, and, in its work as "seller rep," finding British buyers for U.S. companies that wanted to sell. The firm also sold some commercial paper, a few private debt placements, and the occasional U.S. tranche of an international securities syndication, but it was primarily a broker of American stocks to British institutional investors. All trading was still done in New York so it could be controlled and processed by New York's back office. Middle Eastern brokerage accounts were also covered out of London. Smith's mission was to build up these businesses and to see if the firm could develop some indigenous investment banking business in the UK and on the Continent. Eurobonds were one possibility, but bidding by competitors was so aggressive that, as Smith explains, "winning these mandates could also be an easy way to lose a lot of money." In late summer of 1982, Goldman Sachs acquired the London merchant-banking arm of a U.S. bank to help in financing J. Aron's global commodities business and renamed it Goldman Sachs Ltd.[4]

In the early 1980s, international business represented 20 percent or more of the firm's bond and M&A businesses and a bit less than 20 percent in stockbrokerage, but still only 10 percent of the firm's total revenues—and it was losing money. But by the late 1980s, International would contribute 20 percent of the firm's profits. Transforming Goldman Sachs into an international powerhouse would require great changes in both substance and perception inside the firm and among thousands of clients and nonclients. From 1921 to 1984, Lone Star Gas had used only two firms for its many transactions: Goldman Sachs and Salomon Brothers. Lone Star was the ultimate "loyal client." Sanford Singer, the CFO, really liked Goldman Sachs and Salomon Brothers, and he knew the firm was doing great work for him in America, but when he had a small piece of business to be done in Europe, he never even thought of calling Goldman Sachs. "Here was our most loyal client simply *assuming* we had no capabilities and no interest in things international," says Smith. "Obviously, if our *best* clients won't call us, we must be very vulnerable with all our other clients."

Thinking back on the disruptions of May Day, which ended fixed U.S. brokerage commissions in 1975, Smith said, "If we'd known what lay ahead for the stockbrokerage business, with its drastic collapse in commission rates, we would have been very tempted to close up shop. Fortunately, we had the leadership of Gus Levy, who was unafraid, as was John Whitehead. 'You can do *anything*,' they said—and they meant it. 'Go out and call! We have the capital and we have the people.'" So in the eighties, while competitors softened and slowed down their international efforts, Goldman Sachs toughened up and accelerated.

Bill Landreth noticed a line on the list of occupants of offices in a large London building that read, "Football." A bit homesick and an athlete, he hoped it might have something to do with the American football he knew, but soon realized it was really about soccer, the game the British call football. Then he noticed another name: Kuwait Investment Office. He certainly knew what investing was and had some free time, so he decided to check it out. Getting off the lift at the appropriate floor, he asked the receptionist with whom he might speak about investing in stocks and was told to talk to a Mr. Buchan. David Buchan came out, they talked, and they almost immediately hit it off, starting an important new client relationship.

Salomon Brothers, which had hired the son of a senior KIO official, was already doing substantial business with KIO, the Kuwait government's investing arm. So was Merrill Lynch. But the Goldman Sachs relationship developed quite rapidly, and soon Buchan was sharing his investment objectives with Landreth. Kuwait wanted to invest for safety and liquidity in the U.S. market. Its plan was to buy shares in a diverse group of American corporations. The total investment would be substantial. "Would Goldman Sachs be interested in helping to get this done—very quietly?"

"Sure."

"Since the SEC requires reporting any ownership position as large as 5 percent, there will be a limit on how much we can buy," cautioned Buchan. Buying almost 5 percent of a long list of major companies' stocks was certain to be very big business for the executing brokers. Even as extraordinarily low-key a man as Bill Landreth must have been working hard to maintain calm as the biggest

account he'd ever heard of was steadily moving toward being *his* account. Landreth managed to say almost matter-of-factly: "That's okay."

Very discreetly, Kuwait would soon place the largest orders ever: Buy major position in each of America's fifty largest corporations.

Stockbroking in London was still a small business but was beginning to show promise. The firm was concentrating on selling British securities to British institutions in the morning and then, when the New York Stock Exchange was open, selling them American securities all afternoon. "We were ballsy, and nobody in New York was checking us out," recalls Smith. "All my international days were frontier days—before the sidewalks were laid down." To get a private placement done for a Danish company, even though the issue wasn't fully taken up when the closing date came, the unsold balance was positioned—bought and temporarily held—by the London office, something the firm would never do in New York. Smith recalls, "We made our first million-dollar loss on a trade we did for Imperial Chemical Industries—after snatching it away from S. G. Warburg. They thought we'd made a profit on ICI and wouldn't talk to us for a week."

After exchange controls were removed in 1979, demand mushroomed for American securities, particularly those of technology and pharmaceutical companies. Talk of the European Union and a single multinational currency were in the air. Prosperity was quite clearly returning to Europe and promising opportunity. Sales volume in securities had been going up, thanks to the leadership of security sales manager Bill Landreth.

Given these positive changes, increasing numbers of partners were becoming interested in capitalizing on John Whitehead's international vision and making a major commitment to expansion in Europe—and even Asia. Not every division head was in favor of this commitment, and some were strongly opposed—the opportunities available to Goldman Sachs in Europe looked small, and the costs that would have to be absorbed by the firm were surely large. Even more important, opportunities in the United States were large and obvious, and incremental business fell directly to the bottom line as pure profits that the partners could take home. The argument illustrated the conventional problems of partnerships making long-term strategic decisions: Consensus is needed, and each partner

frames the issue in terms of his own particular business and experience. These conflicts are compounded by the economic reality that while a particular commitment might achieve substantial, long-term benefits and profits for a *future* group of partners, it would impose large and certain potential short-term costs and difficulties on the *present* partners, who will be making the decision on whether or not to absorb the costs and make the investment. It is a testament to the strength of the Two Johns' leadership and their long-term vision that the large investment in International was made and sustained over many years.

As a trader who always had to worry about the very short term, Bob Mnuchin might have been expected to resist a large long-term strategic investment, but he was strongly in favor of the commitment to building the firm's international business. "We know capital markets and trading in ways the Asians and Europeans may never know. They don't understood how to use capital in trading. It takes years to learn block trading—and they may never figure out how to do it properly." As so often before, Menschel and Mnuchin did not agree.

Richard Menschel was skeptical of a major international expansion. "We have great opportunities right here in America. We know how to win this game; we know we have the people who can do it; and we know we can make lots of money—*now*." Menschel was not alone. Many partners took a similar view: Making a big push to go international would be a waste of time and a waste of opportunity to make money. "We can make much more profit by building up our already strong domestic business," ran their arguments. "This is no time to pull our best young lions and tigers—who are rapidly building up the business they generate right where they are—off the line in big markets to redeploy them into markets like London and Paris, which may have famous names but are really very small business opportunities and even smaller profit opportunities. If Europe or Asia-Japan really is a major long-term business opportunity, we can go after it in five years or even ten years. It will still be there. Let competitors bash their heads against the walls of regulation, different cultures and languages, entrenched nationalistic relationships, anti-Americanism, and all that stuff while we build up our profits and our capital and our organization in our huge home market, the biggest, best market in the whole world—and with five more years of doing what we know we can do, we'll own the essential market, our market. Let's not risk losing this once-in-a-lifetime opportunity when, by just waiting, we'll soon be

able to launch an international expansion from a position of great strength. We'll be unbeatable."

Change could create opportunity for Goldman Sachs internationally if the firm could find the right point of entry. So acquiring a strong local firm was an obvious possibility. Wood Mackenzie, one of London's leading brokerage firms, had been doing stockbrokerage business for Goldman Sachs. Because it made every effort to give excellent service, that business had grown until Wood Mackenzie was doing virtually all of Goldman Sachs's agency brokerage and all the trading for partner Bob Freeman's international arbitrage business—making Goldman Sachs its twelfth-largest account. At a luncheon to get to know Goldman Sachs's branch manager, Bob Wilson, John Chiene of "Wood Mac" explained, "We have no U.S.-share business to send your way, so we can't reciprocate directly, but there must be other ways we can be helpful." Wilson knew that Freeman wanted badly to meet with a key European Union regulatory official in Brussels who was proving completely unavailable, so he asked Chiene for advice on whether it would be possible to arrange such a meeting.

"Whom do you wish to see?" asked Chiene.

"Christopher Tugendhat. We can't seem to get through at all."

"I'll see what we can do and will call you back. When would you most like to meet if it can be arranged?"

No need to tell Freeman that he had known Tugendhat for years, had retained him as a consultant to Wood Mac, and, out of friendship, had been one of his initial financial backers when he wanted to run for a seat in Parliament. Tugendhat took Chiene's call, of course, and said he would be delighted to meet at any time on any day. In less than ten minutes, the inaccessible and essential official had an appointment with Freeman at just the right time, and Chiene had made a vital point: Wood Mac was good at getting things done.

The partners of both Goldman Sachs and Wood Mackenzie were beginning to think of a possible combination. The conclusion of Wood Mackenzie's annual partners' business-planning weekend was that the future would bring transatlantic ownership of securities firms. But by whom? Not knowing the answer, Chiene went across to New York and called on every major firm. After meeting Dick Menschel and others, Chiene concluded, "It's a no-brainer. Goldman Sachs is clearly number one." After Britain's Big Bang in 1986 brought deregulation and

substantially opened up the firms of London—previously closed by law to outside ownership—Goldman Sachs was interested in acquiring a 14.9 percent stake in Wood Mac, the largest amount then allowable, so a full day of discussions and a dinner were arranged in New York City. Chiene prepared a thirty-page "tell all" memo on Wood Mackenzie, and discussions during the day were so candid and forthcoming that Dick Menschel said, "We've told you more about our firm's operations and profitability than we've ever told anyone else." The discussions went smoothly; goodwill was steadily increasing on both sides. After a short break, the discussions were to be picked up again during dinner.

The purchase price—set at $350 million—was too much for Goldman Sachs's management committee to pay for a strictly agency broker in the UK, but if American-style block trading could be added, perhaps a deal could be struck. Bob Mnuchin would be critical to any major move based on the potential profitability of block trading, because that was clearly his business.

As the fifteen Wood Mackenzie partners and their counterparts from Goldman Sachs sat down for dinner, the day's open cordiality was displaced. The evening's discussion was dominated by Mnuchin's increasingly aggressive questioning about how Wood Mac was organized for trading, particularly block trading. As Mnuchin's manner became more and more belligerent, Mnuchin's partners recognized alcohol as the probable cause, but the Scottish visitors didn't realize what was going on. While Chiene and others tried to clarify politely that in London, a firm was either an agency broker *or* a market maker and could not be both, Mnuchin didn't get it and persisted in pressing his tougher and tougher questions in an increasingly argumentative way. The meeting rapidly deteriorated until it could continue no longer. As the evening broke up, Mnuchin and Chiene took a cab uptown together. As Chiene observed years later, "It was a *long* cab ride."

The next morning, Chiene got a call from a Goldman Sachs partner: "We're told Bob really bombed last night's meeting."

"Yes, he did."

The discussions were over—forever—and another way would have to be found to build a significant business in London and Europe.[5] As Steel later explained: "You could argue that the buildup would have been faster with an acquisition, but most of such combinations have proved to be costly disappointments—usually within just a few years' time."[6] Big Bang in 1986 not only allowed agency brokers

to combine with market-making dealers, gilt (British Treasury bond) dealers, and merchant banks, it allowed foreign banks and firms to buy into British firms. In a flurry of activity, over twenty combinations were effected in just two years. Almost all were soon failures.

After substantial debate and disagreement, the strongest leaders prevailed—particularly John Weinberg and Jim Gorter, head of the Chicago regional office and one of the real powers in the firm. The decision was made in late 1986 to build, not buy, and to build as quickly as possible. As David Silfen recalls, "We could see the first indications of major change developing in Europe—change that was coming our way. So we made the decision to pull some of our very best young people out of their positions in Chicago, Los Angeles, and New York, and send them over, saying, 'You have two responsibilities. First, figure out how to build a significant and sustainable business over there and build it! Second, find your successor—somebody with a local passport—and show him or her how to be very successful. After that, you can come back home.'" For those who were successful, the promise of a partnership didn't need to be spelled out.

Bob Steel remembers Dick Menschel saying to him, "Some clown will call you and give you a song and dance about going to *London,* for God's sake." The message was clear. "Don't be a fool and don't be a sucker. Going would *not* be good for your career." The next morning Steel got a very different call from Jim Gorter: "Bob, this is probably the most exciting moment in your life and the best day in your career. You have done very well at Goldman Sachs, so now you'll have the chance to go to *London* and show us all how very good you really are." Similar calls went out to all the chosen. Steel went to Terry Mulvihill for advice, ready for his "uncle" to try to keep him in Chicago, but the reaction was completely different: "This is your great opportunity, Bob, so you just get the hell out of here, go to London as fast as you can—and make us all terribly proud of you and what you can do."[7]

Gene Fife, Bob Steel, Jeff Weingarten, and Pat Ward were among the pride of ten young lions who went to join Bill Landreth and John Thornton in London and Henry James in Tokyo to transform those offices from remote overseas outposts into major international centers and to take the profits from marginal to major. The talent infusion comprised some new partners still determined to prove themselves and some almost-partners with at least equal determination, all believing

they could certainly do good and maybe great business by selling sophisticated services—services they knew well from experience in America—into European markets where the local bankers and brokers had had no experience with many kinds of transactions. The pan-European market was just developing, so no indigenous firms and no international competitors had entrenched positions.

"In the early years the firm rarely sent over its best people," acknowledges Thornton. "Predictably, in those circumstances, the most outstanding European professionals were not going to join the firm either. Just saying 'We want to be global and excellent' was not enough. Even after the firm started to invest seriously in Europe, most of our best people chose to stay home, focus on U.S. clients, and do familiar transactions with well-established strategies, with assured high-margin revenues and profits. So in Europe, we decided to take the hand we'd been dealt and do the best we could through intensity of focus and effort. Our recruiting and business development had to be done country by country so as to build critical mass in each market. Once you succeed in recruiting one outstanding European, it is easier to get a second and a third and so on. We started in the UK and expanded to France and Germany and then the other major economies."

When Steel arrived in London from Chicago in February 1987, assigned to build a large, profitable stockbrokerage business based on trading and arbitrage, Goldman Sachs was doing only a modest twenty-million-dollar annual business selling American shares to British and Continental institutions in roughly equal proportions—along with a few tired brokers peddling British shares. It was clearly not an important business, but Steel's mandate had been made clear to him: "If you make this business important to the firm, the firm will make you a partner." That was not going to be easy. The British-share business was large in volume, but very low in profit margins, while the American-share business was growing in volume, but margins were shrinking as commissions were negotiated lower and lower. The best hope was to convert a low-profit agency business into a profitable proprietary dealer business with arbitrage primarily in two dozen dual-listed stocks—including BP, ICI, Royal Dutch Shell, and Tokio Marine—that had shares in London and American Depositary Receipts in New York, where an American firm had a comparative advantage.

"We realized that with Big Bang, institutions would soon be dominating the stock market, and their demand for liquidity would increase a lot," recalls partner

Peter Sachs. "This meant block trading would come to London, and this would change the market so much that the whole process of corporate deals would speed up. With Big Bang, bankers, dealers, and brokers would be combining, and markets were sure to move upstairs and require huge capital bases. The London brokers and merchant bankers had little capital, so not only were they unable to defend their home turf, they couldn't attack ours. It was classic Clausewitz! We knew from our U.S. experiences with May Day just what kind of future London was moving into with Big Bang, so we knew we could create a major business. But first we had to become a strong indigenous firm or merchant bank." Though the stockbrokerage business usually ran at or near breakeven on routine business, a skillful and committed trading firm could see most of the trading possibilities, so it could pick and choose the best opportunities for profitable trading. On top of this base business, any underwriting business a firm did would bring in almost pure profits. The last thing London's established firms wanted was to share those limited revenues with newcomers and outsiders like Goldman Sachs. "The British firms wasted no love on Americans trying to muscle in on their business," remembers Steel, "particularly since it really wasn't a very big business. Offices were shabby, trading was all agency business, and there was too little business to share—and yet, there we were!"

Steel decided to reconnoiter the situation by calling on major clients to see how the firm was perceived and how it could increase its business. "I went over to King William Street to see Mercury Asset Management, by far the largest account in London and in all of Europe, to see what our strategy ought to be and how we could build on the base of our U.S.-share business, where we knew we were getting ten percent to twelve percent of their brokerage business." The first thing Steel learned was that Mercury's U.S.-share business was just a tiny fraction of its total brokerage-commission volume. While Goldman Sachs had an okay competitive position in American shares, that business was really unimportant to Mercury—and, as just an American-share broker, Goldman Sachs was unimportant too. The fact that Goldman Sachs was doing pretty well as a broker in U.S. shares did not matter one iota to the people at Mercury who were doing the really big business in British shares, Japanese shares, German, Dutch, French, or Italian shares. Finally, every investment group—domestic British or Japanese or Continental—was on a separate floor of Mercury's building; every

group made investment decisions and allocated brokerage commissions in its own particular way. To be important *overall* to this very important account, Goldman Sachs would have to build relationships on each and every floor—almost always starting near zero and competing against formidable, established competition.

"So that's what we set out to do," says Steel. "I went to the management committee and said we should hire two and a half *times* as many people as we had. The management committee said 'Go!' and we hired twelve people that first year. We hired people with talent, drive, and skill—thirty- to thirty-five-year-olds who knew their business and were ambitious—by offering them the chance to work with the big accounts they would have had to wait ten or twenty years to take over at their old firms. We had zero turnover in our people, while other firms suffered twenty percent to thirty percent turnover. And we added three percent to six percent through new hires each year—all MBAs—and focused on the discipline of going for dollars. In the recruiting interviews, we learned a lot about how the City really worked and how the game was really played. For example, we learned that senior people of [the patrician London brokerage firm] Cazenove would give research insights first to favored clients who were insiders in the old-boy network, so they could get invested ahead of the other institutional investors. We didn't think that was an ethical way to do business."

Fortunately for Goldman Sachs and the other American invaders, the established British firms made serious strategic mistakes. Some joined with commercial banks to get capital, but along with the capital they got stultifying commercial-bank management and commercial bankers' concepts of compensation and risk taking, which soon smothered the acquired brokerage units. Some brokerage firms combined with other brokers to get scale but did not get the capital they would soon need for market making. S.G. Warburg, then Britain's strongest merchant bank, dispersed its once-formidable strengths with an unfortunate acquisition strategy of buying up one of the two or three leading brokerage firms in each country on the Continent. That strategy would doom the once-great firm to a business model with a high cost structure but only mediocre revenues, and to strategic sclerosis, with proud local executives, experienced in their own national markets, holding on to their familiar strategies and their own senior management positions while trying to protect their local people from the disruptive impact of the drastic changes that were required for an integrated firm to become cost-effective.

Cost-effectiveness was clearly the strategic imperative as the business went from closed and protected national markets to open markets with intense international competition steadily eroding the commission-pricing structure. Most Continental stockbrokers tried to combine with brokers of other countries, which made them, like S.G. Warburg, high-cost, rigid-structure outfits. This unfortunate strategy made it almost easy for the Americans—particularly Goldman Sachs, Morgan Stanley, and Merrill Lynch—to break through with aggressive speed and flexibility. While S.G. Warburg bought the firms of the past and imprisoned itself in an inflexible, balkanized, high-cost organizational structure, Goldman Sachs began recruiting one by one the best individuals for the future while keeping costs under control and maintaining flexibility. Equally important, Goldman Sachs appreciated the inevitable direction and formidable magnitude of change that lay ahead for every firm, having just experienced the same revolutionary market transformation to institutional dominance in America.

The most important objective, particularly in investment research, would be to shift the firm from being perceived as the risky, here-today-gone-tomorrow American firm that nobody who was really any good would feel safe in joining to the powerful, here-to-stay global leader that understood the future and knew how to succeed in the new era. To establish unusual, visible strength in research, a few key hires were essential. At this juncture, the firm got lucky because, as always, chance favors the prepared mind.

After growing up in Rhodesia, reading economics at Oxford, and completing his doctorate at Cambridge, Gavyn Davies went to No. 10 Downing Street with the Labour government of James Callaghan. He then joined Phillips & Drew, a well-regarded research and investment firm where he worked with David Morrison for a few years before they went together to Simon & Coates. "With the looming prospect of Big Bang, we felt it necessary to upgrade our employer," says Davies. "We decided in 1985 to investigate the Wall Street firms and thought Morgan Stanley or Goldman Sachs would be right, but we didn't actually know anyone. We knew that Goldman Sachs had no international economist, so I called Lee Cooperman in New York and he passed me on to Gary Wenglowski, who was the firm's chief economist."

Wenglowski was brusque: "Never heard of you. Why do you want to work for Goldman Sachs?"

"We've identified you as a firm that can *win*."

"Well, I've no idea who you are or what you can do, so I can't give you any encouragement." And that was effectively the end of that.

A year later, Goldman Sachs was expanding in fixed-income dealing in a series of markets straight across Europe—gilts in the UK, Bunds in Germany, and others. As an ambitious but novice bond dealer in Europe, the firm needed an economist to cover these new markets. "They did a search," recalls Davies, "and found . . . David Morrison and me."

"Why should we go there now?" asked Morrison cautiously. "They didn't hire us when we offered ourselves to them a year ago."

But a year had passed, and they could now credit Goldman Sachs with being committed to developing strength in research and having some basic knowledge of the major economies of Europe. Davies was increasingly confident that Goldman Sachs was a winning firm and that he and Morrison could be winners within Goldman Sachs, a double multiplier. They became the European economics team at Goldman Sachs and then expanded their international coverage to include Japan and Asia while Bob Giordano built up the U.S. economics operation, which Davies and Morrison then integrated into a whole—not as U.S. economics with an international adjunct, but as international economics *including* the United States. Their timing was perfect.

The markets, particularly the currency markets and the debt capital markets, were being integrated worldwide, and institutional investors were expanding their international commitments. So everyone was suddenly looking for a global-economics context for decisions, and the traders at Goldman Sachs were looking for helpful guidance on where to avoid troubles and where to look for profit opportunities. Recalls Davies, "Clients saw Goldman Sachs taking the *world* seriously. The U.S. was the elephant, but that was not the whole story."

Because David Morrison enjoyed the debt markets even more than he enjoyed economic theory, all their work on economics and currencies got integrated into the trading operations of the firm and made serious money for Goldman Sachs. The firm's traders found his help valuable because Morrison had a keen eye for

short-term anomalies in the market as well as the long-term political policies of various nations.

Davies concentrated on the central banks and forecasting interest rates and changes in exchange rates. "We did a lot of writing and personal presentations using charts to make things understandable. Institutional investors found all this quite useful to them. We were in the right place with the right information at the right time, and in less than two years we each gained a partnership—partly because the firm knew it needed to have highly visible European partners in order to overcome the rampant local prejudice against flighty, unreliable American outsiders who don't understand our ways and our values." This xenophobic but widely held view of American firms would have to be changed if Goldman Sachs was going to recruit the best and brightest Europeans to combine with the group of young firm leaders sent over to Europe by Gorter, Rubin, and Friedman.

"Next came a major money-spinning success in the currency markets," recalls Davies. "We called two major devaluations. Also, the firm was keen to be a government bond dealer in the UK and Germany, and our work on those two economies was quite helpful." Inside the firm and in the markets, it was soon recognized that Goldman Sachs was serious about being international. "God damn!" said Leon Cooperman. "I never would have believed we'd have a partner who was an international economist—and never *ever* that we'd have two!"

Davies and Morrison started Goldman Sachs's research in each new market by establishing the visibly best economic research product. They were determined to avoid two critical errors: having too short-term a focus on the vagaries of any specific business, and having a single worldview; intellectual competition within the firm was encouraged. A third factor crucial to their success and their credibility with clients was their evident independence. "We were independent of any inappropriate pressure to act on behalf of the House," says Davies. This would be proved by a dramatic confrontation.

Analyzing their data on the French economy and the French franc, Davies and Morrison came to a strong conclusion that the franc was seriously overvalued and sure to be devalued. The finance director of the French central bank, a Monsieur Stan, came to Davies's office one day in 1993 waving Davies's report that

France would probably devalue the franc. "What *is* this report? Do you *dare* to believe what you have written?"

"Yes," said Davies calmly, "I do."

Stan was indignant and left quickly, giving assurances that more would soon be said.

Two days later, Jean-Claude Trichet, Stan's superior, insisted that Steve Friedman come to his office at the Banque de France. He was in a rage. "You are ignorant! You do not know France! You are ignorant! We will *never* devalue!" The whole weight of a major nation's central bank was projected—at the highest level—directly at forcing Friedman to fire Davies. "You are useless and your firm . . . your, your Goldman Sachs . . . will never earn another sou in France unless you fire the person who did this awful thing!"

Having checked out Davies and Morrison with others in the firm, Friedman carefully drew the line in the sand: "Mr. Davies is a fine economist. He has earned the respect of our many clients through the care and rigor of his analyses on currencies. His professional independence is essential to our clients and, therefore, to our firm. So, with all due respect for you and your position, sir, I have no intention of telling him what to say or what to do." In less than ninety days, France devalued the franc.

Davies and Morrison concentrated their analysis of currencies on trying to develop just three or four major opinions a year. For each major opinion, Goldman Sachs was able to create significant, highly leveraged trading positions. About two-thirds of the time, Davies and Morrison were correct. For skillful currency traders, these very favorable odds were an enormous advantage. Big money was made over and over again.

Tim Plaut, S.G. Warburg's stellar auto analyst, understood the strategic realities of the revolution coming to London but could not get his alarming view of the future recognized at his own firm. So, thinking *if you can't beat 'em, join 'em,* he contacted Davies. They discussed the outlook, and Davies lured him into Goldman Sachs as one of the first of a pan-European all-star research team—all located in London—that would be a strong third leg of an integrated multinational research-banking-trading triangle with powerful competitive advantages. With its multinational organization, Goldman Sachs would steadily gain dominance over the country-by-country brokers, particularly at the larger institutions where the best brokerage business was concentrated.

With this "first robin," Jeff Weingarten, who himself had been a celebrated analyst in America, launched a one-by-one recruiting campaign and steadily built a strong research team. His strategy was to probe the major British institutions' analysts in each industry for the names of "promising but still too young" analysts with a strong commitment to client service and unusual drive, offering these comers a chance to move up faster than their current employers would think appropriate. As an "analyst's analyst," he was a convincing recruiter and soon made Goldman Sachs a career-destination firm.

On many occasions in its long, competitive struggle to market leadership, Goldman Sachs made large, sudden advances or ducked large, sudden losses. Sometimes it was by being lucky; sometimes it was by being astute. When David Mayhew, head of Cazenove, wanted a meeting with Goldman Sachs's senior management, Pat Ward took over for Bob Steel, who was in New York for meetings. A South African who had been working out of the Tokyo office, Ward was new to London and had not yet met Mayhew, who was coming to the firm to discuss a bid for a large block of newly issued Daily Telegraph Company stock.

Mayhew arrived at Goldman Sachs's London headquarters at five in the afternoon. To greet his guest, Ward put on his suit jacket, because Cazenove was recognized as the queen's stockbroker and held a special and carefully nurtured prestigious position in the City. Going to Room F, Ward greeted his guest and introduced his trader, Mike Hintze. Mayhew took out a cigarette, lit it, and, in a gesture asserting control, pulled the heavy glass ashtray toward himself so he could reach it more conveniently. Ward detests smoking and doesn't like the residual smell of smoke in his clothes, so he took off his jacket. Mayhew, clearly expecting to dominate the meeting, spoke with assurance: "The decision maker for this transition is in In-dyah. I spoke to him today and told him that with the market at 513p, the right price would likely be 503p."

Hintze, a six-foot-three Aussie trader who specialized in bidding on large blocks of stock, sat looking vaguely at the floor, rolling a ballpoint pen back and forth between his palms, his hands moving faster and faster.

Ward rose, walked behind Mayhew, began stretching gently to ease a pain in his back, and, carefully avoiding formality, spoke: "David, thank you for coming

and thank you for your preliminary thoughts." Then turning directly to his Aussie trader, he continued: "Mike, you've heard one opinion. You know that this trade is very large—approximately £180 million—and the trade can only be done, can only be *considered,* because of our firm's large balance sheet. It can't be done without us. So, Mike, *you* will decide the price you will pay—and when you have made your decision for our firm, that decision will be final."

Goldman Sachs bid 493 pence. It took two full days to complete the resale—and then, just twenty-nine days later, the market price plunged, dropping over 40 percent to less than 300 pence because Daily Telegraph, worried about faltering sales, had cut the retail price of its newspaper, which was sure to cut deeply into earnings. As Wellington said of Waterloo, "'Twas a damned near-run thing." And as the Sopranos would mutter: "It's not personal. Just business." Welcome to London.[8]

Important as the stockbrokerage business clearly was for Goldman Sachs, it would be even more important for the firm to develop a strong international business in investment banking—partly for profits and partly for prestige. Many UK corporations were worth more than their current stock market value, so the firm soon focused on becoming defense advisers to companies threatened by takeover raids and at least participating in, if not winning, every deal it could. As the leader in takeover defense in America, Goldman Sachs had special expertise in this compelling new aspect of corporate finance and a favorable reputation as the trustworthy friend of management.

The "dance of death," as John Thornton called it, was the process by which a company with no escape would go inevitably and eventually into *somebody's* hands. "You could influence the outcome and you could often select the eventual acquirer, but you could rarely prevent some sort of takeover from happening. The worst choice was for a management to believe such head-in-the-sand foolishness as: 'Those *idiots*. We'll soon be rid of them!' "

Imperial Group, formerly Imperial Tobacco, bought Howard Johnson in the United States via Goldman Sachs's Bob Hamburger. Then Hanson Trust raided Imperial—and won. Goldman Sachs had been on the raid-defense team, backstopping Imperial's traditional merchant banker, but an acquisition was eventually inevitable. After it was all over and the acquisition was about to be formally implemented, all participants went around to Imperial's offices for a "funeral"

luncheon, which lasted almost until the three o'clock moment of official closure on the takeover—after which the Imperial executives were sure to be tossed out of their jobs. Conversation turned to what each man would do next. One said he was off to India; one was going to tramp Hadrian's Wall for two weeks. The pair from Goldman Sachs, sitting at the lower end of the table, said they had to leave for a four o'clock appointment at Woolworths, which had hired Goldman Sachs the day before to defend it against a raid by Dixons, the electronics retailer. Goldman Sachs was focused on the next business transaction.

Intensity of commitment and very long hours differentiated Goldman Sachs. An American got into a London cab at the Savoy Hotel at seven one morning and gave his destination to the driver, who turned and asked another cabbie: "This gentleman's going to the City. Can you guess which address?" The answer seemed obvious to both: Goldman Sachs—for breakfast.

The CFO of Vickers told a partner, "If a British merchant banker were up all night working to complete a transaction, he would never tell anyone for fear he would look inadequately skillful. But if an American pulled an all-nighter, he would make certain to tell me—as proof of his commitment."

From the beginning," Thornton recalls, "we decided to focus on two groups of potential clients: the leading blue-chip companies which we knew would take a long time to win over and companies which were in difficulty and were, therefore, more likely to be open to fresh thinking and new advisers. We believed that we needed to advise one consequential person or company in one significant transaction, and then a second and a third, until one day we would have a compelling record of distinctive advice and impressive results. In 1986, after three years of quietly building the business—almost invisibly—exactly this began to happen. That year we defended four of the five first ever one-billion-pound hostile takeovers and were successful in keeping three of the target companies independent."

Thornton explains: "In a situation like this, at the very beginning, you, as an individual, *are* the 'brand.' You have nothing to carry you and nothing to fall back on. Going from an initial meeting and general discussion to specific, nuanced advice that is listened to and accepted is a transformation that's

completely dependent on you—what you say and do, how you develop each relationship, how you build up the prospect's confidence—not just in your *firm*, not just in your *advice*, but in *you*. And that confidence has to be strong enough to prevail against the tide of general opinion and natural resistance to change, which is particularly strong in major financial transactions. The typical CEO is sixty, and I was twenty-eight—a kid! How could I persuade the CEO to trust me and decide to rely on me? The answer seemed obvious: Be distinctive so you can't be replicated by others. And in doing so build the necessary personal trust and confidence. Eventually, of course, this would translate into respecting and trusting the firm—but it takes a long time."

Another obvious answer was to get help from New York. Peter Sachs, grandson of Harry Sachs, brother of Marcus Goldman's first partner, was assigned to provide senior coverage with Thornton in leading a sea change in London. Sachs recalls: "We went to school on the UK market to learn the business drivers. Press coverage was crucial. Our PR adviser was very helpful to us—and we to him because we brought him in on many deals. The Sunday papers were key to our whole public relations program. We were also the best clients of the law firms that worked with us, and they naturally told their clients how they saw us, our commitment, and our capabilities. Using lawyers, we had both the legal and financial sides covered. With our repeating big fees, we soon became the lawyers' best friends. Our question for lawyers was always the same: not *can* we do this deal, but *how* can we do this deal? We used a lot of lawyers—and taught the British merchant banks to do the same. We brought the 'indemnification letter' to London, whereby the corporation pledges, if a deal fails, to cover Goldman Sachs's costs and losses—unless we were terminated for negligence. For five months, I flew to London every Sunday, came back Thursday night to spend the day in the office on Friday and a Saturday with my family, and then back on the plane on Sunday, headed to London."

Personal commitments such as Peter Sachs's were, like the first few robins of spring, an early indication of the commitment of American firms like Goldman Sachs—where the London organization went from 120 people to 880 in just four years. Such commitment would bring major, disruptive change in the London market and make the rapid rise of Goldman Sachs inevitable.

20

BREAKING AND ENTERING

Eric Dobkin's big break came in 1984, but at first he certainly didn't recognize it when Jim Gorter, as co-head of investment banking, called. "We just had the first meeting of the investment banking strategic planning group and, Eric, here's what we found: Goldman Sachs ranks first in institutional research, first in institutional sales, first in block trading—all the important *parts*—but when you put it all together in equity league tables showing where firms rank in common-stock underwriting, Goldman Sachs ranks . . . only . . . ninth! Eric, *we* have a problem and *you* have an opportunity. Go figure out how to fix it! In equity underwriting, with all our strengths, Goldman Sachs should rank *first!*" Gorter gave Dobkin one key advantage: freedom to pick his own team.

After Gorter hung up, Dobkin, forty-two, was worried, really worried. "I had *no* idea what to do," he recalls. "The next day I had no idea what to do. And the *next* day I had no idea what to do *and* I'm starting to lose sleep. Finally, on the fourth day, I'm standing in the shower when I have an 'aha!' and realize what we have to do: Turn the whole syndicate business on its head."

For decades, the underwriting business had been organized around the

traditional critical need: to get *distribution* for the new issue when a corporation needed to raise capital. Retail brokers had the accounts with individual investors, so syndicates of retail brokerage firms were organized to gain access to the many thousands of individual investors that were, realistically, unknown to the major underwriters who originated issues; as wholesalers, the underwriters traditionally focused on their clients, the corporate issuers. This system worked when the business was dominated by retail investors—but by the early eighties, the securities business was dominated by institutions. For an institutional market with professional investors making all the decisions, the old syndicate business was completely obsolete. It added little value because it required no understanding of each investor's portfolio strategy, how he made investment decisions, why he might or might not buy a particular offering, and the role his research analysts played. Old-line underwriters had no understanding of the new world of institutional marketing and distribution and didn't know how to craft a strong sales pitch or organize an effective road show for audiences of experienced, professionally skeptical institutional investors. "They didn't even know enough to rehearse their presentations," marvels Dobkin in retrospect.

In his shower-stall epiphany, Dobkin realized almost immediately how Goldman Sachs could easily outflank such out-of-date, out-of-touch, ossified competition: "All we had to do was take the skills and strategies we'd developed while serving institutions in the *secondary* market and apply them to doing business in the *primary* market. We'd need salesmen who could really sell the fact that Goldman Sachs has the best institutional relationships *and* the best access to the best institutional shareholders *and* that we know how to merchandise interesting investment ideas to the most attractive institutions."

Establishment firms all have the same priority: Protect their old business—the business senior executives know best and are best at doing. Often, that's also the business with the highest-profit history, cloaked in the folklore of the organization. But business models don't work forever. As clients change and clients' needs change, any intermediary needs to change. A once-great business model can become a dangerous sacred cow when it gets old and tired and profits start fading. Yet change is difficult. Hardly anyone wants to wrench away from the traditional, comfortable way of doing business simply because the traditional way is not fulfilling client needs or preferences.

Wall Street's traditional underwriting syndicates were elaborate expressions of just such legacy issues. The rules that governed syndicate participation were more like those of a fraternity than those of a hard-nosed, pay-for-performance business. The major underwriting firms cared deeply about maintaining their "traditional" positions in each company's underwritings. Because the leading investment banking firms that originated the corporate stock and bond offerings did not have retail distribution, they needed the "wirehouse" retail stockbrokers for distribution, so the wirehouses were powerful—powerful resisters of change.

With retail brokers talking only to individual investors and underwriters talking only to corporate issuers, nobody was organized to serve both sides. So Goldman Sachs positioned itself right in the middle of the action. The major changes on the buy side that came with the strong growth of institutional investing created a vacuum. Institutional investors wanted new services that met *their* needs, which were quite different from individual investors' needs and were not being met by retail brokers. Institutions didn't want to buy a hundred shares, they wanted *a hundred thousand* shares. Institutions didn't want the one-page reports used by retail customers, they wanted twenty- to fifty-page analyses produced by industry experts who really knew the companies and could give well-documented advice on which were the better investments and why. The stock market was moving away from retail toward institutional investors, and a local retail brokerage office in, say, St. Louis or Indianapolis couldn't possibly meet the service requirements of institutional investors—in-depth company and industry research, large block transactions, direct access to corporate management.

Goldman Sachs organized itself to sell very large amounts of stock in an underwriting by developing a rigorous sales and marketing plan for each transaction before the underwriting came to market. If Federated Department Stores was the issuing company, then Goldman Sachs's retail-industry analyst, Joe Ellis, would go out and visit with the major institutions: one day in Los Angeles, one day in San Francisco, one in Minneapolis (mostly at Investors Diversified Services), two days in Chicago, three days in Boston, three or four in New York City, and one in Philadelphia. At each institution, Ellis would review the retailing industry with the institution's retail analyst and one or more portfolio managers; define Federated's competitive position, its strategy and its prospects; cite the key data for the current year; explain the prospects; and answer any and all questions.

The salesman who went with Ellis to make all the appropriate introductions would focus on gauging the depth and degree of interest, sizing up potential demand, and planning the best way to get a major order from each institution.

"If we had the time, we did all the same work when the firm had a big block of stock to sell," explains Dobkin. "So none of this was new to us—or to the accounts. First, we had to recognize that in an institutional market the biggest difference was the number of zeros—and the amount of time we would have to organize and execute effectively. Order size was larger, time to execute was shorter. Plus, in the equity capital markets business, we were working in the primary market, so unlike with everyday new issues, we now had [the issuers'] corporate management on our side, actively working with us, and we seldom had to risk our own capital. Our equity capital markets underwriting business was similar to the old system in only one way: We had an SEC prospectus. Because those were the SEC's rules, we did not issue a *written* research report during the selling period. But we did send our 'rainmaker' analysts around the circuit to lay the groundwork for the actual offering. Besides, just because there was no formal written research report, that didn't mean our salesmen couldn't recite the key facts and tell the story as our industry analyst saw it. At the same time, the firm would identify the probable major buyers, work with corporate management to craft the right story, and set the right price."

The firm could custom-tailor selling to the institutional market—institution by institution—because Goldman Sachs knew from all its day-to-day work with the institutions what each institution wanted and how it made its investment decisions. Dobkin and his team would sit down with the key corporate executives and say, "Here's the right way to merchandise your company's stock to each of the specific institutions we know you really want as investors," and then demonstrate that they knew the institutional market at every level—portfolio managers, analysts, and traders—and knew how to employ Goldman Sachs's investment research and how to deal in blocks. Dobkin recalls: "The corporate executives found it all quite fascinating, and this gave us an edge. We also showed the corporate executives that we were real people—not stuffy, pompous investment bankers like those from other firms who didn't really know either the corporation or the institutions. We put a wedge in between the issuers and old-line underwriting houses like Kuhn Loeb, Lehman Brothers, and Dillon Read because we knew

the institutions inside out—and they really didn't. Then we put another wedge versus the retail stockbrokerage firms because the corporations believed that with increasing ownership among high-quality institutional investors, their stock's price-earnings ratio went up—because we were creating demand for their shares through good marketing."

The old way of underwriting was basically adversarial—and one-sided at that, because the underwriting syndicate always lined up with the corporate client issuing the stock and then pushed the shares through the retail system to individual investors. But Dobkin said, "Wait! We do this kind of selling to these institutions every day. It's not a 'once in a great while' special event." He showed anyone who would listen how his new approach could be made a win-win, with the corporate issuers and the institutional buyers *both* benefiting by working together and developing a shared understanding. "Fair pricing was mandatory, and that was fully understood by both sides. Both the corporations and the institutions got engaged. *That* was the secret sauce!"

With this reconceptualization of the underwriting business and its intensive implementation, Goldman Sachs quickly became a major participant in more underwritings, increased its share of each underwriting, and even ran several major underwritings as the sole distributor. "Profits multiplied," notes Dobkin. From 1985 on, Goldman Sachs was number one in the equity underwriting league tables—except for one year. "As my grandmother always said, 'It's not a perfect world.'"

Developing the equity capital markets business in America was a triumph, but since at Goldman Sachs no good deed goes unpunished, Dobkin had to re-create his stateside success in Europe, starting in the United Kingdom. In the early 1980s, as Margaret Thatcher launched her Conservative revolution to privatize British industry and make voters owners, Kleinwort Benson quickly established itself as Her Majesty's Government's leading merchant banker by winning the bids to arrange the stock-market flotations of British Aerospace, British Telecom, and British Gas. Unfortunately for Kleinwort Benson, its triumph in winning the mandates as adviser to the government and lead underwriter was a classic Pyrrhic victory, one it really could not afford to win. Those mandates

required so much senior-level time to execute that while Kleinwort Benson got the prestige and the gross volume, they tied up its organization so much that it could not compete for important and much more lucrative corporate mergers and underwritings. As a result, Kleinwort Benson worked exceedingly hard for little profit during a challenging era of turbulent change in the City of London when every merchant bank needed extra profits to retain or recruit talented bankers to protect its traditional corporate clientele. Preoccupied with early privatizations like British Telecom, Kleinwort Benson found itself unable to fend off recruitment of its best young professionals—particularly by the more aggressive and profit-focused American firms like Goldman Sachs.

HM Government, while naturally preferring a British firm, took the broader view that American firms might offer particular comparative advantages in fresh ideas and new techniques—crafting a convincing story, rehearsing the presentation to perfection, knowing how to organize and run a road show—that could change the basis on which the enormous privatizations were done. Sir Steve Robson at HM Government and Sir John Guinness, the senior civil servant at the Department of Energy, were personally interested in opening up, if not breaking up, the close-knit oligopoly of the British firms in the City. Without considering other firms, HM Government turned to Morgan Stanley, the British government's traditional North American banker since the days of J.P. Morgan. This so infuriated Eric Dobkin at Goldman Sachs that he resolved to engage, swiftly and vigorously, with each and every senior HM Government official he could identify.

Then Goldman Sachs got lucky—very lucky—and Morgan Stanley could not have been more helpful to Goldman Sachs. British Telecom's privatization got badly screwed up—starting with the Morgan Stanley syndicate head's arrogantly telling the British government that Morgan Stanley absolutely would *not* accept the United Kingdom's traditional two-week exposure to underwriting risks. In the UK, most stock offerings were done by well-established corporations whose shares had long been listed on the London Stock Exchange. Underwritings of common stock—usually 10 percent to 20 percent increases in total shares—were done as rights offerings, with most of the shares taken up by institutional investors that were included in the offering syndicate as subunderwriters when they agreed to take an agreed amount of stock at an agreed price. In addition, the underwriting syndicate's offering price was fixed on "impact day" and

then held for two weeks to provide enough time for individual retail investors to read the full-page newspaper ads offering the shares, clip the order form at the bottom of the page, and mail in their purchase orders. In the usual UK rights offering, this leisurely and gentlemanly way of raising moderate increments of equity capital had been satisfactory for both issuers and investors, but Margaret Thatcher's enormous privatizations were different—radically different in scale and in structure.

In scale, privatizations were huge—many times larger than the traditional, incremental rights offerings—and were initial public offerings in a market with few IPOs. As IPOs they had no price history and no established group of shareholders. This meant that the risk involved in underwriting—and holding to one fixed price for two long weeks—was much greater than the risk in an American-style underwriting, where the whole transaction, after several weeks or days of informal prearrangement, is formally completed in a few minutes or seconds. So Morgan Stanley balked and the Bank of England agreed to take 100 percent of the market risk by underwriting the U.S. placement and thereby guaranteeing Morgan Stanley against loss.

Then everything went wrong. The UK underwriters badly misjudged both the pricing of the offering and the aftermarket demand for British Telecom shares. Investor demand from both institutions and individuals was *very* strong. A particularly insistent demand for shares came from the large index funds because the *Financial Times* had decided to include British Telecom in its widely used "FTSE" stock-exchange index, known as Footsie, on the day of the offering. Every index fund felt compelled to buy British Telecom. However, the index weighting of British Telecom was calculated as if 100 percent of British Telecom shares were publicly owned, while the initial offering was only for 25 percent of British Telecom shares. As a result, supply was far too limited to meet the index funds' requirement, so the stock was bid up in price an astounding 100 percent on the first day.

That was bad underwriting in the UK, and the impact in the United States was worse. Despite the British government's policy priority of establishing a broad retail investor base, Morgan Stanley sold most of its part of the offering to a few favored institutional clients that quickly sold the stock to take their quick profits. All the stock that was supposed to be held by long-term investors in North America got on the supersonic Concorde and flew straight back to London

even before the ink could dry to meet the demands of the index funds. The reflow was terrible. None of British Telecom was still held in the United States! It was a disaster. Morgan Stanley got blamed in the press. This made it politically difficult for HM Government to select Morgan Stanley for the next big privatization.

That's when Dobkin, seeing his major competitor blocked so he had an open field to run in, began commuting to London every week, sometimes taking the morning Concorde over and the next Concorde back and sometimes staying several nights in London. His focus: Win for Goldman Sachs the mandate as lead underwriter for the next privatization. British Gas would be the largest IPO in the world; all institutional investors would be keenly interested; the competition to be North American lead manager would be intense; the manager would be selected strictly "on the merits"; and Morgan Stanley, the British government's traditional underwriter, was almost certainly out of the running with its handling of BT. Dobkin was playing to win on a grand scale.

"Intensity was Eric's middle name," says Bob Steel. "He called me to say we would meet Sunday at noon at the Dorchester. So off I went, telling my wife I should be back in less than two hours. Not even close: We went—intensively—that Sunday from noon until midnight. One morning, I got a call from Eric at three a.m. Struggling awake, I couldn't help asking: 'Eric, do you know what *time* it is in London?'"

"Of course I do," came the reply. "I'm here too."

Tony Ault of N.M. Rothschild & Sons, a tall, lanky chain-smoker, was appointed as HM Government's adviser for the privatization of British Gas. Dobkin was glad to have Ault playing this key role, partly because he had made his own way in life and was bright and direct, but particularly because he very clearly, like Dobkin and Dobkin's colleagues back at Goldman Sachs, had *not* gone to Eton. Ault would not be influenced by old school ties; he had made his own way. "Tell me what you're thinking about," began Ault. Dobkin, aggressive as usual, moved in quickly. "Cut the crap, Tony. Tell me what we need to do to win British Gas."

"Will Goldman Sachs accept the traditional UK underwriting risk?"

"Yes."

"Will you put that in writing?"

"You bet."

"You'll need to be prepared to put that commitment in writing."

Once again, Dobkin was out on a limb, committing the firm. Now, he had to get Bob Mnuchin's okay right away. Since Mnuchin had no way of knowing that Dobkin's call was urgent, it took three calls to get through to the Coach. Mnuchin had one question: "Will they price it to sell?"

"Absolutely. There's no way the British government is going to let retail get hurt; they're all *voters*."

Silence.

"Tell 'em we'll take one *billion* pounds."

"That's great, Bob. Absolutely great! Of course, you should sign the letter since you're the key decision maker."

"No, *you* sign. You're a partner."

"Seriously, you've gotta sign. You have the global stature."

Dobkin drafted the letter and faxed it to New York, where lawyers made minor changes and the letter was retyped, signed by Mnuchin, and faxed back to Dobkin, who went immediately to see Tony Ault at Rothschild. "I came to see you to present something very special. Here it is for your eyes to read."

Ault read the short, bold letter and, putting it down, said it all in just one word: "Wow!"

"Do I have the business?"

"Forget about *that*, Eric! This is just the first round in a very careful and quite deliberate selection process. The process cannot be rushed—even with this letter. It will take about a year." So for a year, Dobkin was on the Concorde almost every week—usually having five or six meetings, but sometimes only one.

A year later, the formal "beauty contest" was held to evaluate prospective underwriters. The adviser to the government, Ault, greeted Dobkin as a friend: "Hi, Eric." But this would not be a meeting of friends. Dobkin would be making his presentation to a review board composed of senior partners of London's major firms—the "great and good" of the City, serving their patriotic duty on behalf of Her Majesty's Government. The preliminaries were over; a final decision on the lead underwriter for the crucial, large North American market was on the table, and the question was put: "Mr. Dobkin, on behalf of Goldman Sachs, what is your price recommendation?"

Dobkin was determined not only to win the North American mandate for

British Gas, but to do all he could to force a revolutionary change in the way underwriting was traditionally done in London. In his answer, Dobkin attacked established tradition directly—on every front. If British firms traditionally kept secret which institutions were cooperating as subunderwriters, Dobkin would show all his cards, and promptly passed around an outsize multipage spreadsheet listing the institutional investors down the left-hand side and, across the pages, showing specific data for each institution in a series of columns with such headings as "Total Assets," "Equity Assets," "Comparable Stocks Owned," "Price Acceptable," "Required Number of Shares," "Number of One-on-One Meetings Held," "Research Contact," and so on. Total disclosure was Dobkin's objective. And that wasn't all. "For each institution, if you care to know more, we have in the large binders beside me a complete dossier—one page per institution—on our firm's evaluation of each aspect of that institution's decision making on British Gas." Then Dobkin asked for a much larger allocation of shares to North America, where institutions aren't interested in holding small amounts of a stock: "To do our job well for HM Treasury, we'll need more shares so we can meet the real demand among institutional investors in the U.S.—so they will get enough to have positions large enough to keep and then buy more."

Then he turned specifically to the question of price. "You ask what is our recommendation as the proper offering price for British Gas. In our judgment anything less than 125 pence would be wrong for Her Majesty's Government and wrong for the British people. Anything less and, candidly, I'll be personally insulted because both the Crown and the British people deserve full value. One other commitment: Goldman Sachs promises it will buy five hundred million dollars of British Gas shares up to a price of 135 pence."

Silence.

"Thank you, Mr. Dobkin. Would you please wait outside?"

Dobkin rose, collected his papers, looked slowly around the panel of judges with all the gravity he could muster, and left the meeting room, walking with as much formality and dignity as he could manage, and sat down quietly in the anteroom. After half an hour, he expected some sort of response. After an hour, he was unable to imagine what might be going on. Had he overstated his case? Had he left anything out? Were other firms making equally strong presentations? Could *any* firm possibly be even stronger? After two hours, Dobkin's sangfroid

was giving way to real concern. Something, somehow had gone wrong—perhaps very wrong.

After two and a half hours, the door opened. It was *not* Tony Ault. It was John Guinness's secretary. "Be patient, please, Mr. Dobkin." A while later, John Guinness, chief of staff of the Department of Energy, came out to say, "Following your presentation, the *good* news is that on the strength of your argument, a larger proportion of the British Gas underwriting will be allocated to North America. The *bad* news is we cannot allocate to North America as much stock as you had recommended. But there is one more piece of good news: Your allocation [for North America] *has* been increased . . . to a substantial degree. Further good news is that your advice to price the issue at 125 pence versus 120 has required an interruption of the minister's luncheon and, as you have seen, this has taken some time."

The British government announced Goldman Sachs's selection as lead international underwriter on Monday morning, and Sir Evelyn de Rothschild, acting as the government's adviser, called John Weinberg in New York. Weinberg had to come out of a management committee meeting he was chairing to take the call and get the exciting news.

Weinberg called Dobkin: "Congratulations, Eric. You've just won the largest and most important privatization in history. This is very good news. We're all very proud of you and what you've done—so far."

Then, in the typical Goldman Sachs manner, his tone hardened: "Eric, don't screw this one up. Don't make *any* mistakes. We'll all be watching you—and counting on you to do everything just the right way."

21

HOW BP ALMOST BECAME A DRY HOLE

On Friday, October 16, 1987, a sudden strong storm with winds of nearly one hundred miles per hour slashed across southeastern England to London, uprooting dozens of century-old trees in St. James's Park—trees that would take over a year to cut up and burn or haul away. With broken trees blocking trains and roads in the surrounding commuter towns and villages, many commuters couldn't reach the City, so the stock exchange would have stayed closed for days even if it hadn't been a weekend. When the exchange did reopen on Monday the nineteenth, the extraordinary event of nature was followed by the worst-ever single-day drop in London share prices, with comparably sharp declines hitting stock markets all around the world. In New York, the Dow Jones Industrials plunged 508 points, or 22.6 percent—a record for a single day's fall.[1]

Several months before, the British government had chosen that very Monday for the sale of an enormous block of stock: its remaining 31.5 percent shareholding in giant British Petroleum.[2] For the BP offering, each underwriter would have a defined role. Goldman Sachs's strategy had been typically direct: Make application to be appointed the government's adviser on the large tranche of shares to

be placed internationally, for which the firm's well-known strengths in America would give it a major advantage. And then, as was customary practice, Goldman Sachs would appoint itself to be a leading distributor and underwriter when the issue came to market. BP also planned to sell £1.5 billion of new shares, so the offering would total a record £7.25 billion (over twelve billion dollars at the 1987 exchange rate). "By a malign coincidence," wrote Nigel Lawson, chancellor of the exchequer, "the world's largest-ever share sale collided with the world's most dramatic stock-market crash."[3]

Underwriting practices in the United Kingdom were then very different from those in the United States. These differences would matter greatly in the BP offering. American underwriters are at risk with their own capital for all the shares they underwrite, and everything is organized to minimize, usually to minutes, the length of time over which they are exposed to the vicissitudes of the market. In the traditional British system, which was well suited to modest increases in equity, a group of institutional investors would serve as subunderwriters. For a share of the underwriter's fee, institutions would buy large, specified amounts of stock at the agreed-upon price, so the merchant banks acting as the primary underwriters would have only a small exposure to the major risk facing any underwriter: owning unsold shares that are declining in market price. Since the British economy had few technology or other fast-growth companies, IPOs were a rarity. Most public offerings were modest increases in the equity of established corporations at well-established valuations. Most institutional portfolios were either indexed or quasi-indexed, so institutional investors participated in most underwritings. The British system was based on the concept of preemption—that current investors had preemptive rights to protect their percentage ownership by buying an equal proportion of new shares being offered. It was almost leisurely. The system comfortably suited all parties—corporations, institutional investors, and merchant-bank intermediaries. It assumed that already-public companies would be raising only moderate increments of equity capital and that a slower process would suit all participants well. The American system of underwriting assumed instead that speed of execution would protect the underwriters by keeping their exposure to market risk very brief.

Under the British system, individual investors would have the assurance that well-informed professionals, having had ample time for objective analysis, had determined that the offering price was fair and reasonable, since they were committed to pay the same price for their shares. As part of Margaret Thatcher's "people's capitalism," several unique inducements were added in the BP offering to broaden participation by individual investors. An unusually simple order form was developed, and small investors were assured of receiving their first one hundred shares, and proration on additional shares, if they were willing to accept whatever price "cleared the market." Small shareholders willing to hold for three years would get another 10 percent "share bonus" after the three-year holding period. What's more, buyers of BP shares would not need to pay in full on the date of purchase. Far from it. In this underwriting, they would receive the full dividend per share but pay only £1.20 per share "on application," with two other installment payments spread out over twelve months. Finally, the price to the public would be set at a slight discount to the prevailing market price. As was the custom in the United Kingdom at that time, the underwriters would work over the summer at building up investor interest and at forming the underwriting syndicate—including lining up the institutional subunderwriters and preparing all the necessary documents for the offering. Under British rules, the price at which the shares would be offered would be published in the major newspapers well in advance of the actual offering and maintained by the underwriters at this price for two consecutive weeks, with actual payment settling two weeks later.

In America, by contrast, the price was set only on the day of the offering, and institutional investors were not committed until the last minute (though they might indicate the size of their tentative interest, which could result in a penciled "light circle" on the underwriters' order sheet). For the few minutes that typically fell between the SEC's approval of the underwriting and the formal confirmation of the purchase of shares by both institutional and individual investors, the underwriters owned the whole offering, paid for by signing a purchase agreement with the issuing company.

To protect London underwriters against the risk of a totally unexpected, unmanageable, and uninsurable risk, such as the outbreak of war, British underwriting agreements usually had a force majeure provision. If an unforeseen event

of great importance occurred, there would be no obligation to plunge stubbornly ahead: The issue could be delayed until normal conditions returned.

Privatization—though never featured in any of her statements before she led the government—was the dramatic and radical initiative by Margaret Thatcher's Conservative government to transfer ownership of over two dozen major businesses employing nearly a million people from state ownership to the private sector by selling shares to large numbers of individual investors. Her Majesty's Government felt no obligation to protect preemption and knew that the major corporations it intended to privatize would almost automatically become part of the *Financial Times'* FTSE (Footsie) market index. This meant that British institutions, to maintain market-matching portfolios, would surely be reliable buyers of each offering, as they had been with British Gas. The government also knew that the London market could not readily absorb large IPOs; access to the international markets—particularly the American market—would be crucial. Since British merchant banks were not powerful distributors in North America or Japan or across Europe, international distributors would be central to underwriting success.

Mrs. Thatcher had become convinced that the British government owned far too much of British industry; that service by government-owned companies was poor and getting worse; that the companies were not well run or efficient; and that the whole British economy was stagnating because those large government-owned companies were far too risk-averse, afraid to take chances or innovate, and had no appetite for hard decisions that might upset voters. Mrs. Thatcher insisted that to justify taking entrepreneurial risks for growth, British managers needed to have the freedom to fail. Her solution was to separate British industry from the British government and the stifling "compact of politics" by selling off the nationalized corporations, starting with the telephone company British Telecom, followed by British Gas.[4] Privatization was a remarkably successful program that revitalized many major companies, greatly broadened British share ownership, broadened and strengthened Thatcher's Conservative political party, and reversed decisively the postwar global trend toward increasing nationalization.[5]

However, these massive sales of common stock from the government to private investors were orders of magnitude larger than the underwritings for which

the British system of underwriting had been designed. Since the nationalized companies were typically owned outright by the government, there was no current market valuation of the shares before the offerings. The privatizations were IPOs, so the price would be determined by supply and demand for shares, with the large institutional investors that served as subunderwriters having the dominant voice.

In planning the privatization of British Telecom, HM Treasury had structured the underwriting group with both domestic and international underwriters—with separate groups for the United Kingdom, continental Europe, Japan, Canada, and the United States. The telephone giant had been ideal for Thatcher's privatization program because everybody used telephones. Kleinwort Benson had been retained by the government to advise on the November 1984 sale, which totaled £3.9 billion for 25 percent of the equity, and the privatization doubled the number of share-owning Britons as two million people bought shares, half subscribing to four hundred shares or less. Next, in December 1986 British Gas was privatized in a flotation raising £5.4 billion, and British Airways was sold to the public for nine hundred million pounds in February 1987. Following these successes, the major stock markets of the world were all unusually strong during the first three quarters of 1987. By September the NYSE was 44 percent higher than it had been in early January. The London market peaked in July, up 46 percent, and Tokyo was up 42 percent. Market conditions appeared ideal for further privatizations, and BP was in the queue and proceeding smoothly.

BP was different in advantageous ways from prior privatizations. It was already a publicly traded company. While the British government owned a large part of the giant company—obtained when Britain took over Middle Eastern oil fields—BP had always been run as a private-sector corporation. And the political-party politics that might be troublesome over the sale of a valuable property owned by the British public had been neutralized. The Labour Party, which would vigorously challenge other privatizations, could not easily oppose the BP sale because a Labour government had sold BP shares as recently as 1977—and the Conservative government had sold another £290 million block of shares in November 1979 without any political protest. The government and

the British stock market both had every reason to expect a quiet and orderly reception of the giant offering of BP.

On the advice of his appointed adviser, N.M. Rothschild & Sons, Nigel Lawson decided that it would be wise to appoint two major international underwriters. As it had with the British Gas privatization, the Treasury conducted a "beauty contest" examination of non-British underwriters. This time it chose Goldman Sachs, not Morgan Stanley—the U.S. firm traditionally used by the British government. (To manage its own £1.5 billion simultaneous share offering, BP chose S.G. Warburg.) For Goldman Sachs, this was a major breakthrough, confirming the success of years of building up its stature in the City.

A few people at Goldman Sachs had special reasons to feel proud of the firm's selection. Eric Sheinberg had been developing Goldman Sachs's London market-making operation, which helped the firm's winning presentation to the British government. The firm's UK oil analyst had well-recognized expertise on BP as a company and would perform an important role in distributing the shares to institutional buyers. Eric Dobkin, who had developed the equity capital markets division in New York, had led Goldman Sachs's campaign to be a major underwriter of privatizations in the UK, stressing the firm's distribution experience in major global industries like telecoms and banks and its strength as a leading underwriter in America, the world's largest securities market. In distributing British privatizations, particularly outside the UK, Dobkin's drive to win business was increasingly effective. The firm's campaign was strengthened by BP's desire to increase its shareholder base in the United States significantly.

Discussion of the enormous BP underwriting began with private meetings between HM Treasury and the leading underwriters in early January 1987. A public announcement of the intended offering was made in March, and the traditional process of organizing all the many parts of the underwriting process culminated at 11 a.m. on October 14 in a meeting at the Treasury called to specify the price at which BP shares were to be underwritten. Michael Richardson of N.M. Rothschild & Sons, acting as official adviser to the government, indicated he might not get agreement among the underwriters for a price of £3.50 per share but would try his best. A few hours later, Richardson returned to No. 11 Downing Street to say that as shares were already trading at £3.50, £3.30 was the best he could do; a noticeable price discount would be necessary for a successful offering. Contrary

to the usual expectation of protracted back-and-forth negotiations between the seller, which would want the highest price, and the underwriters, which would want the lowest price to facilitate an easy, riskless sale, Chancellor of the Exchequer Lawson surprised everyone in the room by declaring: "Done!"

The next step was to set the fee concession to compensate the subunderwriters, using competitive bidding. The normal concession was 0.5 percent. The average bid to underwrite BP—with its broad, deep market already well established—was much lower: 0.18 percent, or £1,800 for each one million pounds of shares placed with subunderwriters. The next morning—Thursday, October 15—more than four hundred investing institutions signed up as subunderwriters.

The public market price for shares in BP closed at £3.47 on Thursday. Most London merchant banks, sensing easy profits on a well-known, highly regarded corporation's straightforward underwriting, decided to keep more than the usual proportion of their participations on their own books rather than arranging larger subunderwritings with institutional investors.[6] While they were now more than usually exposed to underwriting risks, the magnitude of their exposures, while significant relative to their equity capital, was still moderate—typically ten million pounds for a major UK underwriter, not the bravura exposures of fifty million to one hundred million dollars taken on by each of the U.S. investment banks, led by Goldman Sachs.

Then came that unprecedented market drop on Monday, October 19. And on Tuesday, the London market plunged again. BP had been underwritten at £3.30. With £1.20 paid in cash and the rest deferred, meaning that buyers would be responsible for the deferred payments, the partly paid shares were suddenly selling at only seventy-five to eighty pence. Obviously—and ominously—investors would not buy from underwriters *above* the market, and the British government rightly feared "tagging" (harming) individual investors—and voters. Unless the BP issue were called off, which would require "unwinding" or nullifying the sales already made to investors at prices as high as £3.30, the underwriters—particularly the Americans—would take substantial losses. The total loss for London underwriters and subunderwriters would be seventy million pounds; while divided among over four hundred participants, the two largest City losses would be ten million pounds each for Rothschild and S.G. Warburg.

The drop in BP's price could cost Goldman Sachs, Morgan Stanley, Shearson

Lehman, and Salomon Brothers nearly one hundred million dollars apiece—and this was in addition to the heavy losses they had each taken in their regular block-trading businesses during the stock-market plunge. The American underwriters had serious arguments among themselves because they had sharply different views of their financial and reputation risks, but they didn't break ranks in public. In meetings on Friday, October 23, and on the following Monday, they asserted that the week's market trauma was exactly what the force majeure provision was all about. They insisted that the enormous, sudden drop in *all* the world's stock markets was indeed a force majeure event that clearly justified withdrawing the offering and waiting for better and more normal market conditions.

The collapse of world markets was certainly a major force, unexpected, unmanageable, and uninsurable. But was it sufficient to declare force majeure? Should the BP underwriting be delayed and the underwriters absolved of their obligations and their sudden losses? "Within the City of London, the initial consensus was that the BP issue should not be reversed, and the City firms agreed to take their losses as part of the nature of the business and to protect the traditional pricing system," explained Sir Win Bischoff, chief executive of Schroders. "We thought that that was a rational business decision—for the long term." Market drops, even very large ones, were not part of the understood reason for force majeure. So at first the British underwriters quietly agreed to carry on.

The American underwriters—Goldman Sachs, Morgan Stanley, Salomon Brothers, and Shearson Lehman Brothers—saw things differently. In America, there were no subunderwriters. These four firms had taken 480 million BP shares onto their books and were now facing up to $330 million in sudden losses. For each of them, the loss on BP would be the largest loss any underwriter anywhere had ever experienced.

While the Americans claimed the right to call the whole thing off, the force majeure escape provision could only be triggered by a claim by the leading *domestic* British underwriters in London. The decision centered on clause 8, the force majeure clause that explained under what circumstances underwriters could request a release from their obligations. Because the British underwriters were so numerous and the percentages they had underwritten themselves (versus passing on to subunderwriters) were relatively small, their individual exposures to loss were much smaller than the Americans'—typically only 10 percent as large—so

some of the British firms continued to feel that the October market break, while clearly very unusual, did not trigger force majeure. But eventually a majority of the twenty-two major UK underwriters voted to recommend to HM Treasury that force majeure should be declared. If the Treasury agreed, the underwriting would be off.

Exposed to much larger losses, the Americans were initially unanimous that the BP underwriting had to be postponed. With the sudden drop-off in share price, swallowing the losses would cut deeply into each underwriter's equity capital. Eric Dobkin *assumed* that the market drop was a force majeure event and said that it would be dumb to go ahead with the underwriting. Dobkin flew to London to plead with HM Treasury officials to pull the BP issue. Archie Cox for Morgan Stanley and Bill Landreth for Goldman Sachs went to the Bank of England to call on Eddie George, the deputy governor of the bank. Their mission was to strongly recommend that their firms be released from their underwriting commitments because of the largest market break in history, which they declared triggered the force majeure provision.

Governor George refused. They were underwriters. They had won the mandate precisely because they guaranteed the contractual price to the British government. A guarantee was a guarantee.

Similarly, Chancellor of the Exchequer Lawson said he was "not impressed and certainly not convinced," but the underwriters' opinion did trigger a careful process of formal review by the Bank of England, the Treasury, and Parliament—with the Bank of England staff siding with the underwriters' concern. The bank's staff proposed to guarantee a stock buyback at £3.10. If effected, this would have saved the three groups of underwriters £750 million and resulted in the Bank of England's owning most of the BP shares. Chancellor Lawson quickly rejected the bank staff's idea.

On Tuesday the four American underwriters went to U.S. Treasury under secretary George Gould, pleading for help. He agreed to see what might be done. On advice given in clear and emphatic terms by Gould's British counterpart, it was decided not to have President Reagan call Prime Minister Thatcher: "No! Absolutely do *not* have Mr. Reagan call Mrs. Thatcher. She'll do anything he asks!" Instead, James Baker, secretary of the Treasury, reached Nigel Lawson—in full evening dress at eleven in the evening after a Mansion House banquet—to

plead on behalf of the U.S. underwriters in what Lawson later called "the strongest possible terms." A senior White House staffer tried to persuade Mrs. Thatcher to intercede with Lawson. And BP management joined in calling for a postponement. Lawson refused, and Thatcher backed him. Because Alan Greenspan was only two months into his job as chairman of the Federal Reserve, his predecessor, Paul Volcker, was asked to call the four U.S. underwriters to assure them that the Fed would flood the banking system with liquidity.

Later in the discussions, it was agreed that a buyback floor of £3.10 would be put below the market price to reassure the 270,000 small investors; the floor wouldn't apply to the underwriters. It was put in place, but no investors chose to use it. After frustrating delays caused by the slow production of the Bank of England's advisory report, Chancellor Lawson told Parliament at 10:05 in the evening of Thursday, October 29: "I would like the House to be quite clear about the objectives of my decision: first, and most important, to allow taxpayers to secure the full proceeds of the BP sale to which they are entitled; secondly, to ensure that there are orderly aftermarkets in BP shares; thirdly, to make quite sure that the sale does not add to present difficulties in world markets. It is *not* my objective in any way to bail out the underwriters, whether in this country or elsewhere. By proceeding as I have indicated, the City will uphold its reputation as the world's leading international financial center."[7,8]

Everyone now knew that Goldman Sachs and the other major American underwriters owned enormous blocks of BP shares that they would have to sell at whatever price they could get. There was a "buyer's strike" by institutional investors, particularly in London. Hedge funds in New York and other dealers began to drive the market price even lower by selling BP stock short, knowing they could easily cover their shorts by buying shares from the major underwriters. Worse, short sellers could sell *lots* of shares because the underwriters had such huge amounts of stock they would sooner or later have to sell.

At Goldman Sachs, one of the most important units, and the least known externally, is the commitment committee. Its focus is on making certain that the firm never makes a "life-threatening bet." It works to ensure that all the risks in every capital commitment decision are fully identified, fully discussed, and fully understood before any significant commitment of the firm's capital. As Bob Rubin once explained, "I can see for myself what could go *right*. Concentrate

your analysis on what could go *wrong*. That's where you can really be most helpful." Eric Dobkin and Bob Steel had been responsible for writing the twenty-page memo on the BP underwriting for the commitment committee, and they both knew the rules: Cover *every* risk; 100 percent candor; no selling or advocating; explain *all* the worst-case possibilities of what could go wrong; specify how much the firm might lose. Dobkin and Steel had followed the rules all the way, so, as bad as BP clearly was, their worst-case estimates were at least accurate—which helped the firm's decision makers stay focused and rational.

The American underwriters scrambled to find a legal basis for asserting force majeure. "Sue them!" was the reaction at Morgan Stanley. "Sue the British government?" "Absolutely!" John Weinberg didn't join in the complaints and legalisms. Knowing how enormous the loss could be, he said, "We bought it and we own it." He knew the loss was painful. He also knew how much Goldman Sachs had invested in the past few years to establish itself in London and that it would cost the firm even more in loss of business momentum and morale to drop out. Making a strength out of a horrendous loss—the largest underwriting loss the firm had ever taken—Weinberg, like the decisive Marine he'd been, decided, "Take it!" This was the cost of establishing the firm's position for the long run, just as the costs had been high at Iwo Jima and Okinawa. As so often before, Weinberg was blunt and earthy: "If we cut and run away on BP, we won't underwrite a doghouse in London."

The British were suitably impressed, particularly at the highest level, where it mattered most. Weinberg's intuitive judgment was later proven right when Morgan Stanley pulled back from large privatizations because of the British system for underwriting. Goldman Sachs was able to push ahead, underwrote giant privatizations for British Steel and British Electricity, and was soon established as the leading investment banker to the British government and to British industry.

When the New York stock market crashed, large investors scrambled for safety and liquidity. They rushed into bonds, and the Federal Reserve flooded the financial system with liquidity, so bond prices, particularly government-bond prices, surged. As a major market maker, Goldman Sachs held huge bond inventories and made enormous gains in bonds on the same day that

the stock market crashed. The losses in BP and other stocks were only part of the firm's total portfolio. Big profits in fixed income largely offset the big losses in underwriting and in block trading that could have opened up serious wounds within the firm. The firm's net loss in October was thirty million dollars, pretax. John Weinberg declared that the charge for the BP loss would be made in the firm's P&L below the line that showed profits division by division.[9] This way, there would be no politics; the entire cost would be charged to the firm as a whole, and not to a particular division, where it might become a political football.

Within the firm, BP gave the remaining "nationalists" one last open shot to strike back at the "internationalists." With Goldman Sachs still in the first year of its major strategic drive to establish a strong beachhead in London, the large loss in BP provoked again the familiar internal arguments against going global: Europe was a well-protected market; volume was mediocre; profits were low; each country had its own rules and practices in underwriting; it would take far too long to become profitable; important opportunities—larger, more profitable, and much easier to exploit—were in America; and on and on. Besides, BP "proved" two points: The firm would never lose that much money on one deal in North America, and Goldman Sachs was clearly being "stuffed by the Brits," who refused to invoke force majeure. The internationalists argued that many more privatizations were coming—in the UK and in several other countries—and that American concepts and practices in underwriting were sure to dominate, which would give Goldman Sachs and other U.S. firms important competitive advantages. As always, the question was asked: How much should *current* partners spend on building the business when the profits—if there ever were any—would only come after they had gone limited, so they would enrich only *future* partners?

"The BP offering was the very worst experience of my whole career," says partner Bob Conway. As London branch manager, he got a call from Reuters: "We understand on good authority that Goldman Sachs will be filing for protection under the laws of bankruptcy. Would you care to comment?" In Canada the BP deal had blown away *all* the capital of Wood Gundy, one of that nation's leading securities firms, and forced it to merge abruptly with a major commercial bank. Still, for Conway, explaining to a newspaper reporter who thought he had a prize-winning scoop that the rumor of bankruptcy at the leading U.S. firm

was untrue was almost easy compared to going around to each and every bank to insist that Goldman Sachs was financially strong. "Every night," he recalls, "I called our CFO, Bob Friedman, in New York to review the details of every banker's call. That week was the longest week of my life."

Eric Dobkin also got a call from a newspaper reporter: "You will know this is a very sensitive call, which is why I'm calling you personally. I have it on very good authority that your firm has taken a major loss in BP shares and that Goldman Sachs may be in serious financial difficulty at this very moment. Can you verify this—or can you assure me that it is not true?"

Dobkin responded: "I have not spoken to New York for three hours, so it's always possible that something has gone wrong that I don't know about, but I very much doubt it. Yes, we have taken a big loss on BP—as much as seventy million dollars—but BP is not our only position. Our largest positions are not in stocks at all—they're in bonds, where we've become a major market maker, and prices of bonds have gone up a lot. Goldman Sachs has made a lot more money in bonds during the past days than it has lost in BP—a *lot* more."

Dobkin knew he had created an opening and knew how to use it: "Now you owe me one. Where did this rumor come from? Who's saying Goldman Sachs may be in trouble?" It turned out to be the charming, patrician Simon Garmoyle—then Viscount Cairns, later an earl—who was head of Scrimgeour Vickers, a leading London stockbroker, and later chief executive at S.G. Warburg. So Dobkin, who is five-foot-six, went to see Cairns, who is six-foot-two, and gave him a blunt and memorable "don't ever try that again" warning. Both men knew that leadership in the City was changing.

Goldman Sachs partner Bill Landreth called his friends at the Kuwait Investment Office: "British Petroleum is clearly solid value. The price was set at a very attractive level a week ago, before the offering. Now, after the big market break, the price is even more attractive—and there is very good 'buyer's liquidity,' making it easy to buy a major position in a great company at a price certain." The KIO agreed to acquire a significant part of Goldman Sachs's block and kept right on going with open-market purchases. BP chairman Peter Walter warned in late October that "an unwelcome buyer could obtain a major stake in

BP for a very low initial cost."[10] On November 18 the Kuwait Investment Office announced it had purchased 10 percent of BP and was still buying. By year-end, the KIO owned 18 percent of BP, and in March 1988 the KIO owned nearly 22 percent, acquired through a series of major block purchases arranged by Goldman Sachs and other firms.

While the KIO is a strictly commercial operation, it is owned by the Kuwait Investment Agency, which is responsible for advancing the strategic and political interests of the Kuwaiti government. On the basis of KIO's large share ownership, Kuwait had demanded a seat on the board of directors of Daimler-Benz and might now do the same at BP—even though BP was a direct competitor of Kuwait Petroleum Corporation (brand name: Q8). When KIO ownership reached 22 percent, Margaret Thatcher and Nigel Lawson referred the matter to Britain's Monopolies and Mergers Commission. The KIO stopped buying and announced it would reduce its ownership to 20 percent and voluntarily limit its voting to 15 percent. That was not enough for the Monopolies and Mergers Commission, which ruled in September 1988 that the KIO's ownership would be limited to 10 percent and set a one-year time limit—later extended to three years—for the KIO to conform.

Over the next several years, the Kuwait Investment Office's remaining shareholding in BP kept increasing in value. The market price tripled during the 1990s, and securities firms, sensing the opportunity for large, profitable trades, kept in contact with the KIO. The Kuwaitis chose to work through Schroders, and just before five in the afternoon of May 14, 1997, Schroders called Goldman Sachs, Salomon Brothers, and UBS—which had all known for a few weeks that a very large trade was coming—and gave them one hour to make their bids for the biggest block trade in history.

Goldman Sachs was ready. In April 1996, Gary Williams, with no prior experience in trading European stocks, had moved to London to head equities trading in Europe. During his first week in his new role, a senior partner in corporate finance got a hint from another client of a possible sale of KIO's BP. Williams and Wiet Pot, co-head of the European-shares business, called David Silfen in New York, who suggested they offer to bid for the whole five-billion-dollar position to make a powerful, memorable proposition.

As soon as a meeting could be arranged, David Silfen, Pat Ward, Williams,

and Pot met with the KIO and made Goldman Sachs's bid: a 5 percent discount off the prevailing price for the KIO's entire five-billion-dollar stake in BP. The KIO seemed impressed but gave no indication that it might sell. Both sides agreed to stay in touch. The group from Goldman Sachs met again a month later with the KIO and were introduced to Philip Mallinckrodt of Schroders, which was advising KIO "on various matters." Over the next several months, they met several times to explore various alternatives to maximize KIO's proceeds, but no specific plans were ever acknowledged by KIO. "The KIO and Mallinckrodt were most professional," recalls Williams. "They gave away nothing but were completely honest in what they did say."

Pot and Williams had many discussions over the next several months. They agreed they should do all they could to be fully prepared, because they knew from experience that very big trades could be time-pressured, leaving too little time to get approvals, design hedging strategies, check legal questions, and develop a specific strategy for reselling. By resolving all these aspects of the trade well in advance, they could concentrate on making the "right" bid, given liquidity, risk factors, and current market conditions. One thing they would not do: talk to any potential buyers or even to anyone who would be talking to clients. Over a full year's gestation of the trade, there were zero leaks from Goldman Sachs, but there were occasional hints from other firms. So Williams and Pot grew to expect that if they ever did get a call, it would probably be in competition with other dealers.

When Schroders phoned on May 14, 1997, Williams was at a scheduled meeting at Britain's Financial Services Authority. A colleague got a call on his cell phone from Williams's secretary—because Williams didn't own a cell phone: "Wiet says the trade is on and wants to know how soon you can get here." The trade would be two billion dollars, not the five billion dollars originally considered but still by far the largest ever.

Williams excused himself from the meeting and, borrowing the cell phone, went looking for a cab, but no empty cabs were to be found shortly after five, so he started walking in what he hoped was the right direction. He called Pot, who was organizing a conference call with Roy Zuckerberg, Eric Dobkin, and Bob Steel in New York and John Thain in London. (Silfen had retired at the end of 1996, so he was not included.) Finding a cab at last, Williams returned to the office, participating in the transatlantic phone call while riding through the City.

Williams had an advantage: He had a feel for how traders make pricing decisions in blind competitions because of his experience with similar trades in convertible securities. BP shares had closed in London at £7.44. The group settled on a reoffering price—the price at which Goldman Sachs would offer the shares to investors if it won the bidding—of £7.15, a discount of 4.2 percent. Williams then suggested that £7.16 would be seen as virtually the same. So they increased it to £7.16. Then Williams said, "If we all thought 715 [pence], we must assume our competitors will too. If it's 715, the natural bid would be 710. But experienced dealers know not to bid round numbers, so the guy who'll bid 710 will add a 'tail'—he'll actually bid 710.10, or maybe 710.20 to be really clever. So, if we're going to die with this trade, let's go down in flames. Let's bid 710.50—so we won't be edged out by a fraction of a penny." Dobkin had been thinking the same way, so the extra tail was confirmed.

Forty minutes after getting Schroders's call, they were agreed on a price of 710.50 for 170 million shares. Pat Ward, who knew Philip Mallinckrodt and Dr. Yousef Al-Awadi, who headed KIO in London, called Mallinckrodt with Goldman Sachs's bid. After nearly an hour, which seemed a very long time, Ward called Mallinckrodt again, hoping to gain an insight into what might be happening. Mallinckrodt's guarded response: "Pat, are you calling because you want to raise your bid?"

A few minutes later, Mallinckrodt called back. Goldman Sachs's bid had won.

"What was the cover?" asked Ward. The next highest bid is customarily disclosed to the winners.

Mallinckrodt responded: "I've never seen anything this close. Are you sure you didn't collaborate?" Goldman Sachs could not have colluded because it did not know which other firms were bidding. The next highest bid was . . . 710.10—a gap of less than one-tenth of 1 percent on two billion dollars!

Now that it owned 170 million shares of BP, worth over two billion dollars, Goldman Sachs did . . . practically nothing. The position was far too large to hedge. The only way to protect against market risk was to sell well. That's why the firm planned to tell clients about the trade only after the 4 p.m. close of NYSE trading. U.S. clients would be solicited immediately after four, Asian clients would be contacted overnight, and UK and European clients would be approached the following morning—before the London opening.

The carefully developed plan took a detour, however, when at 3 p.m. a senior partner in New York, uncomfortable with the market risk, phoned Pot and Williams and proposed a launch as soon as possible, saying that some of the decision makers at big U.S. clients would be leaving early for the day. Pot and Williams felt they had to follow his lead, so they did. It might have been possible to appeal to a higher authority—but Williams and Pot limited themselves to one more recitation of their reasoning. When that brought no change, they accepted that there was no time for a full debate. Now they had a problem. Although sales to clients would be an "off board" (non-NYSE) distribution, regulations required that when clients were solicited prior to the 4 p.m. close, the specialist's book had to be "collapsed" after the close down to the distribution price and that all higher public bids had to be filled at the distribution price. This would make the discount look less attractive. Furthermore, a preclose announcement would give market opportunists the chance to "shoot against" the price for the rest of the trading day. All of this raised the risk of something going wrong.

As directed, a few substantial sales were executed in the United States that afternoon and evening, and the balance was sold to UK, Continental, and Asian clients the next morning. Before it was over, Goldman Sachs resold the shares to more than five hundred institutional and individual investors worldwide at £7.16 (or $11.77 for an American Depositary Receipt representing one BP share and an allowance for currency conversion). Inside the firm, traders were professionally proud that there had been zero leaks and that BP was the largest block trade ever done by a single firm as a pure blind bid, where the bids of others weren't known.

Goldman Sachs made a profit of seventeen million dollars—and demonstrated that massive transactions could be executed at a very low cost relative to the assets involved. It was a triumphant trade, but with two billion dollars at risk, seventeen million dollars of profit was tiny—hard evidence that in the block-trading business, the margin of profit had become far too low to justify the market risk.

22

CHANGING THE GUARD

In the quiet, walnut-paneled dining room at London's Connaught Hotel, John Weinberg was in a candid discussion with Lord Weinstock, the CEO of GEC, the British General Electric Company. Their subject was succession. Weinstock, apparently unconcerned about nepotism, said he was doing all he could to arrange it so his son would be chosen to lead GEC. Weinberg said he was committed to meritocracy but wasn't finding it easy. "I spoke with the one guy I really wanted, but he said he didn't want to take the job as sole CEO, so I'll have to appoint two as co-heads."

Developing his successors was a high priority for Weinberg, and he would soon position Steve Friedman and Bob Rubin, his chosen heirs apparent, by pairing them as co-heads of the fixed-income division. Rubin and Friedman had enjoyed a special relationship from their first meeting. "As lawyers, Bob and I had a lot in common," says Friedman. "Lawyers learn to ask lots of questions and learn to think systematically. We first met when a friend called me to say he had a pal who was leaving the practice of law and wanted to introduce us." Despite their differences—Friedman would bore down into the detailed data to master all the evidence while Rubin looked for large governing concepts—they were very

much alike: Besides sharing training as lawyers, both inspired unusual personal loyalty, each liked and trusted the other, and both took a cerebral view of business decisions. Both were determined to accelerate the firm's pace to make it more entrepreneurial, more creative, and more profitable. Over many years of working together, they developed an unusually close and deep friendship that continues to be important to both men to this day. As they bonded together, more and more people within the firm saw them as the obvious heirs apparent.

Rubin could cheerfully spend several hours analyzing different possibilities and working out his understanding of the nature of a complex problem. Friedman was superb at quickly establishing rapport with a new client's key decision makers, particularly if they felt under pressure. His intensity showed clients how deeply engaged he was in solving their problem or their crisis. Rubin was good with clients partly because they recognized how smart he was, partly because he had no visible ego needs, and partly because he saw events and personalities within a broad context.

They were and had always been primarily individual contributors. While both were outstanding at relating to individuals or small groups, neither man was a large-group "people person" by nature or training, and neither was widely experienced at working with and through large numbers of other people in managing the different and often competitive groups that make up large, complex organizations. For most of their careers they had both been inspiring leaders, usually of small, close-knit teams, not large groups of five or six hundred or complex organizations of five or six thousand. Appropriately, Bob Rubin's sole acknowledged extracurricular passion is fly fishing, where the secret for success is learning to think like a fish.

As several partners observed, Rubin and Friedman had been insiders focused on a series of specific transactions, with little responsibility for developing long-term relationships. Both men excelled at finding creative solutions to hundreds of individual problems. But like most of their predecessors and peers at other firms, neither had needed to develop the skills of building consensus across large groups—skills needed for integrating very different kinds of businesses and different groups of people into a coherent organizational strategy.

Still, the two men differed greatly in managerial style and in ways of operating. As they prepared to take the lead in restructuring the bond business, Friedman gathered up more than a yard-deep pile of computer printouts and financial reports and dove in, working on his own through page after page of specifics,

often making careful notes of questions to examine with extra care as he developed factual mastery to assure himself that he had a thorough understanding of every aspect of the bond-dealing business. Then he would cross-examine the unit heads—asking, as always, *lots* of questions—probing more and more deeply to develop a bottom-up understanding. In contrast, Rubin invited unit leaders to meet with him and explored with them each of the concepts and business models that seemed most important, and particularly those that appeared to be gaining importance, so he could understand the way the business might develop and where the firm would have the most interesting challenges and opportunities—and the risks in each case. As a result of his learning strategy, Rubin got to know the managers as individual people, and how they thought and understood their business, in ways Friedman never could.

Friedman almost instinctively thought in the terms of a wrestler: Speed, agility, initiative, and strength were important characteristics, but his focus was on defending against his competitor—one on one—and on winning each match. As Friedman says, "I like to argue—vigorously—as a test: Can you change my mind?" Rubin was in a different arena: He had no more interest in winning a discussion than in winning at Frisbee. As a result, they could see things differently. For example, while both men joked about having to wear kneepads, because, on behalf of one area of the firm or another, they so frequently had to get down on their knees in apology to outraged clients, they reacted very differently on the day that a distressed partner pleaded: "This is a major client and the guy is *really* angry. And he's demanding an apology—at *least* an apology."

"He's *wrong*," insisted Friedman. "And we know we're right. There's no need to genuflect to the SOB—no matter how big a client he thinks he is."

"I'll go," offered Rubin quietly. "His office is uptown. I'll stop by this afternoon on my way home. No big deal."

When Rubin got to the client's office, it was clear that the client was *very* angry—and he said so in no uncertain terms while Rubin listened. For emphasis, the client made his point again as Rubin listened. The client continued to vent his frustration as Rubin listened. The client explained why he felt so upset as Rubin continued to listen. The client said he hoped Bob understood and was glad he was listening. The client said he recognized he might have overreacted, but appreciated that Rubin had come to his office to listen. The client hoped that now

that the matter was out in the open, now that there was a realistic understanding, they could get back to their old working relationship—maybe even better. Rubin listened and the client said he really appreciated Bob's dealing so quickly and thoughtfully with a situation that could cause some people to overreact and blow things out of proportion. Rubin continued to listen. A little later, as Rubin listened, the client paused and then reached out to shake Rubin's hand, saying; "Thanks again, Bob. Thank you for coming to hear my side. I really appreciate what you've done today, coming and hearing me out. I'm glad all that's behind us now and we can get right back to doing good business together. Bob, I really owe you one for what you've done today to restore our fine relationship. You're a prince." Shaking Rubin's hand, warmly, he walked his guest to the elevator and, smiling as the doors closed, said, "Thanks again, Bob, you're the best."

The next day, Friedman asked: "Bob, I know we joke about 'creative groveling' and having to kiss all four cheeks in our jobs, but don't you *ever* tire of having to listen to all that blustering bullshit?"

"He was upset and needed to have a chance to have his say—to get it out and be heard by one of us," Rubin explained. "So while he was going on and on, certain that I was listening to his every word, my mind was on what I'll be doing tomorrow. Being there, letting him talk it all out, was no problem for me."

Management in a continuous-process business (and every professional service business is continuous) involves all-day and every-day nurturing of better and better performance, and carefully reducing or removing errors. *Leadership* concentrates on decisive acts and decisions. Bob Rubin was unusually good at both leadership and management.

"Frank, could I see you for a minute?" Rubin had followed partner Frank Brosens out of a management committee meeting. The meeting had been a triumph. Brosens had presented a compelling case for a bold commitment to arbitraging Japanese equity warrants, and the committee had strongly agreed with his recommendation. Brosens had made the entire presentation, but, as a learning experience, he had invited Zachary Kubrinick to sit in on the meeting as an observer. Brosens knew he'd had all the bases covered and all the facts clearly in hand, but he could hardly believe Rubin had been so impressed that he would

leave the meeting to compliment him immediately. Brosens was right; Rubin was not rushing to compliment him on his performance.

"Frank," said Rubin in his soft, relaxed voice, "you and I both know that, as young as he is, Kubrinick knows all that you know about Japanese warrants and he could have made the case equally well. You really should have let him make the case—and get the experience of coming before the management committee. By not taking the credit, you become *more* effective. If you do right by people, *they* win *and* you win. Frank, always go out of your way to share credit."

"Bob Rubin was my best boss ever," says partner Tom Styer. "He always listened to you, really *listened*, to get a full understanding of all your information and your best ideas. He was clear, absolutely clear, on the plan of action. He was *always* calm—incredibly calm—and never flustered or put off by markets or by the sometimes truly outrageous behavior of individuals, which never, ever got to him. And he was decisive on action plans." Rubin's response to everyone who asked his opinion was always the same: "What do *you* think?" This obliged others to do their homework and offer their best judgment. It also gave Rubin a little extra time for thought and a "first approximation" estimate of what might be the right way to frame the question or understand the problem.[1]

"Whether Bob agreed with you or not, he made it so clear that he really understood the point you'd made or the view you held that you didn't feel any personal loss if he made a different decision, because you knew he knew all you knew—and must know more." One thing Rubin did *not* do was change a well-reasoned, fact-founded plan of action. He would get annoyed, even angry, with anyone who wanted to reopen a discussion he thought was closed. He always stayed with the agreed plan unless the facts changed significantly.

When Brosens had first been put in charge of arbitrage, he had one exciting talent in the division—Eric Mindich, a man in his early twenties whom he wanted to put in charge of risk arbitrage for the firm's own account. Silfen and Zuckerberg wondered about assigning so much responsibility to such a young star. "Last year was a tough year in arbitrage. Shouldn't you focus more on this area yourself?"

"I believe with a hundred percent of his time, he can do better than I can do with forty percent of my time."

Rubin joined in: "Age is irrelevant. By expanding his responsibilities now, you may keep a real star that you might otherwise lose."

Mindich soon became the youngest-ever partner of Goldman Sachs, at age twenty-seven.

In 1984 Goldman Sachs's rank among corporate bond underwriters had dropped from first in mid-1983 to fifth as market share fell from 11 percent to 9.6 percent, while a more aggressive Salomon Brothers's market share had shot up from 16.2 percent to 25.8 percent.[2] Apologists within the firm pointed with pride to the fact that the fixed-income division had gone in less than fifteen years from breaking even—and that only because payouts to salesmen had been shaved—to being the firm's most profitable division. Realists, however, showed that too much of the apparent gain in profits was misleading. The "gain" had come from two seriously wrong sources: milking the firm's business by not being fully competitive as a dealer and losing to competitors the bond-underwriting business of longstanding clients like Sears Roebuck. Rubin and Friedman were determined to make major changes: "We see where the markets are going, and we're going to adjust." That was an understatement: They were determined to revolutionize the bond business and change everything, beginning with the business concepts or model and the leadership.

Bob Rubin and Steve Friedman had an agenda. They were convinced—just as convinced as the Two Johns had been during their sandwich lunches at Scottie's—that Goldman Sachs had to change. The firm could prosper as a small boutique *or* as a large multifaceted organization, but it could not succeed for long as a midsize firm "stuck in the muddle in the middle," which is where they thought it was. As they pointed out, it was already too late to choose the boutique option. The strategic imperative, therefore, was to expand in services and products, and particularly in markets, by going international. They wanted change both in course direction and in pace of process, and they wanted to move away from limiting the firm to Whitehead's and Weinberg's focus on client service by adding increasingly bold use of capital in disciplined, risk-taking, proprietary businesses. Competition was accelerating, particularly from large international rivals and emboldened commercial banks using capital more aggressively, taking more risks. This meant the firm risked being, relative to the best competitors, too slow, too siloed, and too cautious about new ideas and new business. They

believed that the firm's "every tub on its own bottom" tradition of divisional independence made Goldman Sachs as a whole less effective than it could and should be. They worried about the implicitly cautious incrementalism of being only "fast followers"—and not always being even that. They argued that the pace of competition and the markets had accelerated so significantly that in addition to being fast followers, the firm had to be more creative, more aggressive, and better coordinated. As Friedman said, "If we're not leaders in innovation, we won't be fast enough to reap the really good profits that the innovators get—and deserve." Firmwide strategic planning was needed to identify new business opportunities, like seller-rep and tender defense, early so the firm could get out ahead of the competition.

The first step toward firmwide cooperation was for the individual departmental barons to give up their customary focus on what was best for their own separate units. "I give Bob a lot of credit for self-denial," says Friedman. "Over and over again, when we discussed how to play particular takeover battles, he *always* came down on the side of 'What's best for the firm?'—*never* on what's best for arbitrage or for him personally. He couldn't have been more partnerlike."

To Rubin and Friedman, even Goldman Sachs's traditionally great strength in nurturing client relationships could be used as an excuse for not innovating, which could hold the firm back from being fully competitive. Too many people, particularly senior people, were reluctant to upset old-time relationships or, as they saw it, tarnish the firm's sterling reputation by getting into high-profit areas like unsolicited takeovers, high-yield bonds, mortgage-backed and asset-backed securities, derivatives, and all the other rapidly emerging ways that the firm's steadily accumulating capital and its capital-markets expertise could be used aggressively to make money with money by deliberately taking informed risks. This was the origin of the transformation of Goldman Sachs from a service firm acting as *agents* to a formidable organization of capitalists acting as *principals*.

"I got caught up in a mission to fix the place," recalls Friedman. "The firm was seriously underperforming, so it was clear that there was an awful lot of work to do, but I never had a focus on becoming managing partner the same way I had dreamt of winning the national wrestling championship or a law-school prize for earning top marks or becoming a partner of Goldman Sachs. Those three were truly burning ambitions, but doing the work that had to be done at Goldman

Sachs was just an obvious responsibility. Being managing partner was a means to strengthen the firm and a responsibility, not an end."

Rubin and Friedman were right about the risk that being wisely conservative can deteriorate into defensive caution and about the importance of the firm's becoming more aggressive. John Whitehead had seen it, and it was an important factor in his decision to retire. But the obvious irony was that the cautious, conservative style Rubin and Friedman found so constraining had been at the core of the strong, team-centered culture, the reputation for integrity at every level, the consistent service to corporate and institutional clients, the strong earnings and solid financials, the persistent and skillful recruiting, the superior management, and the consistently disciplined execution upon which their more aggressive business strategies could now build. In many ways, Friedman and Rubin managed to carry these traditions forward while making Goldman Sachs an increasingly unified "one-firm firm" by reducing divisional separations, having annual reviews done by people in other departments, explicitly recognizing and rewarding cross-departmental teamwork and cooperation—and penalizing those who did not "get it."

The changes Rubin and Friedman wanted—bolder use of capital, more risk taking, rigorous evaluation of individual performance with more differentiated compensation of both employees and partners, more coordination and interaction between business units, more computerization of operations, and centralized strategic guidance—would require important changes in organizational structure and decision making. Building a strong bond business was one major reform, but only one. The totality of change they wanted amounted to a transformation of Goldman Sachs.

The kind of coordinated acceleration Friedman and Rubin sought was already taking place in mergers and acquisitions and across the investment banking division, often the incubator and beta testing site for new initiatives. The firm's key player in M&A was a young, charismatic partner, Geoff Boisi. Jesuit trained and by nature intensely committed, Boisi had come into the firm at flank speed searching for a place to make a total commitment. He started in M&A in 1971 and then ran the department informally from 1977 on and officially from 1980, a period of rapid growth and high profits. Boisi has a powerful capacity to solve problems by analyzing complex, interactive developments, evaluating all the alternatives, and, like a chess master, projecting the outcomes many moves

ahead with remarkable rigor—rigor that some would see as inspiring but others would see as leading to views so strongly articulated they could appear impervious to argument.

Boisi at his best had been on display in 1984 when Getty Oil stock jumped 38 percent from $80 to $110 on a takeover bid by Pennzoil. Goldman Sachs was retained to defend Getty from the unsolicited takeover. Conflicting interests and factions within the Getty estate and its representation on the board complicated the situation. Gordon Getty, one family representative on the board, had worked with Pennzoil in developing its unsolicited offer. Influential Getty directors were in agreement that this generous and surprising offer should be accepted. Boisi, much the youngest man in the room but one of the most experienced M&A bankers in the country, took a different position that was vintage Boisi. Getty had retained Goldman Sachs to protect the shareholders' interests, and Boisi was the representative of the firm's careful, comprehensive work on the range of prices that Goldman Sachs would consider fair. So young, so analytical, so tough—and so confident he was right because he was sure the team working on the question back at the firm had rigorously examined every facet of every possibility and come to a carefully reasoned conclusion—Boisi explained that the breakup value of the company's assets was demonstrably higher than the offer. While Pennzoil's was the only offer then on the table, he insisted that an even higher offer was highly probable if Goldman Sachs was permitted to explore the merger market; so the rational decision was to reject Pennzoil. But being so very rational came across to some of the conflicted parties as unrealistic, given the time constraints of the Pennzoil offer. He was increasingly alone as one after another of the directors—some thirty years older, some forty years older—challenged his judgment and the analysis behind it. But Boisi would not be moved.

Tension mounted. Voices rose. But Boisi would not be moved.

Finally, Larry Tisch—new to the board, but experienced in business and particularly in takeovers—rose in anger: "You young guys—guys with *no* stock and *nothing* at risk—don't know what you're talking about! You don't know anything at all! You're all wrong! This is a *great* deal! This deal should be accepted—now!"

Boisi would not be moved. He was representing the careful judgment of Goldman Sachs.

Time was getting short: Under the law, Boisi and his team from Goldman Sachs would have only ten days to obtain an even higher takeover bid. But Boisi held firm. Then, four days later, after Goldman Sachs found several potential bidders, Texaco bid $130—adding nearly 20 percent more for shareholders. At eleven billion dollars, it was then the biggest acquisition in history.

At sixty, John Weinberg was at the height of his powers as a relationship banker, enjoying substantial personal success, doing some of his most impressive deals with major clients, earning large fees, getting increasing recognition for his accomplishments, and enjoying the admiration of both clients and partners. Having devoted all his time and energy to Goldman Sachs, he had no major outside interests and almost no friends outside his business friends, so Weinberg was understandably in no hurry to leave his beloved firm or his position as its head. As Weinberg saw it, he was carefully bringing along his chosen successors, making sure Rubin and Friedman proved themselves as capable, strong organizational leaders both to the partners and to the firm's many major clients. This would take time, and there was plenty of important work for them to do in the meanwhile as they got some seasoning.

Weinberg was still leading the firm in its fast-changing business and making important strategic decisions, often "not" decisions—*not* to do the bridge loans that wreaked so much havoc at other firms, *not* to change the firm's policy against lucrative hostile takeovers, and *not* to continue the Water Street "vulture" fund. While many of Weinberg's decisions were wisely conservative, as markets changed some later appeared *too* conservative. Experienced in an era when bonds were divided into the three broad categories of high grade, medium grade, and junk, Weinberg was traditionally disdainful of dealing in junk bonds—later called high-yield bonds; he was understandably slow to recognize the rapid changes in the debt capital markets and in corporate finance that were coming because insurance companies and bond-oriented mutual funds were accepting greater credit risk in individual bond issues in their continuous search for higher bond yields for their well-diversified bond portfolios.

Weinberg believed that ensuring orderly leadership succession would be an important capstone for his career. He thought he had it all worked out and

was proudly bringing along his heirs at what he saw as the right pace, schooling them to be co-leaders. When he announced in early August 1985 that Rubin and Friedman would co-head fixed income from December 1, Weinberg said, "They are very capable, very talented people, but we have a lot of talented guys around here." Weinberg was not ready to retire and not nearly ready to anoint successors, despite the widely held expectation that Rubin and Friedman would eventually be chosen. (Rubin had been with the firm for nineteen years and Friedman for twenty.) Weinberg continued with his deliberately restrained praise: "Steve and Bob have not been in the fixed-income business, but they are good organizers and will be there long enough to give the talent we have in that division some time to grow so future leaders could come from within the division."

Weinberg saw the announcement as a clear step in his long-term plan to bring them along and was proud of having given them more and more authority over the preceding five years in a progression-transition that affirmed the special quality of Goldman Sachs's thoughtfully planned leadership. But Rubin and Friedman saw it differently.

They believed that as an intermediary in an intensely competitive market, Goldman Sachs would need to expand the range of services provided and establish leadership in major regional markets around the world as the markets globalized. As Goldman Sachs expanded, it would simultaneously move in stages up the economic and profitability ladder from agency broker to underwriter and dealer to managing agent to managing partner to independent, capital-strong, risk-embracing principal. The ceiling of one stage became the floor for the next stage. As leaders, Rubin and Friedman were determined to provide the conceptual framework, and they stimulated and rewarded entrepreneurial leadership to increase the organizational drive that would make serial transformation possible. "John Weinberg was not much interested in strategy and planning," explains John Whitehead, "so Steve Friedman and Bob Rubin inherited the budgeting and planning side of the business *and* running the firm on a day-to-day basis."

"Nobody chose us or assigned us to take over the bond business," says Friedman, somehow misremembering John Weinberg's key role. "No one appointed us: We were really *self*-appointed as we worked at solving problems. Nobody chose us to lead the firm. We just led. We could see the job that needed to be

done, so we just did it. We were de facto COOs of Goldman Sachs several years before we got those official letters, and Bob and I became co-heads of the firm by self-selection. For the bond business, we just started marching to the sound of the guns and improvising as we went along. While we were never thwarted and wanted to be sure we understood everyone's opinion and perspective, it took way too long to get action, particularly when we sometimes had to go back over everything to include in the loop all the other people John Weinberg felt should get a hearing." Rubin and Friedman were convinced of a need for radical organizational and strategic change, but Weinberg was not so sure, particularly as he saw other firms absorb large losses on "imperative" innovations.

Every fully developed organization is hardwired, and it's a challenge to rewire that organization to recruit and train people who are really different, particularly if the objective is to make the new organization both different and better. Doing that implies upgrading the quality of the people already in place. Friedman and Rubin had no time for patient gradualism: They wanted major change now, particularly in fixed income.

Abrupt changes, transfers, and demotions were new to Goldman Sachs, so it was striking to many when two senior partners were abruptly transferred. Eric Sheinberg, a fourteen-year partner, was switched out of his position as head of corporate bonds and soon linked up with Robert Maxwell in London, and John D. Gilliam, a twelve-year partner who headed corporate underwriting, had his position taken by two-year partner Nelson Abanto. Sheinberg was shocked and said only, "I would rather not comment." Others thought, *It's about time!* As Friedman puts it, "What's so fair about keeping tired older partners when that means blocking the best young people and violating our commitment to meritocracy?"

When the firm won business by bidding too boldly against Salomon Brothers and had to carry hundreds of millions of dollars in unsold inventories, Gilliam observed sardonically, "History tells you that we were too aggressive." An unrepentant Abanto would say, "I plead guilty to being aggressive." As Rubin and Friedman had intended, the firm's concept of the bond business soon changed from risk-avoiding, minimal use of capital and extensive customer service to boldly risking the firm's own capital to make much larger profits.

Revolutionizing the bond business was matched with important internal changes. For example, the back office was not up to date and not well integrated

into the firm's operations. Information Technology would get a request for a new subsystem, go work on it for a year, and come back only to be told, "We can't use that. Our business has changed. We don't do our business the same way anymore." Friedman took the lead in rationalizing the firm's enormous expenditures in IT—nearly five hundred million dollars a year. He started by interviewing a lot of IT managers about management and quickly concluded, "It was pretty obvious and took no great genius to recognize that IT had to be integrated directly into operations and that Goldman Sachs needed to work out the costs versus values right at the line-manager level so that when a manager decided what *value* he wanted, that automatically meant the *costs* were his too."

Friedman took responsibility for dealing with complaints provoked by the incentive compensation system he and Rubin had inherited in fixed income and were determined to make more effective as a way of making the unit more competitive. Bond salesmen could—when they got everything right—make a lot of money compared to investment bankers, so some bankers went to Friedman to complain. They got this response: "Yes, the bond salesmen make more money than you do, and some make a *lot* more. That's because of two things. First, they're very talented in their work and they work very hard. Second—and this may be far more important to you—they are on a different career path with very different prospects of ever becoming a partner. So don't bitch to me unless you really think bond salesmen have a better overall career situation. If, after serious consideration, you really think theirs is better, let me know and I'll arrange an interview in bond sales for you right away." Complaints vaporized.

Friedman and Rubin pressed Weinberg more and more explicitly to turn the firm leadership over to them, but Weinberg started thinking he might stay on a while longer as senior partner. Agreeing that they would have to force the issue of Weinberg's passing the baton, Rubin and Friedman went to see him. "I told him then and there," recalls Friedman, "that if he was thinking of making a decision to stay, he had to know he'd also be deciding that it was time for me to go because I'd always said I wanted to retire young enough to have a second career. I wouldn't wait around until he was seventy and then take over the leadership for another ten years after that. That would be taking up too much of my time."

In December 1990, Rubin and Friedman officially became co–senior partners and co-CEOs, and Weinberg became senior chairman and continued

working on megadeals for major clients. Rubin and Friedman would serve as co-CEOs for just three years.

They pressed ahead with organizational changes that matched their strategy. Departmental silos had to be removed and different units of the firm much more fully coordinated and integrated. The departmental barons' independence had to be reduced in favor of a firm-first orientation with far more accountability both for planning and for the results produced. "It's easy to have a strong, consistent culture when only a few people are involved and they all grew up in the same business with the same objectives, same standards, and same economic interests," says Friedman. "As the firm grew in numbers of people—and particularly in variety of allegiances, experiences, and priorities—the whole concept of teamwork became more and more important and more and more challenging."

To accelerate the dynamism of the firm, a change they believed necessary, Rubin and Friedman identified talented people who were impatient for constructive change and promoted them into key positions where their demonstrated talent and impatience would help pick up the pace in their whole unit. To preclude "too easy" acceptance of their ideas, Friedman and Rubin insisted on talking it all out and promoting debate—asking the junior people to speak first so they would not be disputing their seniors, and so seniors would have the insights of younger people before expressing their own views. They also believed that full and open discussion would result in stronger commitment to what was decided.

They intended to lead, direct, and control through the management committee—and to lead that powerful committee by consistently thinking through and agreeing on decisions in advance, which meant they were taking and holding the initiative. They would get together and work their way through each complex problem on each meeting's agenda, clarify the essence of an idea or decision, and then try to develop the best strategy and the most effective implementation. "We would work out our agreements in private and then take them forward," recalls Friedman. "If either of us felt strongly about any decision, we would defer to that strong view. If we both felt equally strongly about something, we would take the more conservative way. Bob and I never had an argument. I do not recall ever being upset with Bob. We were always asking one core question: How can we advance what's best for the firm—and make more money?" At the same time, recognizing that all members had useful information and insights to

contribute "even though not all were equally valuable," they worked hard at making the committee a forum for discussion and *decisions,* not merely approvals.

However, while Friedman and Rubin believed that they never pushed things through and always thought others had useful insights, and that discussion flushed out all the key variables, other management committee members began to feel that they really brought issues to the committee just for ratification. Friedman and Rubin were determined to raise the bar: If a presenter was taking too long or repeating himself, he'd be cut off with a comment like "We heard you the first three times you made that same point." The rigorous questioning of division heads was seen as a radical change from John Weinberg's open, laissez-faire style of trusting and empowering the unit heads in the different lines of business and in different geographic regions. Some participants felt it was not the right process in a true partnership.

Rubin and Friedman would signal their disciplined focus on decision making by declaring, "There'll be no presentation. Assume always that we have all read your memo of recommendation with care." This put some investment bankers off their usual game plan of starting every discussion with crisp, energizing presentations that would frame the decision and dominate the meeting.

"Bob and Steve agreed on one dominating factor—brains," recalls Bob Steel. "They always went with the smartest guys." But this focus on brainpower was not always the right way to go. As another partner recalls, "Steve and Bob were so rational, they ignored some of those human aspects that are also very important." The intellectual rigor of the meetings increased and then increased again as Friedman and Rubin drove for what Friedman calls "strategic and tactical dynamism" and zero defects. Silfen remembers, "As the management committee took up very complex issues—and only the really hard ones go to that committee—Bob Rubin time and again would ask the deeply insightful killer questions, the ones you had been hoping nobody would be asking. With his enormous range of knowledge and amazing processing and conceptualizing capability, that was Bob's real specialty. It was uncanny. He had a tremendous grasp of what really mattered and why. Very rational, but not necessarily so good on emotional intelligence or working with other people."

Friedman mixed outward self-confidence with indications of inner uncertainty. For example, he could worry over the slightest details, even the phrasing

of a simple thank-you letter after a client visit. One partner, in frustration, blurted out: "Steve, Goldman Sachs is a big firm. You have important work to do. Sign the damn letter!" Others on the management committee were amused by one member who seemed too obvious in his frequently stated admiration for Friedman's comments and opinions during and shortly after meetings. "The management committee of twelve," recalls one partner, "divided into Steve, Bob, nine others for Bob, and one for Steve: Hank Paulson," a fast-rising investment banking partner in Chicago. Friedman saw Paulson's agreement with him as demonstrating their similarities in objectives, similar experience as bankers, and similar thought processes. They had almost always already discussed the agenda items; Paulson made a practice of calling Friedman at home over the weekend. These conversations brought the men closer together on substance and, increasingly, as friends.

As Friedman and Rubin looked ahead, they agreed that with globalization, big opportunities were opening up for Goldman Sachs, but bold action would be necessary. Otherwise the best business would be taken by the firm's many smart, tough domestic competitors, like Morgan Stanley, Salomon Brothers, Lehman Brothers, First Boston, and Merrill Lynch, and by international firms like S.G. Warburg, Morgan Grenfell, Schroders, and Nomura, plus the best of the big banks, like Citibank, J.P. Morgan, Deutsche Bank, Sumitomo, HSBC, and the large Swiss banks—and a hundred other contenders. While most commercial banks would probably find a way to fall short or blunder, some were sure to get it. With their powerful resources—big balance sheets, well-established corporate and government customer relationships, and armies of people, plus the advantages of local-market national pride—they could only get stronger as competitors. Caution, delay, and half measures by the firm would be dangerously part of the problem.

While Friedman and Rubin felt frustrated by what they thought was slowness on strategic decisions, their drive to break siloed separations between divisions helped internal communications within the firm to accelerate and become a phenomenal competitive strength. This transformation depended on a combination of individuals' driving commitment to both send and receive actionable information quickly for all who might be concerned; the power of the organization's "no secrets" culture of lateral sharing and communicating widely; the flattening of

hierarchy during Gus Levy's era; and the communications technology that the firm provided everyone. Even on Saturday and Sunday, a hundred incoming and a hundred outgoing messages every day would become normal for every partner—with immediate response common and same-day response mandatory, no matter where in the whole world the sender and receiver might be.

Friedman and Rubin were particularly proficient at communicating with each other. Like Whitehead and Weinberg, they were determined to prevent the obvious problem of having people play one of them off against the other, so they set out a clear policy: "If you talk to one of us, you've talked to both of us. It's our job to keep each other fully up to date." A late-night policy question to one of them might be answered with a specific decision early the next morning by the other. As Friedman recalls, "We didn't want any chance of anyone getting one inch of water in between us. We were tenacious because we had to be, but I felt badly when people thought we were too aggressive and called us the Doberman pinschers."

As managing partners, Rubin and Friedman had to be actively engaged in the firm's major client relationships globally and had to understand the market risks being taken worldwide. So both had huge travel obligations and each had key clients to cover. "We adopted an effective one-here-one-traveling coordination, recognizing that when two people coordinate *and* focus, their impact on an organization can be truly formidable," explains Friedman. He then smiles as he adds mischievously, "We split countries and client coverage as evenly as possible. Bob got Moscow, so to be entirely fair, I graciously took Paris."

Rubin and Friedman wanted to differentiate Goldman Sachs in the breadth and intensity of service received by the firm's clients and prospective clients, so they drove for a superior level of coordination across the whole firm through "360-degree" personal-performance reviews based on evaluations collected on each person by everyone he worked with, in and out of his department. They also established "cross-roughing" reviews in which people were evaluated by managers from other units to ensure consistent firmwide objectivity. "With three-sixty reviews, everyone knew they had a real say in one another's evaluations and that everything was put out in the open twice each year," recalls Friedman. "Everyone was taught to play to their strengths and not to expose the firm to their weaknesses." Taking control of performance appraisals and compensation—which

traditionally had been left to the different unit heads—was important to Rubin and Friedman. Centralization facilitated consistency, rewarded firmwide teamwork, and reduced the powers of the divisional barons. As Friedman recalls, "We needed control of the personnel review process to drive cooperation through."

Friedman believed there should be much more differentiation in compensation, to achieve more discipline and accountability—and more control by the firm as a whole rather than by the separate divisions. Explains Friedman, "On compensation, the firm had become more interested in maximizing social harmony than in rigorous evaluations, so actual payouts to individuals were closer than might be expected, and they were converging." As Friedman identified one source of the problem, "If a reviewer had fifty reviews to do—which was not unusual—it was awfully hard not to start skipping and skimming to get the task out of the way, even though people's careers were at stake. But this was not fair to the careers of the individuals. We owed them accurate feedback." Friedman and Rubin were prepared to force objective discrimination to prevent cronyism. Every unit head was required to evaluate all his people twice a year, divide them into quartiles, and reflect those rankings in compensation—even unit heads who protested sincerely, "But I don't have *any* fourth-quartile performers!" Anyone in the bottom quartile was likely to get fired. If someone was in the fourth quartile for three or four consecutive years—sometimes called the "fifth quartile"—he was almost sure to get fired.

In the past, most members of a partnership class had traditionally held the same percentage of the partnership for many years. No more. After the second two-year review, performance-based differentiation took hold—and the partners knew one another's percentages. The differentiation in partnership percentages became increasingly significant. If they were not continually strong performers, partners were, with increasing frequency, taken out of the partnership and obliged to go limited.

Friedman was convinced that principal investing was a highly profitable opportunity and that Goldman Sachs was in an ideal position to move boldly into the business by combining its own capital, its expertise in corporate finance, its many corporate relationships, its research knowledge of companies and indus-

tries, and its access to institutional investors and, through Private Client Services, to wealthy individuals. Through its extraordinary relationships with senior executives at thousands of client companies that might be open to considering spin-offs and divestitures—as many did as clients for tender defense—Goldman Sachs would have the valuable competitive advantage of getting the first call on potential deals. But launching principal investing was not easy.

"It was a bitch to get the firm to make the first principal investments," recalls Friedman, who wanted to put five million dollars into the first KKR fund to get a window on how to succeed in private-equity investing. Resistance was strong, with comments from partners like "We don't work to support other people's business" and "Go start your own fund." (Earlier, Friedman had been tempted to resign from Goldman Sachs to do private equity on his own, and after eventually leaving Goldman Sachs, he did go into private equity.) To one complaint, "KKR will see us as *competitors*," Friedman replied: "Yes, but they'll get used to it." And then he got an okay for a starter deal with KKR. "Eventually," he says, "for four million, we bought a small paper business from the Rockefellers. At least it got us started."

As Friedman recalls, "For private equity, the ultimate key was to get Hank Paulson—a one-hundred-percent-certified investment banker and co-head of IBS—to oversee and take the lead and head up that unit and incorporate its results into investment banking's P&L.[3] If we were okay on our skills as investors and we had the best deal flow, we would have a clear competitive edge overall. But we needed the superior deal flow that could only come from our many corporate clients, and that meant we needed the IBS guys out there working for *us*. Once we got the system going properly, it was clear that we would often be the preferred investors."

Friedman got little active support and considerable resistance for his private-equity initiative, confirming his observation that "it's harder to get a good idea accepted than it is to get a good idea." But with fund-raising help from PCS salesmen and a three-hundred-million-dollar commitment of capital by the firm, Goldman Sachs raised one billion dollars for GS Capital Partners I in 1991. With another three-hundred-million-dollar commitment, the firm raised $1.75 billion for GS Capital Partners II in 1995. As investment results confirmed the firm's capabilities, even larger funds would be raised, and Goldman Sachs became

increasingly prominent in private-equity investing. In 1994, 28 percent of Ralph Lauren's private company was acquired for $135 million, and that investment more than tripled in value to $578 million in an IPO three years later. Understandably, enthusiasm for private equity increased.

As his interest in real estate led him to study the driving factors in that business, Friedman was told by the firm's experts in real estate that the key to success with an important office building was getting the prime tenant. "As a major firm with a large number of employees, lots of equipment, special spatial needs like a large trading floor plus attractive space to accommodate numerous visitors, Goldman Sachs was clearly a prime tenant," Friedman recalls. "So why give that economic advantage to a developer when we could, instead, keep it and use it ourselves? Since we knew we could deliver the prime tenant—ourselves—we should own our own building." This thinking was behind the firm's acting on a recommendation by George Doty that it buy and complete the large headquarters at 85 Broad Street being constructed by a Columbus, Ohio, developer. Upon completion, it was sold as a fully rented building to MetLife and then leased back for the firm's use on terms that gave Goldman Sachs 100 percent control of all operating decisions, plus a tidy profit.

In the early nineties the firm also took a hard look at Canary Wharf in London. Commercial-property leases in London are traditionally long term and "marked to market" every five years. The only way out of risking these escalations was to buy a building. As the managing partner charged with all sorts of administrative responsibilities, Fred Krimendahl bid—but was outbid—on two City properties. Then the *Daily Telegraph* moved its huge printing presses to the London Docklands, and its cavernous building on Fleet Street became available during Christmas week—if a deal could be closed by year-end. The vacated space was ideal for constructing a major new office building in a fine location now known worldwide as Peterborough Court. Krimendahl quickly organized a Channel Islands company for tax reasons and bought the property—only to be criticized for not clearing it with the management committee. The move was a great success.

The alternatives remained unattractive. As Friedman recalls, "I could see that by 2010 Canary Wharf would be a superb property, but back at the time of decision, there were way too many problems: None of the stores or apartments

you see now were there, transportation was awful, the location was completely unfamiliar, it took too long to get there because the tube and light-rail lines were not yet installed, and, as a partnership rather than a corporation, we'd have had all sorts of significant tax problems. So we passed on that particular project." However, the commitment to capital investments, and not just in buildings, was gaining momentum at Goldman Sachs.

Bob Rubin saw numerous opportunities to commit capital in high-profit principal trading and knew that since the greatest risk in trading is *time*, traders must have long-term, patient capital that can wait for results; as Keynes observed, markets can stay "wrong" longer than a dealer can stay liquid, causing "gambler's ruin." If the firm was to pursue its most profitable principal trading opportunities, Goldman Sachs would have to accept abrupt, irregular gains and losses and would need very patient capital.

As a principal investor, few other financial organizations in the world had so much going for them. The firm's network of agency relationships was a powerful advantage. But one big ingredient was wrong for principal investing and acquisitions: Goldman Sachs's partnership economics. Great investments could take many years to mature fully, but partnership accounting measured everything annually. The risks on a principal investment would usually concentrate during the early years, but the payoffs would usually come in later years—off cycle with a partnership. One solution to this mismatch would have been to use dated accounts, under which the partners who made the investment would reap the returns no matter when they came.

But that approach wasn't Friedman and Rubin's. Both were skillful and experienced defensive players, watchful to identify risks and uncertainties and to protect against them. The combination of more capital commitments and the need for more liquidity was a straightforward management problem to Friedman and Rubin, and there was a better solution: public ownership, originally suggested long before by Fred Krimendahl.

With more and more firms talking about going public, or taking action, cagey John Weinberg had been ready to explore the question for Goldman Sachs but made no explicit commitment: "Do you think I want to go public?

Not me!" Weinberg and others spent years of off-site meetings pondering an IPO and how to maintain the spirit of the partnership, and Friedman and Rubin had quickly championed the idea. In December 1986, they had made their ill-fated presentation to the partners on behalf of a unanimous management committee of a proposal to take Goldman Sachs public. At the Saturday morning meeting, Rubin and Friedman, who were already widely accepted as the next generation of leaders, gave their vision of the future opportunities that were opening up for the firm as a trading powerhouse and as a private-equity investor and why an important pathway to becoming that higher-profit firm was public ownership.

Looking back, those who were there say the Saturday morning presentation was not successful because it was surprisingly weak and amateurish. An important problem was that almost no time had been given in advance to preparing the partners' thinking about an IPO, so the partners had not thought enough about the complex subject or its many implications to agree to such a major organizational and cultural change. The partnership had always been considered almost sacred to the people—and especially the partners—of Goldman Sachs. Most had assumed the firm would forever be a private partnership, and most believed the partnership had been and would always be the vital engine of the firm's continuing success.

Everyone could see that an IPO would make senior partners suddenly wealthy, but it was also clear to the thirty-seven new partners—twice as many as in any prior class—who had become partners only one week before, that they would be frozen at small percentages, getting only a very small part of the wealth they could expect to accumulate over the next ten or fifteen years as active partners. (Rubin, given his cautious outlook for the business, had actually thought even the new partners would be better off with an IPO.) Senior partners tended to be in favor, but were silent. Various groups raised questions. Some expressed concern about the loss of privacy regarding their accumulating wealth. Investment bankers had no need in their business for large amounts of permanent capital and were unenthusiastic about making major capital commitments to support trading. As the meeting continued, partners spoke with increasingly strong feelings and sometimes in loud voices—even with tears—about the risk of losing the spiritual values of a partnership that had been nurtured for many years by their predecessors and that would, they hoped, be strengthened and passed on to worthy successors. Resistance was so strong that it was back to the drawing boards

for an IPO. But both Rubin and Friedman were determined to change Goldman Sachs in structure, strategy, operations, incentives, and controls, and to commit to international expansion, embracing risk, using technology, increasing discipline, and deploying capital.

Perhaps symbolically, John Weinberg had taken a seat on the dais somewhat physically separated from the management committee and expressed no support for the proposal, even though partners in the audience knew that his share in a public offering would be worth well over one hundred million dollars. No decision was made on Saturday, and the traditional partners' dinner dance was held that night at Sotheby's.

Sunday morning, before the meeting reconvened, the new partners gathered together. They could, if they agreed, vote as a block of thirty-seven. Then Steve Friedman arrived. He was angry and insisted there be no block voting by any interest group—everyone should think for and vote for the firm as a whole. "You don't have to be Mother Teresa, but vote—individually—with only half being what's right for you and at least half what's best for Goldman Sachs." The new partners were daunted: They knew Friedman was strongly in favor of an IPO, and they all knew that future changes in their partnership percentages would be made by the management committee.

Jim Weinberg, who for many years headed up IBS and provided invaluable informal counsel to his younger brother John, rose to speak for faithful stewardship and the partners' responsibilities to the next generation. In his view, the proposal just didn't make any sense. The heritage that had been entrusted to the current partners as stewards brought with it a responsibility to make the firm stronger and pass it on to the next generation. Besides, he had no interest in reading in the newspapers about partners' earnings. This signaled for many that John was not really in favor of an IPO. As Jim Weinberg often did, he had caught the consensus of the partnership. No vote was taken or needed.

Some believed that with the consensus not to go public, the traditional values of the partnership were reaffirmed and the partners were rededicated to building the firm. Some believed the business strategy of going global was agreed. Others worried that the genie of greed was out of the bottle. For many, the infusion of equity capital from Sumitomo showed that an IPO was not necessary to obtain the capital needed for a strategy of growth and expansion abroad. It didn't really

matter. The partners of Goldman Sachs were not psychologically ready to be a public company.

After the silent decision not to go public became clear to all, Bob Rubin spoke to the whole firm: "As partners in this firm, we are not the owners of the firm. We are closer to being fiduciaries and caretakers of the culture. We really believe we don't have the right to sell Goldman Sachs."

On December 11, 1992, an impromptu meeting of the available partners was called via e-mail and held on the thirtieth floor of 85 Broad Street. The partners of Goldman Sachs had expected five or ten years under Rubin and Friedman. Nobody had expected Bill Clinton to win the presidency. Ten days before, Warren Christopher, soon to be named secretary of state, had called Rubin, sounding him out about becoming secretary of the Treasury, but Rubin said he was too new to Washington and felt that Lloyd Bentsen was the best candidate for Treasury because he had the right experience. Then Christopher and others pressed Rubin to take a new economic-policy-coordinating job at the White House.

"Can I talk to people outside the government to get their judgment?"

"Can you give me an example?"

"Well, I'd always want to get Steve Friedman's thoughts."

After a long meeting in Arkansas, Rubin—who had not expected to go to DC and had not known Clinton well—would be going to Washington. When he returned to New York early the next day, he went directly to Goldman Sachs to meet with his partners and tell them of his plans. He was obviously tired and hungry. On the plane from Little Rock to New York, he'd made some notes of what to say, and he spoke to the group as he ate some breakfast. He talked informally and emotionally about how much he treasured his experiences and his friendships at Goldman Sachs. But it was clear to his partners that he was already relocating his personal center of gravity to Washington.

Steve Friedman would now be alone. Partners would urge him to appoint strong people to share the burdens of global leadership. For many, the loss of Bob Rubin was far more than the loss of a unique business leader. It was spiritual.

"For me," recalls Styer, "the defining picture of what it really meant to be

a partner of Goldman Sachs is the picture etched into my mind of Bob Rubin and Bob Mnuchin, each with a Styrofoam cup of coffee in his hand, standing together in the trading room, quietly chatting—chatting about the markets and some ideas of what they might do—and it's only seven in the morning! Why so intensely engaged so early in the morning *every* day? Because that's what they truly wanted to do and where they wanted to be. And that's the way it was all the time for everybody at Goldman Sachs. At Morgan Stanley, where I also worked for a while, people saw their work as personally defining—it was what they could do and did do—but at Goldman Sachs, it was much more: It was *life*."

In the past, the firm's career compact with its professional staff had been clear: almost no lateral hires, so those who had made a commitment to the firm had no worry about competition being brought in over them. The longer people work together, the better their understanding of one another and the better their communication. Over the years, however, this policy has been diluted by so many exceptions that it's no longer a policy. International expansion was a force for the change, as were the move into bonds, the acquisition of J. Aron, and the expansion of Goldman Sachs Asset Management.

When there were no strong internal candidates, key people had been recruited from other organizations. George Doty came from Coopers to head internal administration. Claude Ballard came from Prudential Insurance to lead a new effort in real estate. And Jim Weinberg joined the firm after fifteen years at Owens-Corning Fiberglas when John Whitehead called to say: "We're hiring good people to join us in investment banking and developing our corporate-client relationships. This could be just your kind of work." Mike Mortara came from Salomon Brothers to lead in mortgages; Simon Robertson came from Kleinwort Benson; Sylvain Hefes came from Rothschild to develop investment banking in France. In 1993 E. Gerald Corrigan, who had just completed nine years' service as president of the Federal Reserve Bank of New York, joined the firm at fifty-two to chair its international advisers group.

Lateral hiring is not as easy as it may at first appear. As a banking partner explains, "When you are growing too rapidly to develop all your own people, and start hiring people laterally, you *will* make mistakes—hiring wrong people and promoting wrong people. Those people can become the organization's enemy within—people other people don't want to help, do want to avoid, and

will even risk hurting the firm just to penalize the bad guy. You try to hire only very strong outsiders, but they usually have to unlearn the habits, practices, and ways of doing things that worked very well for them in their old place. This almost assures they'll be different. Combine this with their not knowing most of our people and our ways of doing things, and the odds of disruption are high. The odds go up again when they come as strong individuals to a culture that depends upon teamwork and interchangeability and commitment to the group and the firm—to *we*, not *me*."

"Transferring into Goldman Sachs from other firms is usually quite difficult," says partner Jun Makihara. "Having learned how to succeed in other firms, lateral transfers typically reach for P&L authority and accountability, but that would conflict with Goldman Sachs's concepts of teaming." Ken Wilson, who came in laterally, makes telling comparisons: "If you try a solo hero deal and fail, you're in double jeopardy—once for failing and once for trying to go it alone. At Salomon Brothers, it was hard to get the right analyst or product specialist to schlep all the way to Asia, but at Goldman Sachs, it's easy. 'On the next plane' is SOP. This firm plays to win—as a firm."

23

TRANSFORMATION

For many years, Wall Street traders and academics were worlds apart and each group was proud of both not respecting and not liking the other. Each group was articulate in dismissing the other as knowing nothing of importance, understanding nothing that mattered, and doing nothing of great value. But in one of history's great intellectual revolutions, the rigorous quantitative models of academic finance, bolstered by powerful computers and extensive databases, came into a powerful coherence with the creativity of Wall Street's highly motivated traders. That combination changed everything.

The primary change-making factor was the development of financial derivatives. Trading in derivatives grew exponentially in a profusion of variations. In a single decade, derivatives grew to dominate the traditional cash markets in value traded. Moreover, they created bridges between previously separated markets and currencies that "connected all the dots" into one massive, interconnected global market for all securities in all currencies over all time spans.

The first linkup between academics and traders occurred in the seventies in a small "skunk works" unit at the World Bank. Led by Eugene Rothberg, an iconoclastic innovator who served as the bank's treasurer, the unit made the bank

one of the world's largest and most creative borrowers. Rothberg's objective was to minimize the bank's cost of borrowing. His strategy was to minimize cost by maximizing innovation. That's why Rothberg hired bold creative rationalists like Mark Winkelman into his skunk works of creativity.

In 1977 Mark Winkelman was recruited from the World Bank to Goldman Sachs by Victor Chang to set up a business within Fixed Income to trade financial futures versus Treasuries. (T-bill futures began trading on the Chicago Merchandise Exchange in 1976 and Treasury-bond futures began trading in 1977.) No one in Fixed Income at Goldman Sachs understood futures, so Winkelman was joining others who were leaving the World Bank to make real money in this new business, which seemed certain to grow rapidly. But even the most enthusiastic optimists would be astonished by the explosive growth that developed quickly and continued to compound for several decades. Growth in futures exceeded all expectations and created an expanding series of profit-making opportunities for Goldman Sachs.

Being new and poorly understood, financial futures—whose true value was hardwired to the price of the underlying Treasury security, which had no credit risk—were often substantially mispriced. This created opportunities to go long or short futures and short or long the underlying Treasuries in a wide variety of riskless arbitrages of the frequently mispriced spreads. With half a dozen different and interchangeable government bonds, Winkelman had ample trading options to work with, so—with very little real risk—he made substantial and steadily increasing profits. Chang was also interested in "rolling down the yield curve"—exploiting mispricings between, for example, three-month Treasuries and six-month Treasuries. But the magnitude of these mispricings was much smaller and the arbitrage less perfect than when working with futures versus Treasuries.

In 1978 "interest rates went completely crazy," recalls Winkelman. The main causes were political. To have both guns and butter—to pay for both Vietnam and his Great Society commitments without raising taxes—Lyndon Johnson had produced a delayed tsunami of inflation, which surged under Jimmy Carter until Federal Reserve chairman Paul Volcker slammed on the brakes. By forcing interest rates to record highs, the Fed opened up a rich variety of highly profitable opportunities for cash-versus-futures arbitrages for Winkelman's unit to exploit.

Chang understood the academic theory of fixed-income arbitrage, but he was

much too theoretical for Goldman Sachs's traders, wasn't a trader himself, and was, unfortunately, a poor presenter—particularly to rough-and-tumble traders and the men on the management committee, who were unfamiliar with futures and options and still held the prejudices of traders about academics. When Winkelman began meeting with the management committee to explain what he was doing and how it worked, the reaction was, "Thank goodness you finally made this stuff all clear and understandable!" The management committee's increasingly favorable reaction, and the increasingly impressive profits Winkelman produced, encouraged Jon Corzine to use the new techniques on the government-bond desk. After Henry Fowler joined the firm, Goldman Sachs had become a registered dealer in U.S. government bonds, but Corzine agreed with Winkelman that "you'll never make any real money as a routine dealer in Treasuries." Corzine would make substantial profits for Goldman Sachs in risk-embracing trades based on long-maturity Treasury bonds.

As a long-bond trader in governments, Corzine was in a very different business from Winkelman as an arbitrageur, and their styles of thinking were divergent. Winkelman was rigorously analytical, stayed close to market specifics, and was careful. Corzine understood concepts, had a sensitive feel for the markets, was intuitive, and boldly took substantial risks. Their fundamental differences in concepts and approach to trading would spring to the surface when both men—for different reasons—wanted to hit the same major bid or offer, putting them into direct conflict for a profitable trade.

Friedman and Rubin went looking for people who could make Goldman Sachs at least fully competitive with the two leading bond dealers, Salomon Brothers and First Boston. Their first approach consisted of promotions and transfers within Goldman Sachs. Rubin knew Winkelman was a good manager of people and a smart leader with the power of disciplined determination. Winkelman was rational, dry, a bit formal, and a loner. Corzine was a strongly intuitive risk taker and a relentless trader. With his warm teddy-bear personal touch, he was unusually well connected within and without the firm. Winkelman was not willing to come into Goldman Sachs as a subordinate of Corzine's—which was what Corzine clearly expected. After some awkwardness, the two men agreed they would share an office on the fifth floor as equals. When Friedman and Rubin were appointed co-COOs, Corzine and Winkelman were made co-heads of fixed

income. Again, Corzine was disappointed not to be in complete control. Later Corzine would see all too clearly the drawbacks of divided executive power, but once Friedman and Rubin made it clear that Corzine and Winkelman had to work together, they worked at it with reasonable success. "Once we developed an understanding that we would have to work together," says Winkelman, "we developed a sensible structure and soon found working together was pretty easy." But their differences in personality, ways of doing business, and strategic concepts could neither be hidden nor fully harmonized.

When Friedman and Rubin had taken over the division in the early eighties, they identified Salomon Brothers as the business pacesetter and the firm to beat. In a deliberate break with the firm's traditions, they hired in several Salomon people, who jump-started the buildup in the mid-eighties. In a few years, most of the imports from Salomon Brothers had left, but they had made an important impact on the firm's strategic change from service and accommodation to a profit-focused, risk-taking, principal and proprietary trading dealer.

With considerable help from the powerful imports from Salomon Brothers, Goldman Sachs deliberately and conscientiously transformed the bond business from the old business of making judgments and taking risks on interest rates and bond maturities—which had proven too difficult as savvy institutions became increasingly dominant in the bond markets—to a business that concentrated on managing spreads and arbitrages in deliberately crafted portfolios across markets and between different types of securities in markets all over the world. As partner Rick Garonzik explained with evident satisfaction, "Now, it doesn't really matter whether interest rates or markets go up or down. We're organized to produce profits on a regular basis, and this stability of earnings is important to our cost of funding our very large dealer positions. The complexity of operations in a modern bond dealership, thanks to computer systems and sophisticated risk controls, is awesome. Our bond business is so complex now that it is very hard to explain. While the guys in the business have much more understanding of their business situation and what they can do as managers, it's *really* hard to explain to people outside the business—and even harder for them to understand."

Taking deliberate risks and managing those risks had long been central to the way business was understood and conducted at Goldman Sachs—particularly

under Gus Levy and Bob Rubin, who both came out of arbitrage, where they developed a way of thinking about using risk productively to make profits. Explains Garonzik, "We make every effort to know and understand each risk and the interconnectedness of all the different types of risks, and then build a *portfolio* of business risks that is profoundly different from a simple sum of the parts."

In one area after another, Friedman and Rubin made simultaneous changes on many dimensions in the strategy and structure of the firm's bond business. The accelerating speed of innovation and the faster maturation of the proliferating new bond markets—which brought new-product profit margins down—was a fundamental change in the character of markets. It brought changes in the competitive strategies of firms and in the pace of competition. No longer could Goldman Sachs afford to follow Whitehead's careful strategy of letting the competitor firms develop new products and services and then figuring out the best feasible design enhancements and rolling to market dominance through its well-established network of corporate relationships. "That strategy was too slow; any firm following that strategy implementation wouldn't get to the market until the best part of the profit party was all over," recalls Steve Friedman.

A series of strategic initiatives were launched to capitalize on market developments or catch up with competitors. Steve Friedman brought over Arthur Walter from First Boston to develop an interest-rate swaps business, but his operation was limited by credit concerns, particularly on "long tail" swaps that didn't fit at all comfortably into partnership accounting. For many years, the firm would do swaps only on an agency basis, but Corzine and Winkelman campaigned for and finally did get approval to act as principals in the swaps business.

Joel Kirschbaum was charged with developing a fixed-income capital markets group to work with bond issuers to create transactions by showing investors ways to create tactical gains by making market-sensitive trades at rapid-fire speeds. This replicated much of what Gus Levy and Bob Mnuchin had created in block trading for the institutional equity market.

In bond research, a rapid buildup reached one hundred people in short order. In mortgages, Salomon Brothers already had a bear hug on the business by the time Goldman Sachs got going. It would take five or six years of slugging it out without profit for Goldman Sachs to establish a major market presence—too

long a time in a partnership. Other firms, like Salomon Brothers and First Boston, already had the high ground and could dictate the terms of competition from positions of great strength in the markets. But Rubin and Friedman were determined. Goldman Sachs resolved to absorb several years of losses to muscle its way into the business.

International bond dealing surged in the late seventies and early eighties as Eurobonds, for which all trading had to be executed overseas, became an important part of the international financial markets. But Goldman Sachs was slow internationally and executed poorly. As Garonzik recognized in retrospect, "In the mid-eighties, when I went to London, we were losing a lot of money. Part of this was not having the right people. It was chaotic, a real mess."

Rubin had initiated futures arbitrage as part of his experiments in potential new markets and wanted to build a small commodities business. He had started a small foreign-exchange business and was considering trading in gold when the purchase of J. Aron overwhelmed those nascent strategies.

As commercial-paper spreads shrank, Friedman and Rubin recognized that adjustments would not be enough: The firm's longest-running business needed a total reorganization. Recognizing the difference in approach to business problems between Winkelman and Corzine—analytical versus intuitive and objective versus people-sensitive—Friedman and Rubin assigned Winkelman to reorganize not only commercial paper, but the whole money-market business. This would include T-bills and federal-agency securities, which intruded into what Corzine saw as part his territory as head of Governments. As Winkelman recalls, "The firm's commercial-paper business was run pretty much the same way it had been run for thirty years, even though, with commercial banks forcing their way into the business by cutting prices, spreads were collapsing. Risk-adjusted, the business was no longer profitable. It was dumb to be making markets in commercial paper, but we did it to support the guys in investment banking. We made no money, but at least it helped start relationships with corporations, relationships the firm could build on."

Winkelman quickly saw the only realistic way out of the box: Cut costs so much more than any competitor possibly could that profits would come back. The only way to wring out costs was to automate and computerize all but the most unusual or difficult orders.

. . .

Inconsequential as it may have appeared to them at the time, the decisive moment in bringing academics and traders together was a phone call in the mid-eighties from Bob Rubin to Professor Robert Merton. While living in traditionally separated worlds, both men were exceedingly bright and quietly charming, and each had enjoyed their recent first meeting. Rubin was looking for leads on unusually talented people who might be able to help Goldman Sachs develop a new kind of business based on an intriguing cluster of insights being developed by financial economists at a few universities. Searching, as usual, for extreme brainpower, he asked Merton, "Do you know anyone who is really good at quantitative analysis and sophisticated models?" Merton suggested talking to a young MIT professor, Fischer Black. "He's very good—a serious prospect for a Nobel Prize—and he's getting a divorce so he may be looking for a real change in his life situation. He's unusual in several ways. Even spells his name differently: It's F-i-s-*c*-h-e-r. I think he's special."

Increasingly fascinated by the profound changes he saw coming with the development of the Chicago Board Options Exchange, where he had gotten involved from the beginning, Rubin was interested in the potential of capitalizing on the new mathematical concepts of market behavior coming from leading academics, particularly the "quants" at MIT, Chicago, Harvard, and Yale. As Rubin would soon learn, the creative leader of this group at MIT was in fact Fischer Black. He taught a rigorous course on capital-market theory and liked to begin classes with descriptions of anomalies—observable market behaviors that did not seem rational.[1]

"The Value Line index trades on the Kansas City exchange," announced Black as he began one of his classes. "The individual stocks represented by the index trade on the New York and American stock exchanges. There appears to be a mispricing here because the share-weighted price of the index is not an identity with the sum of the prices of the shares taken individually." Students had heard things like this before. To most, it illustrated how predictably arcane the finance classes could be at MIT, particularly with a professor as extraordinarily intelligent and classically "ivory tower" as Fischer Black, who was already becoming famous for coinventing the Black-Scholes options-pricing model. While students admired Black's brilliance, most thought his odd fascination with recondite

anomalies was surely a useless waste of time, meaningless in the *real* world where they hoped to be heading: Wall Street.

In physics, the concept of equilibrium, where two opposing forces cancel each other exactly—for example, when the heat flowing into a body cancels exactly the heat flowing out—is formidable in its applications. Black believed that market prices were determined by similar cancellations by opposing forces, so equilibrium was at the center of his research. In Black-Scholes, the value-determining equation assumes that a stock and an option on that stock will be in equilibrium, and since their prices will provide investors with the same expected return per unit of risk, a rational investor will be indifferent between buying the stock and buying the option. When written out mathematically, this produced the original Black-Scholes equation, but solving the equation took several more years. Robert Merton, working in parallel to Black and Scholes, developed a rigorous understanding of the logic behind Black-Scholes. He showed that the value of a stock option can be replicated with a "simple" dynamic blend of cash and shares of stock by continually exchanging shares for cash or cash for shares until the investor winds up with the same payout as the option; so the value of the option is always exactly equal to the cost of buying the correct initial mixture of cash and shares at their current market prices. Merton's approach was more formal and hence more powerful, so it became the standard approach for users, including Fischer Black. Before Black-Scholes, each trader had to have his own way of estimating the correct price of each stock option—estimating only approximately and never accurately enough to commit significant money to making good markets based on small apparent differences. Because it provided the exactly correct prices traders needed to make reliably profitable markets, the Black-Scholes model went directly from an academic journal to the floor of the Chicago Board Options Exchange and the trading desks of all major securities dealers.[2]

After the introduction of Black-Scholes, the markets for options—and an exploding proliferation of other derivatives—mushroomed from marginal importance to global dominance, transforming corporate finance and all financial markets, particularly the options-dealing business. Options changed from a business with high risks of capital losses for the dealer due to mispricing to a business with virtually no dealer risk of mispricing. Through "dynamic replication," a dealer could create his own options by continually changing the mix of cash and

stock, and therefore would always know the exact cost of doing so. With mispricing risks to dealers expunged, the premium costs charged to option buyers shrank greatly and the pricing of options became standardized. As a result of these three major changes, options came out of the closet and trading volume took off. Before Black-Scholes, options dealers were always at risk as principals on every option they wrote, so they wrote options in small amounts on special terms and at high costs to the buyer—which, of course, kept demand low. But now—after the insights of Merton, Black and Scholes—dealers could use the model's recipe to mix up their own calls out of cash and shares and easily and accurately estimate their costs. This meant they could price their homemade options correctly to make a profit while taking zero capital risk. As the costs fell, creativity on Wall Street flourished. All sorts of new kinds of options were developed and traded, including options on interest rates, credit ratings, weather, energy and commodity prices, and all sorts of other futurities.

In 1971 America had followed Germany and Japan in leaving the Bretton Woods system of fixed currency-exchange rates, and exchange rates floated, set by supply and demand. In 1972 the International Monetary Market opened for trading in Chicago, and in 1976 the ban on commodity options was lifted by Congress. In 1982 the Chicago Mercantile Exchange would begin trading a new "commodity": futures contracts on the S&P 500 stock index. And in 1983 it began trading options on S&P futures—setting off the chain reaction of the derivatives revolution on Wall Street and in global finance. By the 1990s, the underlying value of CBOE options would exceed the value traded in the NYSE cash market. In the current decade, derivatives volume worldwide has ballooned to a total value estimated at $150 *trillion*—many, many times larger than the volume of all the stock, bond, and currency markets.

A member of the Chicago Board Options Exchange since 1973, Rubin understood the Black-Scholes formula, which he'd been using since before it was published. Rubin and a few others at Goldman Sachs recognized the potential profit power of coordinating and even integrating the brainpower of a Fischer Black with the firm's trading operation, where a new kind of trader was learning to understand the importance of having rigorous analytical models to determine the correct way to hedge against each risk exposure.

Rubin was clear in his reasoning on hiring quants: "They see and think

about things outside the range of our thinking. That appears to be a difference that might work. And if it does, it's so different that it could make us a lot of money. And if it doesn't work, we can easily kill it."

In December 1983, Professor Black met in Cambridge with the partner in charge of the most "real world," profit-focused, pragmatic business unit at Goldman Sachs: risk arbitrage.[3] Black was favorably impressed with the caliber of Rubin's analytical mind, and Rubin sensed that there was an opportunity to engage Professor Black's conceptual and analytical brilliance with the data-processing power, trading know-how, and risk capital of Goldman Sachs.* After several hours of mutual probing, they each knew the other was a very special thinker and believed they could work well together. Rubin soon offered Black a job as an "experiment"—an experiment that would work remarkably well. Black was surprised by the amount of pay Rubin offered "for starters" and agreed to consider it. Two months later, Black left MIT and moved to Goldman Sachs.

For Black, the lure of an academic life had been the freedom to think new thoughts. Now, Black would find Goldman Sachs even "better for learning than a university, partly because the firm's business required continual learning as it adapts to new conditions."[4] Explained Black, "One of the things I like about doing science, that is the most fun, is coming up with something that seems ridiculous when you first hear it, but finally seems obvious when you've finished."[5] He believed that fundamental discovery could come only from challenging conventional wisdom and that the ultimate test of any theory or innovation was its practical usefulness.

At Goldman Sachs, Black found not only high rewards and the freedom to think new thoughts, but also, given Rubin's strategic drive, a truly compelling need to think still more new thoughts. Just as Black believed that in all investing, the biggest source of risk is time, Rubin believed it was important to have few *beliefs*, because the markets are uncertain and always subject to change; the secret to successful adaptation was mental agility and flexibility. Rubin was experienced in uncertain markets and skilled in the disciplines of arbitrage, so he knew that taking on risk as a measured part of the skilled, intelligent use of capital was vital

* Technology development at Goldman Sachs was profit driven, so it could be very advanced where profits were to be made and archaic in nearby areas. For example, even in 1990, the Goldman Sachs payroll system could not cut checks for more than one hundred thousand dollars, so if a bonus was one million dollars, the recipient got a stack of ten envelopes, each with one check for one hundred thousand dollars inside—just before Thanksgiving.

to the firm's future. He turned to David Silfen, a sophisticated and serially innovative trader: "You'll be the one to amalgamate Fischer into the firm"—and left the two of them to figure it out. As Black would soon recognize, "flow trading"—knowing all about the many sources of supply and demand—enables traders in the middle of all those flows to anticipate price movements.

"Bob had the vision to appreciate how the guys with the academic theories and quantitative models could work with the traders and add substantial value," recalls Silfen. "He was clear that the only guys who could really cut it were the guys with the very high candlepower—real intellectual talent." Rubin quietly and quickly made it clear that every division head should focus on recruiting, on getting the best brains. "Bob's a democrat, both personally and politically," explains Silfen, "but in business, he was consistently and insistently interested in one thing—excellence."

Rubin wanted Black to help in two ways. First, use computers and finance theory to make money trading stocks and options for the equities division, where Black organized the quantitative strategies group.[6] Second, apply financial theory to identifying the underlying source of profit making in *any* area of the firm's business, generalize that source of profit, and suggest how it might be increased or applied in other parts of the firm.

One of Black's early subjects for examination was the risk of going long, a European-style put option—which can only be exercised at the end of the option period—and short, an American-style put—which can be exercised at any time during the period.[7] Black's work was to be part of Rubin's overall strategic drive to develop innovative market powers that could transform the firm into *the* leading investment banking and market-making organization worldwide. "We will learn from Fischer and he will learn from us" was Rubin's assurance to his partners.[8] Working together, Black and Rubin launched an intellectual revolution within Goldman Sachs.

Black was one of the first of the quants to arrive, but others came in rapidly increasing numbers from the physics, math, computer sciences, and economics faculties of America's leading universities, and from aerospace and computer companies and Bell Labs. Their challenge was to create analytical computer programs that would enable traders to combine the rational consistency of advanced mathematics with their street smarts and market experience to produce profits

again and again—on numerous occasions, very large profits. Black was used by the firm to vet other candidate quants. If he had any doubts about a candidate, those doubts were usually decisive.

After Fischer Black, Rubin recruited professors Richard Roll from UCLA and Steve Ross from Yale and a series of other brilliant, innovative thinkers in markets and finance. Roll set up a mortgage research group that would enable Goldman Sachs, with its powerful, persistent sales organization, to race from far behind to well ahead of the initial innovators at Salomon Brothers. The traders were often impatient for answers and often could not explain their real problem clearly. The quant experts' first task was to understand the question behind the question when traders came to them with one of their problems.

While some quants were attracted by the paychecks, most came to Wall Street because that's where they found the most interesting and intensive intellectual action in finance. In a few years, hundreds of quants were working their hypothetical, innovative ways of thinking and analyzing into the fabric of Goldman Sachs and profoundly changing the firm.

Black, whose office was specially soundproofed to keep out the clamor of trading, never did a major transaction or "bellied up to the bar with the boys." He fit into Goldman Sachs in one, but only one, way: He believed he could change the world—in his case, by changing the world's ideas about how the world itself actually worked. Black understood that his ideas could change the world only by changing the way people looked at it. If they resisted, he did not take it personally. He learned that the way to change any business practice was not by sudden revolution, but by proposing small changes to those who were both directly engaged and emotionally and intellectually ready to embrace change.[9]

Black was a remarkably organized filer. In addition to seven three-drawer paper files, he created a twenty-megabyte database comprising the summaries he typed up of every conversation he had and everything he had read or thought. Deeply introverted and shy, he seemed remote and aloof to others. This set him apart from the guy-bonding so common in an intense trading environment like Goldman Sachs's. Black's office on the twenty-ninth floor had on the wall a large Nike poster showing a long country road with this caption: "The race is not always to the swift, but to those who keep on running." In his contract with the firm, he had one day a week for his own research—plus Saturdays and Sundays.

He may have thought he had an ideal situation: Wall Street compensation, no classes, and ample time for research, but others resented it. Most of the people at Goldman Sachs didn't understand and didn't see how Black could be adding much value, because there were no trading coups or corporate transactions with his name on them. Black was never part of the firm's culture in many other ways. He interacted with several hundred people, but only to the extent that their interests overlapped with his and he was learning from them. Without Rubin's sponsorship and guidance, he would no more have become part of the firm than oil mixes with water. A loner, he never could join in the intense collaboration that was so central to Goldman Sachs's operations. He was certainly not a team manager, and he had no selling skills and no interest in developing client relationships, particularly outside normal business hours. Worse, using Black with clients could backfire on a salesman because Black always spoke as he thought at a particular moment; he was not predictable. Even more clearly and significantly, in a firm where making money was the common denominator, Black did not consider money a particularly useful measure of success. For some, this wasn't all bad: As Jon Corzine recalled, "He was the easiest partner in the world when it came to discussions about money. Basically, he didn't care."

Devoted to simplicity and clarity when giving directions, Black was precise and expected all others to be precise too, so he forbade taking decimals beyond the "significant numbers." Steve Ross, a Yale and MIT professor who often consulted with Goldman Sachs, recalls: "Fischer Black looked like an academic should look, and when he talked, he sounded like an academic should sound. Fischer also had a few quirky academic habits like going silent for as long as a minute on the phone while thinking about the right way to answer your question." After studying his options pricing model and his articles, the Japanese and many Europeans revered Black. To them, his long pauses and rigorous manner showed he must be a genius.

While the capabilities of traders and quants might be integrated, their payouts could differ markedly. If a quant developed a new idea for a money-making trading model that could be used by a trader, the quant might get $150,000 for a year's work, while the trader using the model and doing what it told him to do and how to do it might get ten times as much. The quants developed sardonic ways of explaining this reality: "There are form guys and substance guys. If you're all substance, you're actually of *no* value because nobody will use your ideas. And if

you're all form, there *is* no value." One quant unit had a chart on the wall, trying to plot where the optimal position would be—and where an individual would get paid the most.

Black was quantitative to a fault. The rigor of his logic and his inability to be anything but entirely logical led him to state some positions that were so perfectly rational that they were really very irrational. For example, one day he stopped everyone's clock with his conclusion that Goldman Sachs should go short—ten billion dollars short—in financial futures. "If we are intellectually honest with ourselves, we will go short futures by enough to fully hedge our exposures to the cash markets, instead of always being net long. That way, we will be operating the firm with zero net exposure to market risk."

"Any idea how much that would involve?" asked David Silfen.

"Yes, I've examined the market-risk exposures of every unit in every division. On average, the firm is long—every day—by ten billion dollars. So to expunge those collective exposures to market risk, we should simply short financial futures by ten billion dollars."

" 'Simply' was the key word," recalls Silfen. "For Fischer, it was completely rational." But that was theory, and the pragmatists of Goldman Sachs—with less than one billion dollars in total capital—simply couldn't imagine establishing a "simple" short position that was ten times as large as the firm's total capital. For them, Black's idea might be academically valid, but it was so totally irrational that it was insane. Besides, for a real-world firm like Goldman Sachs, a rising market—rewarding long positions, not short—was vital to M&A, underwriting, Goldman Sachs Asset Management, and virtually every other aspect of the business.

In sharp contrast to the frenetic energy displayed in Goldman Sachs trading rooms, Black was always calm and in personal equilibrium. For Black, models brought with them systematic disciplines that helped prevent operational errors by traders and would augment a trader's intuition by enabling experimentation. The real world, in Black's view, differs from the idealized world of the capital-asset pricing model in three ways. Costly information, costly management, and costly selling were all frictions that caused the real world to deviate from the ideal.[10] And every deviation offered an opportunity for traders to profit.

Black held the view—a superbly profitable view when put into action by Goldman Sachs's traders—that central-bank interventions were never made to

earn profits, but were often made to move interest rates or currency exchange rates in ways that free markets would not, and that these not-for-profit moves could create large profit opportunities for astute, rational traders. Black argued that central-bank interventions were usually *not* rational and so were wrong, and that traders could take the other side of central-bank distortions at significant profit. Those profit opportunities began increasing almost exponentially in the 1980s.

Within months of his arrival, Black began building a large arbitrage position on that same Value Line index mispricing anomaly he had presented to his finance class at MIT. The futures contract had been trading—at the wrong price—on the Kansas City exchange since 1982. The Value Line index was a geometric average, not an arithmetic average, and since a geometric average is always less than an arithmetic average, the futures contract was always overpriced.[11] So the appropriate action was to go long the stocks and short the futures—a nightmare to implement unless it could be automated. Fortunately, the DOT (direct order trading) system that Goldman Sachs had recently introduced was automated, so the firm put together a large matched-book position: Long all the stocks in the Value Line index and short the futures. This position made many small arbitrage profits—so small they never disturbed the market. During the spring and early summer of 1986, this long-short position was steadily expanded until it represented a full one-third of the open interest in the Value Line index. This meant that the local Kansas City market participants were indirectly and unknowingly providing the other side of the firm's huge arbitrage position. The largest position on the other side was held by a group of finance professors who were trying to exploit the "January effect," in which small-cap stocks often make excess returns in January. The professors were long Value Line and short the S&P 500. They thought they were information traders but were actually no better informed than "noise" traders who act on tips, rumors, and the like.

Rubin looked into Black's office one morning with a question: "What would happen if all those counterparties in Kansas City failed and went bankrupt?"

Black, as so often with his hand on his chin, raised his eyebrows rather obviously but remained silent as he waited for one of his quant colleagues in the room to answer. Since no one spoke, Black did: "If that happened, Bob, we'd be screwed."

"But what are the odds that that would happen? Could you work on it?"

This same question soon caught the attention of the management committee when Rubin asked his standard question: "What's your biggest risk—and can you quantify it?" Satisfied with the answer, Rubin let the Value Line position continue. When closed out later that summer, it had made Goldman Sachs twenty million dollars risk-free. It earned a partnership for Black in 1986 and opened a new line of business in basket trading—where a package, or basket, of five to fifty stocks is sold as a portfolio, and another basket is purchased—and a new category of arbitrage opportunities.

Over time, Black's disciplined analytics became part of the fabric of Goldman Sachs—partly because Rubin was Black's sponsor and partly because in many respects Black was the very model of what Goldman Sachs wants its people to be: unselfish about credit, honest, client-focused, and intellect-driven. For his part, these requirements were exactly what Black liked about the firm: It hires talented, driven people, but only if they are ready and willing to work for the good of the whole firm.

24

FALSE STARTS IN INVESTMENT MANAGEMENT

John, we need your help. We've got a major problem that must be solved quickly, and there's a lot at stake." In 1981 John Whitehead received that concerned call from Paul Nagle, the senior financial officer of Chicago's Household Finance Corporation, on whose board of directors they both served. Nagle was a trustee of a mutual fund that invested in a narrow spectrum of short-term debt instruments for a unique clientele: For smaller banks, insurance companies, and corporations, it had been one of the first of the now-numerous "money market" funds that guaranteed institutional investors full liquidity via unlimited redemptions at par value. Named Institutional Liquid Assets and called ILA, it had a portfolio of five hundred million dollars.

ILA had been operating successfully for years and, with increasing institutional acceptance, its assets had grown substantially. But recently, Whitehead was told, Salomon Brothers, as investment manager, had tried to increase the fund's yield by lengthening portfolio maturities. Just then, interest rates rose sharply, so market prices of debt securities fell, reducing the portfolio's market value and "breaking the buck" by taking the fund's share price below its mandatory stated par value of one dollar. While Salomon Brothers was ready to put up the three

million dollars needed to restore the fund's net asset value to one dollar, ILA's trustees just as quickly agreed they wanted to get a new investment manager. So Nagle called Whitehead to ask: "Would Goldman Sachs be willing to take over and manage ILA?"*

Whitehead recognized a real opportunity and expressed appreciation for the compliment to Goldman Sachs of being asked—but he was still cautious. As he explained, Goldman Sachs had long avoided going into the investment-management business. The reason: It wanted to avoid any conflicts with its institutional clients, and several of the firm's most active block-trading customers—including Dreyfus, Morgan, and Fidelity—had been particularly vocal on the matter. Still, since Whitehead recognized opportunity in ILA, he went on to explain to his caller that most of the expressed concerns related to managing *common-stock* portfolios—a much higher-fee business. Because the ILA fund invested only in money-market instruments and charged a low fee, it might well be okay. Nagle said ILA's trustees were hoping to have a decision made over the weekend. Saying he could make no promises, Whitehead offered to see what, if anything, might be done and agreed to try to get a formal commitment from his partners that same weekend.

But some of his partners surprised him with strong resistance. Nobody at Goldman Sachs seemed to focus on what Whitehead thought was the obvious profit opportunity for the firm, as a dealer in all sorts of money-market instruments, to work closely with a large and regular investor in those very same instruments. In a classic case of looking a gift horse in the mouth, skeptical partners raised a series of cautious questions, including concerns about the sophisticated back-office operations that would be required of a large money-market fund and the cost of clearing dozens and dozens of short-term trades. "This should be of no concern," soothed Whitehead, "because all clearing and other back-office operations will continue to be provided entirely by Continental Illinois National Bank."

George Doty was interested in going ahead with the deal because ILA had developed computer technology that enabled real-time recording of transactions, a capability he believed had applications across the firm. Other factors helped:

* Salomon Brothers alumni offer a different history: Continental Illinois National Bank & Trust made the classic error of selling what was supposed to be purchased, and as the market moved, this error "broke the buck." Salomon Brothers could have put up the three million dollars, but because it was having a bad earnings year, Salomon refused, knowing that the decision would end the business. "We gave it away—and eventually, Goldman Sachs was smart enough to accept the gift," says Tom Brock, former partner of Salomon Brothers.

It was "only" a money-market fund serving "only" financial institutions, a low-margin, niche-market part of the investment business. Even so, after Goldman Sachs agreed to take on the ILA management assignment, Howard Stein of Dreyfus, a major block-trading account, called to complain about business "encroachments" and, to make his point perfectly clear, stopped doing any stock-brokerage business with the firm for several months.

After three long weeks of partners' carefully pondering every tooth in this gift horse's mouth, Whitehead finally got the go-ahead from his partners to do a favor for Nagle, a corporate client's senior executive; enter into the one area of the investment-management business thought to involve no direct conflicts with the firm's large block-trading customers; and manage the ILA fund. Twenty-five years later, the assets of ILA and other money-market funds offered by Goldman Sachs would be two hundred *times* larger: over one hundred billion dollars.

The main reasons for taking over ILA were economic. In the short run, managing ILA made it easy for a major commercial-paper and money-market dealer like Goldman Sachs to do quite profitable incremental business. ILA would earn the firm approximately five million dollars in annual revenues with virtually zero capital commitment and only minor incremental costs. And while any hint of self-dealing must be avoided, there would surely be profitable ways to coordinate the firm's dealing business with this investment-management business. Over the intermediate term, the Goldman Sachs sales force could surely build up the assets under management and increase management fees through their extensive, regular contacts with major financial institutions and corporations.

The hopes that ILA would be the cash cow that might finance the buildup of a major asset-management business were soon dimmed when Dreyfus and Fidelity, the two major competitors in money-market funds, cut their fees in half—from forty basis points to eighteen—forcing ILA and all other competitors to follow. Profitability was clearly deferred. This was not the firm's first disappointment in investment management—or its last.

Before taking over ILA, investment management at Goldman Sachs had had a desultory and disappointing history. An investment-advisory department was organized in the early 1960s under Arthur Altschul, who had been made a partner years before mostly because he could contribute capital the firm needed badly as it struggled to recover from the losses of Goldman Sachs Trading Corporation and

the lean years of depression and war. Altschul's business model was impressively unimpressive: Fees were low because the service was an obsolete, nondiscretionary "advice only" service, with clients making each individual trading decision; the people in the unit were old and tired; and there were few prospects for growth. The main hope for this dull business was that the old retainers in this low-margin, go-nowhere unit would not make mistakes that would embarrass the firm with clients for its other lines of business.

Goldman Sachs partners were settled in the conventional view that, as a leading institutional stockbroker, the firm should stay away from institutional investment management. They had several strong reasons. The firm's Investment Banking Services men wouldn't want to risk an investment-advisory portfolio manager's having poor performance—even for a year or two. Everybody knew that even the best investors had "dry" periods of poor performance and that overall relationships, particularly with corporate clients, could easily be soured by such an experience. If Investment Advisory used the firm's research ideas, how would it manage the obvious conflict of who goes first—institutional clients or advisory clients? If the advisory unit bought shares in a company that was or might become an investment banking client, wouldn't the firm find selling that stock later on "difficult"? As an underwriter, the firm's primary client loyalty had to be to the issuing corporation, so buying any shares in a firm underwriting would be risky. If the stock price went up, questions would be raised: Was the offering price too low? If the price went down: Was the firm "stuffing"? The obvious policy was to stay out of that whole business. Brokerage was brokerage and investment management was investment management—and never the twain should meet.

Anyway, the traditional fees for investment management were so low that the business was not very profitable. And others of Levy's major block-trading clients were as clear spoken as Dreyfus had been: "*If Goldman Sachs wants to continue to be our number one stockbroker, do not compete with us in our investment-management business.*" Finally, everyone at Goldman Sachs remembered the financial losses and the reputational harm to the firm coming out of the Penn Central fiasco, and everyone had heard about Goldman Sachs Trading Corporation. The perceived risk of "you should have known" lawsuits loomed large in the minds of older partners, particularly managing partner Gus Levy.

"We really bought into the idea that you should never compete with your cus-

tomer," recalls Jim Gorter. "We believed it—and believed *in* it. That was certainly right at one time. But just as certainly, we stayed with that policy way too long, which is why we didn't get into the investment-management business in a timely way on a major scale. We would not let the investment-advisory division recruit anyone from our institutional clients. We did not want them to take business away from institutional clients or compete with them for new accounts. Investment management looked like a very low-margin business—particularly if you deducted whatever business you were afraid might be lost in another division." In discussions, lots of hidden risks were linked to the possible harm coming from highly visible investment performance—particularly *under*performance. Investment Advisory was thought of as group of second-rate people doing a third-rate business, crystallized by that ultimate put-down question: "Would you put your mom's money there?" The decisive answer was the same for many years: "No!"

The firm's policy of preventing the investment-management unit from competing with good customers in profitable businesses went way back. Levy, Menschel, Mnuchin, Whitehead, Weinberg, and others had all agreed in the 1960s to stay out of investment management to avoid conflicts with stockbrokerage clients. Some were concerned about corporate clients' being upset about performance problems in their pension funds. Others didn't want to have conflicts with their brokerage clients, particularly while building up block trading. But, as Gorter conceded years later, "At Goldman Sachs, we bought the importance of not competing, not conflicting with our clients. But even the guys at Capital Group, one of our largest clients, never paid up for our 'integrity.'[1] No institution every paid us *more* because we had integrity and therefore we did not compete. It didn't pay to be good boys—but it sure cost us a lot to play that way. Our decision may have been one hundred percent right in 1970, but the world keeps changing and the decision was never revisited. So what had probably been a correct decision became the *wrong* decision. And that was a tragedy. We could have built a fine, big business in asset management."

Goldman Sachs's main underwriting competitors—Morgan Stanley, First Boston, Salomon Brothers, Merrill Lynch, Blyth, and Dean Witter—were definitely *not* in the investment-management business, and they were, back then, explicit that being in investment management would be a clear conflict of interest.[2] But that simple "stay out of the other guy's yard" policy could not hold up

once Wall Street discovered how very profitable the asset-management business really was. One of the first to see how profitable the business could be was Gus Levy. What transformed his skepticism into enthusiasm was a single document.

"We gotta get in on *this!*" exclaimed Levy after reading the IPO prospectus for Donaldson, Lufkin & Jenrette, the first securities firm to file for a public offering with the SEC. Levy was astounded by the scale of that upstart firm's investment-management business and how amazingly profitable it was. Fees were not low; they were high: A full 1 percent of assets—cleverly offset by rebating 50 percent of commissions generated. With high portfolio turnover, this meant that net fees were actually *zero* to the client, but income to the manager was huge because portfolio turnover and fixed brokerage commissions were both high.

No wonder Levy wanted to get into that high-profit business right away. Wasting no time, he put Arthur Altschul out to pasture, changed the unit's name to Investment Management Services, or IMS, moved Bruce McCowan over from research, where he had been the partner in charge, and gave him instructions to build the business—quickly. McCowan pulled together a team of young investment managers and salespeople and went to work on developing a strategy to develop business.

McCowan focused on investing in mid-cap stocks with "growth at a reasonable price," or GARP, and early results were good. The new team won a few corporate accounts such as Heublein and, thanks to recommendations by selection consultants at Cambridge Associates, which was just getting started, mandates to manage pension funds for Diebold, Crompton & Knowles, and Bulova Watch—all mid-cap companies. But disappointments soon intruded. The original strategic concept was to get major sales leverage through IBS's great relationships with corporations—and their pension funds. As partner Denis Turko later explained, "We needed leverage to get up over all the ingrained prejudices—earned prejudices, of course—against broker-related investment managers for churning accounts and buying deals they couldn't sell and all that jazz. We thought all we had to do was hitch onto the IBS powerhouse and the rest would be a sleigh ride into the big time." But the leverage IMS hoped for did not come through. Only Gus Levy, in his role as a corporate director, delivered a pension account.

Then the long bear market of the early 1970s put a stop to any thought of business development. "In that fierce bear market, our stocks got clobbered," recalls

Turko, "and the IBS guys were all saying: 'Jesus! I worked for ten years to build up a good relationship with that company, and we were about to do some great, high-fee investment banking business and get a good return on all my efforts, when, wham! you guys butcher a tiny piece of their pension fund that I helped you get and everything I've ever done for them for *years* is completely ruined. So no, not a chance: I'm never going to help you screw-ups ever again—ever!' " Nobody could blame them, but it meant IMS would get no leverage from the firm.

Without the support of IBS and *with* a hangover of disappointing investment performance, the best IMS could hope for would be a year or more of "consolidation" and then several years of competing for new accounts—one at a time. It would be as hard as pulling up tree stumps, and the firm would never be satisfied with a slow "one step at a time" buildup. McCowan and his team knew they would need to find a way to accelerate their progress, ideally an imaginative "break the conventional rules" way. They needed something new and different, a truly clever breakthrough marketing strategy—ideally something, recalls Turko, "comparable to MacArthur's landing at Inchon." International investing might do the trick.

International investing was just getting started among American pension funds. To get a piece of the action, a few U.S. investment managers, accepting their lack of foreign experience, had begun linking up with London firms that had a long history of international investing. Maybe Goldman Sachs's IMS could try that same strategy. For Goldman Sachs people, the obvious international firm to link up with was the asset-management division of London's Kleinwort Benson, since ties between the two firms went back over seventy years. Kleinwort Benson could use help managing its U.S. investments, and it had hopes of developing an international investing business with American pension funds that were starting to diversify their portfolios. The McCowan team thought Kleinwort Benson's stature and assets would give them just the extra credibility they needed. Gus Levy made the appropriate introductions, and both parties agreed on a combination of the two investment units. Goldman Sachs would own 20 percent—the limit allowed a NYSE member firm—and Kleinwort Benson would own 40 percent; those doing the actual work, including McCowan and Turko, would own the other 40 percent. A contributing factor was a miscall on the ERISA pension legislation then pending in Congress. Goldman Sachs expected securities firms to be prohibited from managing pension funds, but the final bill went the other

way, making an asset-management unit even more valuable—but by then the deal with Kleinwort Benson had already been made.

Despite all the high expectations for the combined unit—Kleinwort Benson McCowan—it didn't work. Kleinwort Benson never moved much of its U.S. business over to the joint venture and, with typical British distaste for anything as crassly commercial as serious institutional selling, it *didn't* sell.[3] The joint venture labored along for a while, but could never get up much steam. In 1980 the American managers bought out Kleinwort's 40 percent and renamed the firm McCowan Associates. Troubles continued. As Turko recalls, "Bruce always thought he was the king and the firm was his kingdom—not a partnership—so in 1983 we split up." Bruce McCowan left McCowan Associates. That split-up was done very quietly because Goldman Sachs still owned its 20 percent and McCowan Associates reported to George Doty. "We knew there must be no adverse publicity about our going separate ways or Doty would kill us. He always kept us on a very tight leash. Besides, we had too much respect for the partners of Goldman Sachs to create any difficulties." A partner says, "Bruce was disappointing as an investor because he didn't know what he didn't know, so he made way too many mistakes. Beautiful to look at and a great relationship salesman, he was *not* a great investor." Soon McCowan Associates bought out Goldman Sachs's 20 percent, taking the firm out of the investment-management business—except for Whitehead's Institutional Liquid Assets, which by then had grown substantially from five hundred million dollars to thirteen billion dollars.

One strategic solution to the problems that had plagued Goldman Sachs's efforts to make a mark in investment management would be to acquire a small firm with a strong investment product and smart leaders who could jump-start the business. In 1987 Friedman suggested to Steve Ross and Richard Roll that Goldman Sachs could buy their investment-management firm, Roll & Ross, and put them in charge of the firm's investment business, assuring them Goldman Sachs partnerships. Friedman knew both men well. Ross, a brilliant economics professor at Yale, originated arbitrage-pricing theory and developed a model for pricing derivatives; he had consulted with the real estate division's management committee. Roll, equally brilliant, was a professor at UCLA who had very successfully created Goldman Sachs's research organization in mortgage-backed bonds. Both had demonstrated their flair for things entrepreneurial by creating their hot

investment-management firm. Acquiring Roll & Ross could jump the firm ahead in the institutional market with a distinctive "quant" product.

Fischer Black wasn't so sure: "We should test their model rigorously to ascertain that it is actually superior to the models we already have." Ross replied: "It doesn't really matter which is 'best.' What the firm needs is a broad portfolio of investment products. It would be a mistake to bet the future of the business on any one product. Ours is a proven winner and would have an important role in any array of offerings—and *that's* what's needed." As he thought about the combination further, however, Ross realized he really didn't want to work for a large firm: "I treasure my independence. I've made my fortune. Why give up my freedom for 'more'?" No sale.

Another possible effort to get a toehold in investment management had come and gone in 1974 when Congress passed ERISA. Turko had been sure such major legislation would create real opportunity, so he teamed up with Peter Hager in corporate finance and went looking for ways the firm could help corporations deal with all those new rules, doing all the homework on everything they could think of. They went to Washington to sit in on Senator Kennedy's hearings; they studied the rules and regulations; they talked to key people in the Department of Labor; they studied every aspect of all the financial questions. Finally they developed what they thought was a business plan and took it to George Doty. After reading their plan, Doty said: "Sounds like a good idea. But let me tell you something: In my past career, I've worked by the hour, and whatever the field is, it's a shitty way to do business. I like to sell *money*. Go ahead with this plan if you want to, but be advised: If you get as far with it as the management committee, I'll be there—and I *will* vote against you!' " The idea died.

For nearly a decade, Lee Cooperman had campaigned for major change. As head of research and in frequent contact with the leaders of the country's major investment-management organizations, he saw others grow rapidly and profitably. "We're really missing the game here. We should make a big commitment to investment management. It's a very big, fast-growing, and hugely profitable business—a business that's really right for us, and Goldman Sachs is really right for it: We have all the right skills in investing *and* in sales."

In 1989 Bob Rubin and Steve Friedman went to Cooperman with a proposition: "You've been arguing and agitating for a decade that we were missing the boat and should make a major move into investment management. The firm has always said no. Well, you were right and we were wrong. We now accept that institutions will accept our going into the business if they know we're competing on a level playing field: paying full commissions, no special access to research or underwritings, charging reasonable fees, and all that. We want you to build the investment-management business you've been saying all along the firm should have." Cooperman agreed to leave his position as head of equity research, where his work had won him a long string of firsts as the institutional investors' favorite portfolio strategist. He was tiring of constantly being on the road giving seminars and speeches, meeting day after day with one after another institutional investor, and always being challenged by hopeful competitors from other brokerage firms to be original, fully documented, decisive—and always interesting, engaging, and charming. Cooperman was increasingly confident that he was as good as anyone at portfolio strategy and stock selection. He was already managing a few accounts for friends and felt ready for a new challenge. He was sure he could build a profitable investment-management business in hedge funds based on a combination of his investment capabilities and the reputation he had worked so long and hard to build for himself. And hedge-fund economics would make the division profitable.

The investment-management division's assets—mostly ILA's low-margin money-market assets—had increased to twenty billion dollars, but total earnings were only twelve million dollars. "Relative to the earnings of the whole firm, it was just a rounding error," recalls Cooperman, who went to Rubin and Friedman with his proposition to establish a hedge fund. It would change the economics completely. With five hundred million dollars of assets, a 20 percent gain with a 20 percent carried interest (the general partners' share of a hedge fund's gains) would produce twenty million dollars profit, far more than doubling the division's earnings contribution to the firm. Friedman and Rubin agreed, and because the firm recognized the need for a major change, a new division was launched named Goldman Sachs Asset Management, or GSAM (pronounced "gee-sam"). It needed just what Cooperman offered, so he moved over with his new strategy. Rubin and

Friedman wanted none of the aggressive action of the more notorious hedge funds, so they told Cooperman to work out controls and procedures with general counsel Bob Katz until they felt truly comfortable. They were halfway through this work when the troubles of Water Street Recovery Fund burst on the scene.

"All would have gone fine until the flak over Water Street," recalls Cooperman. Water Street Recovery Fund, launched by Goldman Sachs in 1989, was in the business of buying junk bonds of companies in financial distress and forcing the issuing companies to negotiate more favorable terms. Some of the companies getting pressured by the fund had been the firm's clients, and some of these protested that they didn't think this behavior fit with the firm's claim of always being on the side of its corporate clients. Then, in 1990, junk-bond investor Bill Huff claimed publicly that Goldman Sachs was improperly using proprietary information gained when it wrote the indentures in its role as bond underwriter; he organized a boycott of Goldman Sachs by high-yield-bond investors. In combination, the corporate protest and the boycott worked: John Weinberg closed down Water Street and returned the investors' money, a full one billion dollars. All Cooperman could do was to protest that the business he had had in mind was entirely different: "But I'm *not* in a zero-sum game like Water Street was!"

Weinberg was unmoved: "Who're you kidding? Say you have a big hedge fund and someday decide to short the stock of one of our investment banking clients. There could be big trouble, and you will *never* explain it away."

The Water Street crisis frightened Rubin and Friedman. "If 'unknowns' like those who launched Water Street can cause the firm that much trouble," said Friedman, "with your strong name recognition your hedge fund might short the stock of an important client and cause us all sorts of trouble. We want you to build up GSAM's business as a business—just as you did in Research. Do us all a favor. Forget about managing money as a star portfolio manager with a hedge fund and build us a major money-management *business*—as a business manager. You built Research up from nearly nothing. This is the same kind of challenge. It should be a natural for you."

The strategy Cooperman developed was to downplay the institutional business. Institutional clients demanded a manager with a well-established track record of superior investment performance over at least three years, and direct

competition with institutional block-trading clients would be inevitable. Cooperman would focus instead on building a mutual-fund business and selling to *individuals*—including the customers of Private Client Services. The key to this strategy's success would be superior investment performance, which Cooperman saw playing directly to his own strengths as a leading investment strategist and stock picker who was well known and highly regarded by the PCS brokers. The best part of Cooperman's strategy was that he had to win only a fair share of the money flowing into mutual funds. "It's a huge potential market," said Cooperman. "All you need is a thin sliver to make a very profitable business."[4] Strong investment performance would pull money into the new unit and quickly make it very profitable. Now, instead of needing five million dollars to invest with Goldman Sachs, an investor needed only $1,200. Cooperman put two million dollars of his own money into the first mutual fund and encouraged other partners to invest their personal capital too.

To get salesmen in PCS to sell the new funds to their clients, an effective financial incentive would be needed. The management fee was set at 1 percent, with part to be paid out each year to the salesmen who put their clients' money into the fund. Recent investment results reinforced Cooperman's confidence: Recommendations from his research department had bested the S&P 500 by 5.4 percentage points during the prior year.[5] To dramatize the level playing field, the eighty-person GSAM division moved out of Goldman Sachs's offices to a new facility in lower Manhattan. To avoid client conflicts, Cooperman's hands would be tied with tough restrictions imposed by the firm. No investment professionals and no mutual-fund wholesalers were to be poached from any clients. And John Weinberg declared, "I'll be goddamned if we'll use the name Goldman Sachs after all that my father went through with Goldman Sachs Trading Corporation." He insisted that "Goldman Sachs" could not be used in the names of any mutual funds—yet he accepted the use of the initials GS as the first two letters of every fund's name, so the connection to the firm was certainly no secret. GSAM's first fund, GS Capital Growth Fund, was launched on April 9, 1990. It sold well, with a substantial fraction of the buying coming from PCS, where salesmen were strongly encouraged by management to put their clients' money *and* their own money into the new mutual fund.

Cooperman, ever the portfolio strategist, was cautious about the market,

saying, "I don't see the overwhelming, compelling case for investing fully in this stock market." Of the money raised, he invested only one-third in stocks. He was right in that the S&P rose only 2.5 percent that year. But after a 6 percent sales load, the fund's net asset value was 12 percent below its offering price. This shortfall was clearly a disappointment; clients, partners, and PCS men were not amused. In 1991 the market was up over 30 percent, and Cooperman's fund did slightly better. But after the first year's results many PCS brokers had decided "never again" on selling GSAM funds to their clients. (Another reason was that once put into those funds, the assets were no longer available for other kinds of transactions and the commissions that could be generated.) Naturally, brokers at other firms had no interest, and no incentives, to sell funds managed by a competitor like Goldman Sachs.

A quant product came next in 1991 in a mutual fund named GS Select Equity Fund, which was managed by Robert Jones, head of GSAM's quantitative stock-strategies unit. Jones focused on "more timely names which have favorable price momentum and better values,"[6] which really meant research-department stock selections sifted through a quantitative screen. Given the frustration with the first fund, it was no surprise that Jones said, "The new fund will be fully invested in equities at all times and have a less contrarian, out-of-favor approach with more mainstream growth kinds of names." After raising only $120 million, GS Select Equity was closed to new money, at least temporarily. Since management fees, trading costs, and 5.5 percent sales charges would offset all or most of the nearly 2 percent rate-of-return advantage that Goldman Sachs's research-recommended list had enjoyed, Jones's computer model was expected to add the value that would attract investors. His quant model used twelve computerized screens to rank recommended stocks on such criteria as P/E ratios, dividends, price volatility, and market capitalization, plus five broad investment characteristics. Fortunately, first-year investment performance was strong—nearly twice the average gains made by comparable funds.

"Leon Cooperman saw himself as a master investor, which he was," says Steve Friedman, "and expected performance to pull in assets like a powerful magnet. But the job as head of GSAM was not really to pick great stocks; the job was to build a great investment business, and the key to business success would have to be excellence in gathering assets even more than investing. In a strategy based

on building assets through selling, a superstar investor was sure to be a problem, not a strength, because too much would depend on that one superstar. He'd be a bottleneck on selling new business to those who believed in him, because he couldn't be everywhere, and for those who didn't believe he could continue shooting out the lights, they'd stay away because they'd think he couldn't keep it up. Leon didn't understand this at all."

When Bob Rubin said, "Lee, you'll have to delegate more," Cooperman turned to Friedman and said, "Bob doesn't understand investment management. He's never had to pick great stocks. He doesn't understand investing. Picking stocks is the core of the business, and that can't be delegated."

Friedman and Rubin came to believe that Cooperman, knowledgeable as he was about investing, did not understand that building the business would require him to focus on gathering assets, or "distribution." The problem Cooperman faced—in addition to the constraints imposed by the firm—was that while long-term investing is in theory what mutual-fund investing is all about, in practice, short-run performance dominates mutual-fund sales, particularly for organizations that are new to the business. Cooperman's early results had been below market because he was a "value" investor, and value stocks had performed poorly. Investors who bought in on the expectation of great results didn't want explanations: They wanted the great performance they felt they'd been promised. As Wall Streeters observe, investment managers who rely on achieving superior investment performance live by the numbers and die by the numbers. After the first mutual fund faltered, Cooperman got almost no help at all in selling the other mutual funds, either from the PCS salesmen or from IBS relationship specialists who might have introduced him to corporate pension-fund executives. Cooperman was struggling with a stock market that was going against him and a senior management that expected a quick fix while not giving him the financial support he'd like and imposing on him a hobbling set of constraints—no competing with firm clients, no recruiting from firm clients, no advertising, and more.

"Lee Cooperman's thesis was that he was an investing expert," recalls a partner, "maybe another Warren Buffett. So, as his client or as his manager, you could and should just close your eyes and wait twenty-five years while Lee did great things. And if you'd only leave it to him, he would give you great results—if you stayed with him for twenty-five years."

Michael Armellino, who had succeeded Cooperman as research director, succeeded him at GSAM in 1991. GSAM's strength in the marketplace during its early years was in fixed income under partner Alan Schuch. While assets continued to build, the hope for a major success would still depend upon developing a strong equity business where fees were higher and profit margins wider. Armellino knew he needed a new strategy to gather assets, and he knew he would have to build a record of at least three years of superior investment performance to be "qualified" for that market. All this meant that he had to succeed in the retail market and do so with mutual-fund distribution through brokers without depending on PCS. Armellino's new strategy for building GSAM's business was to concentrate on developing strong mutual-fund sales, overcoming the major firm-imposed handicaps. "No poaching" meant no hiring experienced portfolio managers or analysts or salespeople from any institutional client—including experienced mutual-fund wholesalers, the key to success in mutual-fund sales because there are so many funds and past investment performance is so unreliable as the basis for selecting funds. Armellino was left to do the best he could to build a mutual-fund business with the management committee having tied one arm behind his back. He recruited MBAs who were new to the business and worked hard at developing "favored firm" acceptance at major regional firms, like Edward Jones, that had strong distribution but did not manage investments. Armellino's first move was to broaden GSAM's product line. Retail sales of GSAM funds increased, and new funds were added in international emerging markets and currencies to provide a full spectrum of offerings.

Other mutual funds soon followed: GS Small Cap Equity and GS International Equity were introduced in 1992, followed in 1993 by a government-bond income fund and an adjustable-rate-mortgage fund. Virtually all fund sales were made through the firm's PCS brokers to their customers. By mid-1993, Capital Growth Fund was again performing well—up 60 percent, well ahead of the S&P 500's 49 percent.

Unintentionally, Cooperman could have done real harm to GSAM had he taken out the man who would, a few years later, figure out a winning strategy for investment management and get senior firm management to accept and

commit to it. As Friedman explained the next steps to get good business management in GSAM, "We drafted John McNulty to work with Lee—no, *under* Lee because Lee never worked *with* anyone. McNulty lasted one month before he came to me insisting on reassignment."[7] After just four weeks in GSAM, McNulty, who had come from PCS, had decided that his views on the business were so at odds with Cooperman's strategy that he should leave GSAM and transfer to another division. Seeing any move to transfer out of GSAM as an act of personal disloyalty, Cooperman, as McNulty remembered years later, said, "Nobody *ever* leaves working for me. If you do leave, wherever you go within Goldman Sachs and whatever you do, I'll be looking for you and I'll be absolutely against you."

McNulty transferred anyway. Several months later, he asked to have lunch with Cooperman. "Lee," he said, "you know we've disagreed in the past, but I've said nothing, ever, to anyone else about our differences. Now I need your help, because I'll be coming up for partnership." Cooperman knew what he had said and knew what he could do, but he decided to relent: "I won't vote *for* you. That's not something I can ever do. Still, I won't hurt you. I won't vote *against* you." So McNulty made partner. He would soon be essential to GSAM's eventual great success.

Cooperman loved investing and had only reluctantly given up plans to leave Goldman Sachs and start his own hedge fund, so when his wife of twenty-five years said, "I've never told you what to do and never will, but how old will you have to be before you do what you really *want* to do?" he went back to Rubin and Friedman. "I'm the fifth-largest percentage partner, so I obviously want the best for the firm. I'll give you two full years. Then let me retire and set up my own hedge fund outside the noncompete provision. I'll consult with you for a year and launch my own hedge fund." Recognizing that Cooperman's mind was made up, Rubin pragmatically said, "We hope you'll use us as your prime broker." And Cooperman replied, "Of course." The firm offered him five hundred thousand dollars for the consulting work. Today fifteen of the twenty largest investors in Cooperman's Omega hedge fund are Goldman Sachs partners.

Progress was being made when Armellino's efforts got hit with another blow: false accounting. Assets had been accumulating, primarily in GSAM's

fixed-income unit. Michael L. Smirlock, then the thirty-six-year-old chief investment officer of that fourteen-billion-dollar unit, had joined the firm after achieving academic distinction as a young professor at Wharton. He had just recently been named a partner and was hiring a cluster of able people that included Cliff Asness, who later created Global Alpha, a triumphantly successful hedge fund. Then, suddenly, Smirlock was fired in March 1993 for deliberately misallocating cash inflows among different accounts by "reassigning" some five million dollars of securities from one account to another, apparently to make investment performance look better. Smirlock's irregularities were discovered on a Friday, and that Saturday he was suspended.[8]

"It's so hard to understand," commented Armellino. "He was young, brilliant, articulate, and he didn't take any money doing it. But he sure ruined his career." The speed with which Smirlock was dismissed and the irregularity reported to the regulatory authorities was considered appropriate for a firm that held itself out as an ethical leader, but the event reminded all too many prospective GSAM clients of doubts about any Wall Street brokerage firm's being trusted as an investment manager. And put a stop to fixed-income business development at GSAM.

Another blow came later. After a fast start, GS Small Cap Equity Fund finished three mediocre years with a return of only 11 percent in the twelve months to March 1996, when the median small-cap fund produced 31 percent. This fund was in the bottom 5 percent of funds for the three-year period. Worse, the thirty-three-year-old fund manager, Paul Farrell, was clearly not using the firm's research recommendations and had concentrated investments in small specialty-retailing stocks.

While Cooperman and Armellino had both enjoyed important prior successes, neither succeeded in the asset-management business because, in addition to firm-imposed constraints, their experience and their managerial instincts were not in harmony with the special needs and rhythms of the institutional asset-management business, a problem that was neither new nor limited to GSAM. Notoriously, executives and organizations that had been successful in insurance or commercial banking failed when they tried to apply the lessons learned in "their" financial service to an apparently similar financial service: investment management. While all involve money and service, the particulars are very

different; what works well in one financial service can fail in another. Even "obviously" similar *investment* services, such as mutual funds and institutional separate accounts, involve significant differences in selling, marketing, reporting, and client service. Incompatibility at the operating level was one of the reasons most banks and insurers failed in their efforts to develop investment-management businesses—even with their own good customers in banking or insurance. Another reason was strategic conflict; each organization's strategic priority was protecting the current strengths of its historic businesses—just as Goldman Sachs had protected stockbrokerage by restricting GSAM.

In retrospect, the best and boldest strategy for GSAM would have been to jump-start the investment-management business by making one or more major acquisitions—as Morgan Stanley, Credit Suisse First Boston, and Lehman Brothers all eventually did. But this was prevented by a major problem for most major firms, including Goldman Sachs: a misunderstanding by senior management of the value of the asset-management business. Not understanding how to value asset-management businesses, they couldn't accept the pricing. Acquisitions to make a strategic entry into the business and get up to scale seemed far too costly.

For years and years, senior management at Goldman Sachs failed to understand the asset-management business as a business, so they made mistakes—major, repetitive mistakes. And because they were smart, rigorous, disciplined thinkers, they made their mistakes with conviction. Not understanding the right way to evaluate the business or do the accounting, firm management didn't understand the asset-management business.

Most partners thought about investment management as a personal-service business, way too dependent on key individuals. They did not recognize how persistent or "sticky" institutional account relationships really were—even as key people came and went—and said, "The real assets in the investment business—the investment professionals who are essential for success—go up and down in the elevator every night. That's not a real business, and it would be impossible to evaluate or put a fair price on it."

The skeptical partners sounded astute and rational, but their conclusion was based on a misperception. Sure, some investment managers do believe they are the be-all and end-all, but as Charles de Gaulle so shrewdly observed, "The cemeteries of the world are filled with indispensable men." The relationships between

institutional clients and investment-management organizations continue on and on even as the specific individual representatives on both sides of major institutional relationships come and go. So the individuals who ride elevators really are all replaceable. The secret to business success in investment management is not so much investment results as it is asset gathering through distribution and sales.

Not seeing this, senior management did not understand how profitable and steady a business asset management could be, particularly if it could be well connected to an asset-gathering juggernaut like Goldman Sachs. As senior executives saw the modest profits reported by Armellino's operation, several frustrated members of the powerful management committee gave serious consideration to shutting it down altogether. GSAM was running at or near breakeven until the accounting was changed and partnership charges were allocated to it. Recalls McNulty: "This put GSAM in the red—big time. That's when powerful people again started asking questions like: 'Do we really need an *institutional* investment business?' They didn't appreciate how long it takes and how much investment spending is needed to build a really strong, sustained profit-making investment business." As advocates of closing down saw the situation, GSAM was not making money; it exposed the firm to all sorts of business and perception risks; asset management was too different from a securities business; nobody had come up with a strategy for substantial success; and GSAM's history was a history of failures. Unless basic changes were made, GSAM would continue laboring along, making modest losses or modest profits, unable to afford the investment capabilities or products that would earn substantial profits and reflect favorably on Goldman Sachs as a total organization. GSAM was late to the market, had little or no brand or franchise strength, and was too high-cost in its operations. It was, in brief, just a bolt-on to a broker-dealer. So long as it stayed that way, GSAM could never become important to the firm, either professionally or economically. During this dark period, Steve Friedman and others advocated getting out of the asset-management business, but Bob Rubin supported Armellino's pleas to stay the course. That would pay off in a major way.

The best acquisition opportunity for GSAM was an easy layup—or could have been. In 1994 Miller Anderson & Sherrerd was a prestigious Philadelphia manager of large institutional accounts that had built a good-size, well-balanced business investing in domestic stocks and both international and domestic bonds;

it also had an international-equity joint venture with a powerful Japanese institution. Assets under management had grown to thirty-six billion dollars—a solid base upon which to build an institutional business because it would instantly establish GSAM as a leading asset manager. In addition, the name principals, Paul Miller and Jay Sherrerd, and their partners were widely regarded as "cream of the crop" in investment management and had attracted a stellar group of young professionals who worked well together and with clients and had a strong track record of investment performance. Even better for Goldman Sachs, with its hundreds of strong corporate relationships and great strength in sales, the investment professionals at Miller Anderson had done little marketing because they believed business development conflicted with their priority as professional investors. They were reluctant to spend much time or energy prospecting for new business, preferring to let clients and consultants come to them. They went out on business development calls only when invited. As IBS and PCS had proved, Goldman Sachs could sell good product very well, so the combination of the two firms seemed to promise wholesale synergy, a very effective win-win proposition.

In approaching Miller Anderson, Goldman Sachs had an "unfair competitive advantage." Richard Worley, the leader of Miller Anderson's booming bond business and for the prior five years managing partner for the whole firm, was known there as "the man from Goldman Sachs." He had been an economist in research at the firm, knew and liked everyone, and was best friends with David Ford and Jon Corzine. Corzine and Worley lived across the street from each other in Summit, New Jersey, and for several years drove in to work together most days and went out with their wives most Friday nights. Ford, who had recently agreed to become co-head of GSAM and very much wanted to build GSAM's business with a major acquisition, told partners: "I said five years ago that we should have made a major commitment to build GSAM quickly, either by acquisition or by multiyear 'investment spending' to build from within." Ford saw a natural strategic fit between Goldman Sachs and Miller Anderson & Sherrerd, so in one of his regular conversations with his friend and neighbor, early in the morning on a lovely spring weekend in 1993, he raised the possibility of a combination: "Could we do something together?"

Worley and his firm had been approached about an acquisition six or more times before. In the 1980s George Russell of Frank Russell Company had come

with a two-hundred-million-dollar offer from Lloyd's Bank. Chubb Insurance made an approach but was waved off for lack of fit. Swiss Bancorp and ING were two other suitors. Worley recalls an observation by the man who did the most acquisitions of investment-management firms: "Norton Reamer once said investment firms only sell when they're scared. Well, we weren't scared and knew we had a good thing going." Worley said Miller Anderson was not for sale but acknowledged that global distribution was becoming increasingly important and that he recognized this was an area where Goldman Sachs had proven strengths. Discussions quickly accelerated. As Worley recalls, "If we were going to be acquired, we should select the right partner ourselves, and if the basic terms of a deal were okay, it would be better to be in a truly global organization like Goldman Sachs."

Merger negotiations went forward rapidly and easily. Everyone could see the compelling advantage: Miller Anderson had the product while Goldman Sachs had the delivery system. Then obstacles began to surface. Miller Anderson people wanted to stay in Philadelphia and run their own show, not move to New York City. With no difficulty, that was agreed. Could Miller Anderson partners *all* expect to be made partners in Goldman Sachs? That would be too many: There were nearly two dozen Miller Anderson partners. Goldman Sachs proposed three partnerships; Miller Anderson asked for twelve. A specific problem for Goldman Sachs was that the name founders and a few others, as part of their partnership agreement, were legally entitled to a substantial "annuity" payout until their deaths. Nobody knew quite how to value this obligation; one proposal was to cap the payouts at current levels and limit them to five years, but this was a far cry from the perpetual share of rising earnings that the partnership agreement had carved out of Miller Anderson. Nobody at Goldman Sachs had ever had a comparable arrangement, and nobody at Goldman Sachs liked it. Miller Anderson wanted a partnership within the Goldman Sachs partnership so it could have its own independent compensation arrangements based on a share of the profits it generated; it also wanted its own decision-making process. For the partners of Miller Anderson, an earn-out was particularly important. Worley proposed that Goldman Sachs buy a large percentage, but not 100 percent, of Miller Anderson's future earnings so there would be strong incentives for future investment professionals. However, that was not the Goldman Sachs way.

In the end, the decisive problems were both financial and perceptual. In one four-hour talk, Corzine and Armellino explained why, given the Goldman Sachs culture, only a few partnerships could be made available—and that limit put stress on the deal, even though both Corzine and Armellino wanted to make the deal work. In addition, Steve Friedman—still thinking "the assets go up and down in the elevator"—could not commit to the $350 million price that Miller Anderson's partners believed was their firm's true market value. An important part of the financial problem was that a partnership has great difficulty making a large investment and fairly distributing the costs and benefits to the ever-changing partners. Friedman decided to lowball the bid and offer just two hundred million dollars. That final offer was made during a luncheon in New York City with Worley and four partners from Miller Anderson—not by Friedman or Corzine, but by Dick Herbst, a lieutenant of Friedman's who had been acting as the banker on the transaction.

The barriers to a successful deal were not all financial. The two organizations had real cultural differences and very different partnership expectations. At GSAM, the culture was to start work before seven each morning. Most people were going full tilt by seven and many were in the office every Saturday. There was a lot of travel too. The senior professionals at Miller Anderson had not been working nearly this hard—and got paid several times as much as GSAM partners. So there was a real miss on cultural fit and compensation.

In January 1995, Friedman had retired. Corzine and Ford came back to Miller Anderson & Sherrerd, but a deal was still unworkable. When they got wind that Miller Anderson was in early negotiations with Morgan Stanley, they were upset and called Worley. As a public company, Morgan Stanley had a convenient currency in its stock and was willing to design the specific deal terms to suit Miller Anderson. Worley spoke directly: "We've been friends for a very long time, and I certainly expect to remain friends. Let's agree on a fair price—fair to our retired partners and fair to our younger partners. You understand fair value in the asset-management business. If Goldman Sachs wants to make a fair offer, tell me and we'll call off our discussions with Morgan Stanley." But Worley's invitation was not one Goldman Sachs was ready to accept. As Worley observes with a knowing smile, "Any deal Goldman Sachs wants to do, you don't want to be on the other side." A year later, Miller Anderson was acquired by Morgan Stanley for $350 million.

25

ROBERT MAXWELL, THE CLIENT FROM HELL

Robert Maxwell was found dead in the water off the Canary Islands not far from his yacht, the *Lady Ghislaine*, on November 5, 1991, nude and apparently a suicide.[1] If, as most observers believed, the bizarre British publisher and high-profile Goldman Sachs customer had committed suicide, it was the one last way for him to escape years of public humiliation and condemnation for piling up unpayable bank loans of $2.8 billion and plundering five hundred million dollars from two public companies and the pensions of thirty-three thousand British workers.

Some suggested that Maxwell, who suffered from prostate constriction and was seriously overweight, simply fell overboard while struggling to urinate after having too much to drink. Others, noting that the sea was unusually calm that night and that the railing on the *Lady Ghislaine* was three and a half feet high—and claiming inside knowledge—said Maxwell's death was not suicide. It was, they insisted, murder by Mossad, the Israeli secret service, for which Maxwell allegedly had long been an agent. Why kill him? Because given his severe financial failures, he was no longer "reliable."

The initial pathologist's report by Dr. Carlos Lopez de Lamela said death

was due to a heart attack, but Maxwell's own doctor said he was not suffering a heart condition. He did not think death was due to natural causes.

The far more realistic and credible explanation is that Maxwell knew he was in an unwinnable confrontation with Goldman Sachs, to which he owed a huge debt and which was insisting on immediate payment. Maxwell had also just been told by Lehman Brothers of its intention to sue for payment of his large debts to that firm, and Credit Suisse First Boston was demanding payment of a big loan too. Maxwell knew that the amazingly complex, many-layered game he had been playing with increasing desperation was now over. He was sure to be bankrupted, jailed, and humiliated publicly—in a very short while. He had nothing good to live for, so why continue? Suicide was Maxwell's last way to control events, as he had done so often before, but he could not control everything. In the cruel way that securities traders make short, crude jokes of the calamities and failures of others, Maxwell was swiftly renamed Captain Bob-Bob-Bob.

Robert Maxwell was born a Czechoslovakian pauper named Jan Ludrodrik—or was it Jan Ludwig Hoch?—on June 10, 1923, and became Juan de Maurier, then Leslie Jones, and then Ian Robert Maxwell. He spoke nine languages, had nine children, stood six-foot-five, adored being important, had a Gulfstream IV and suites in the Helmsley Palace and Waldorf Towers in New York and the Ritz in Paris, entertained celebrities often and lavishly, and knew Margaret Thatcher, Ronald Reagan, Mikhail Gorbachev, and senior officers of the CIA, the KGB, the Soviet military-intelligence agency GRU, and Mossad. For some or all of these agencies, his accusers even claimed that he did what is known in the espionage trade as "wet work" because it can be bloody.

On November 10, 1991, Maxwell's funeral took place on the Mount of Olives in Jerusalem, the resting place for that nation's most revered heroes. It had all the trappings of a state occasion, attended by leaders of both the government and the opposition. No fewer than six serving and former heads of the Israeli intelligence community listened as Prime Minister Shamir eulogized: "He had done more for Israel than can today be said."[2] President Chaim Herzog said: "He scaled the heights. Kings and barons besieged his doorstep. Many admired him. Many disliked him. But nobody remained indifferent to him." Former prime minister Shimon Peres said: "Here on the Mount of Olives eternity will absorb one of its greatest sons. He deserves not only freedom, but rest."[3]

. . .

In the twenty years from 1951 to 1971, Robert Maxwell had gone from obscurity to affluence and prominence and then back down to severe public criticism by an agency of the British government; he was declared unfit to manage a publicly owned company and sent into apparent financial exile. But then, in the twenty years from 1971 to 1991, he rose all the way back up to wealth and power and then, despite both great determination and skillful deception, went all the way back down again to financial ruin and death.

Goldman Sachs—through a long-serving partner, Eric Sheinberg—unintentionally became Maxwell's "principal financial enabler"[4] during the later years. As a result, Maxwell's disaster was also a disaster for the firm. Eventually Goldman Sachs paid a settlement of $254 million—the largest in the long history of the City of London. Bad as it was, the cost of the firm's affair with Maxwell could have been much worse. Goldman Sachs had actually feared an even larger settlement, so partners were relieved that the loss was "limited." As managing partner, Steve Friedman decided to settle rather than prolong the pain in hopes of a somewhat smaller penalty.

Like individuals, securities firms are known by the company they keep, and Goldman Sachs had clearly been keeping intimate company with a man one of its own British partners had correctly warned was "very bad news." Partner Gavyn Davies was equally clear: "He damages our reputation. Doing business with the likes of Maxwell is *not* why I joined Goldman Sachs."

Maxwell's had been a long, complex story. After service with the British army during World War II, Robert Maxwell decided to settle in the United Kingdom. He launched Pergamon Press in 1951 and built it up as a highly profitable specialized publisher of scientific journals. In 1964 he was elected Labour MP for Buckingham. Then in 1971, a formal inquiry by Her Majesty's Government into Maxwell's conduct at Pergamon Press Ltd. criticized his business methods and concluded in its considered judgment that Maxwell, "notwithstanding . . . his acknowledged abilities and energy is not a person who can be relied on to exercise proper stewardship of a publicly quoted company." Maxwell was censured by the Department of Trade and Industry (DTI) in a careful report of its investigation. It would not be the last time.

By the early 1980s he was again a recognized force in the United Kingdom through aggressiveness wrapped in the bluff and bluster of a master showman. He used every handle within reach to gain leverage—including Goldman Sachs, then an ambitious "outsider" securities firm determined to make its way to the top ranks in the City of London, the financial capital of Europe. Maxwell knew how to exploit the ambitions of the expansionist American firms. Once, he arranged simultaneous meetings with three firms—Goldman Sachs, Merrill Lynch, and Salomon Brothers—in one hotel but in separate rooms, so he could go from room to room carrying a magnum of rare Dom Pérignon pink champagne, advising each firm how the others were planning to bid on his offer for ten million shares of Gulf Oil stock, and encouraging each to offer terms more and more favorable to win.

Maxwell did not "walk" his companies, he *ran* them in a most imperial way through a series of complex interconnections that he kept so secret that he alone wielded the second most powerful tool of control: information. And he exercised nearly as total command over the *most* powerful means of control: money. He retained sole signatory authority over all the bank accounts and, except for some U.S.-regulated pension funds, all the investments of Mirror Group's and Maxwell Communication's pension funds. While those who have money generally have great power, there are two decisive exceptions: Borrowed money belongs ultimately to the banks that lend it, and the money of public investors, particularly when placed as retirement savings in a pension fund, is supervised by government regulators. In the United Kingdom, the supreme regulatory power is Her Majesty's Government—as Maxwell and Goldman Sachs were destined to learn.

By 1974, despite the Department of Trade and Industry's negative reports, Maxwell had regained control of Pergamon Press and proceeded to build up its profitability aggressively. Then in 1980 he acquired control of the nearly bankrupt British Printing Corporation, made himself CEO, and renamed it Maxwell Communication Corporation. The night the acquisition became final, Maxwell went to the offices at midnight and commanded that a board meeting be held right then and there. This was done at 2:45 a.m. with nine directors present and then repeated the next afternoon at 2:45 p.m. with eleven directors present. At these meetings, Maxwell demanded and got authority to make transfers from the companies' bank accounts on his sole signature and for any amount.

Maxwell exercised voting control of the two public companies and several private companies and trusts through a Swiss lawyer named Dr. Werner Rechsteiner and a series of Lichtenstein entities with confusingly similar and often changing names of which the main entity was called, after four name changes in just six years, the Maxwell Foundation. In 1984, through the numerous private companies he secretly controlled, Maxwell acquired, for £113 million, Mirror Group Newspapers, which he subsequently made profitable by introducing modern technology, stopping restrictive work practices, and increasing cash flow. Soon he announced his intention to build a major international communications complex and compete on a global basis with Rupert Murdoch by making numerous acquisitions in Europe and North America.[5]

Typical of his complex dealings and his repetitive, complex links to Goldman Sachs, Maxwell got the Mirror Group pension fund to buy Strand House, next to the Daily Mirror in Holborn—the only building in the area that had a flat roof and was tall enough to land a helicopter—on the understanding that Goldman Sachs would lease substantial space. (Tenants complained because diesel fumes from helicopters were sucked into the air ducts of the building.) There had been no firm agreement, but in time Goldman Sachs took a five-year lease. The building was bought for seventeen million pounds and sold less than two years later for thirty-six million pounds, but only a small fraction of this profit went to the pension fund: Most of the profit went to Pergamon Press—which held a secret option on the property.

Maxwell was a showman in crude and obvious ways. With several telephones on his desk, he would interrupt meetings to take or dismiss what purported to be urgent calls. "No, Golda, we do not think this is the right time in the market." "Oh, Helmut, you are too kind and too generous. Thank you for saying such a very nice thing, but, no, we cannot accept such generosity." "Tell Maggie that I'm too busy to talk with her just now." Maxwell sought public attention in many ways: hobnobbing with politicians, movie stars, and moguls; traveling to central London by helicopter; hosting large, noisy parties with champagne and caviar; and obtaining extensive press coverage of his own and his companies' exploits. In a 1986 publicity coup, Maxwell Communication Corporation's stock was included in the FTSE 100 Company Index. In public perception this was like being included in the Dow Jones Industrial Average. Combining charm,

flamboyance, intimidation, and ambition, he entertained and was entertained by leading executives, financiers, and politicians. His star, shining steadily more brightly and strongly, was rising. Perceptions of people change when they have a lot of money, and Maxwell had or appeared to have billions. He certainly had connections, panache, a forceful personality, and lived on a very grand scale.

Maxwell ran the companies and the pension funds as "best suited his overall interests" within a complex empire of concealment.[6] He stage-managed the multiplicity of interrelationships between public and private corporate entities, using confusingly similar names for various entities and disclosing as little information as possible to bankers or investors. He had audits of his various business units done on different dates so he could move money in and out of the different entities to "dress up" their financial reports serially and followed a fully developed practice of being "very economical with information."[7] The appointed auditors, Coopers & Lybrand Deloitte, were paid large fees to provide advice on numerous acquisitions and not look too closely at Maxwell's many secret maneuvers. All of this made it very difficult for his bankers to know or find out what was really going on.

Maxwell's financial practices ranged from unusual to inappropriate. When he needed to sell investments to raise cash, he directed the captive pension funds to buy them and hold them for him—even including large investments in the shares of Maxwell Communication. In 1985, to finance his various businesses, Maxwell began borrowing large sums from the pension funds of both Maxwell Communication and Mirror Group—unsecured and without the trustees' knowledge.

In 1987 Goldman Sachs helped arrange a syndicated bank loan of £105 million secured by a series of Maxwell-related properties. In 1988 Maxwell Communication borrowed three billion dollars to acquire Macmillan, the book publisher, and OAG, publisher of the Official Airline Guide—both in one week and both at inflated prices; the bid for Macmillan was ninety dollars per share, when its shares had been trading at forty dollars. Taking on this large debt would eventually prove fatal to the empire, given Maxwell's swashbuckling ways. By 1989, Maxwell Communication shares were being pledged as collateral for nearly another one billion pounds of bank loans. When commercial banks balked at accepting those shares as collateral for loans to Maxwell's private companies, he began using as collateral shares he simply appropriated from the pension funds.

The appropriation was disguised as stock lending "to make it appear to be the legitimate practice of [furnishing] securities to market makers as part of ordinary share dealing activities."[8]

Largely because serious British investors knew enough about Robert Maxwell to know not to trust him, Maxwell Communication common stock did not perform well. As Maxwell's company's stock price drifted down on the stock market, he started supporting the price with the resources at his command: open-market purchases by the company. The next incremental decision was to turn to the company's pension fund and command it to buy shares.

Maxwell was obsessed by the Maxwell Communication Corporation share price because the shares were the principal collateral supporting the enormous bank loans he had taken out to pay for his corporate wheeling and dealing. Over 50 percent of Maxwell Communication shares were held by Maxwell's private entities, both his companies and his foundations. As part of his scheme to support the market price, he continued to buy shares through his private companies and increasingly though the public companies' pension funds. From January 1988 to October 1991, the proportion of Maxwell Communication's shares owned by his private companies increased from 52 percent to 68 percent—and shares owned without immediate disclosure by the pension funds brought that total up to 85 percent. As the DTI report stated: "From May 1989, he manipulated the market, principally by buying shares secretly through overseas entities. The investment bank with whom he principally dealt was Goldman Sachs."

Using pension-fund assets as collateral, Maxwell continued to borrow substantial sums for his own purposes. By any standards, the abuses were flagrant. As the DTI report explained in rigorous detail, the major abuses were these: One hundred million pounds in cash loans was taken from the pension funds; fifty-five million pounds of the pension funds' large holding of Maxwell Communication Corporation's shares was secretly sold, which should have been fully disclosed in the prior year but was not; and £270 million of the pension funds' stocks was used as collateral for Maxwell's bank loans.[9] Mirror Group Newspapers, which was presented to regulators and the public as an independent company, was "inextricably" tied to Maxwell's private companies, which owed banks one billion pounds. Eventually, Maxwell decided to float 49 percent of Mirror Group Newspapers on the London Stock Exchange to raise money to repay bank

borrowings and to have a second listed stock to use as future collateral for still more bank loans.

In the summer of 1990, when the UK economy turned down, Maxwell's weak financial situation quickly became a crisis. Large bank loans were coming due; market prices for businesses that might have been sold at high valuations had fallen sharply; one hundred million pounds was borrowed from the pension funds, so repayment required the sale of shares; and companies within the group had already borrowed heavily from banks to lend to other companies in the group that were even more in need of funding. Under these large and increasing pressures, someone like Robert Maxwell would turn to expanding deception.

As Maxwell Communication Corporation shares declined in price, Maxwell effectively bought shares worth £130 million. However, these transactions were not reported as purchases, but only as options to purchase. On examination, they were not really arms-length options: With a premium of only one-third the norm, the "options" were really deferred-payment purchases by Maxwell. Two such "option" transactions were arranged through Goldman Sachs as the counterparty. In November 1990, Maxwell sold Goldman Sachs another "put option"—also unrealistically priced—for thirty million shares. The transactions cited are only a few of the large number executed with Maxwell by Goldman Sachs.

Like the American wheeler-dealers that Gus Levy had made lucrative clients for the firm during the conglomerate era—combining trading, arbitrage, underwriting, and M&A—Maxwell was active, imaginative, responsive to ideas for action, personally engaged, very ambitious—and no Calvinist about rules or regulations. As the Department of Trade and Industry report put it, "We have not discovered any evidence that Mr. Robert Maxwell had 'changed his spots' as regards his stewardship of publicly listed companies. Maxwell continued to shuffle large sums between public and private entities he controlled [upwards of an amazing four hundred] and to borrow heavily from the pension funds, including a transaction that was not properly reported in London: the sale in April 1991 of two overseas entities for £55 million through Goldman Sachs in New York. The manipulations and deceptions increased in size, frequency, and complexity with Mirror Group pension funds used to finance other Maxwell businesses. Mirror Group newspapers was not suitable for listing, and the prospectus was inaccurate and misleading."

Maxwell had agreed with the underwriters at the time of Mirror Group Newspapers's flotation not to buy or sell shares without their specific permission. When the shares fell in price, he requested permission to buy shares—obviously to support their price and equally obviously in retrospect to protect their value as collateral for his extensive disclosed and undisclosed bank borrowings. Permission denied, he went ahead anyway, using two overseas entities to buy shares secretly in May and June—the twenty-six million pounds of secret purchases were made through Goldman Sachs—but he was unable to stop a price decline of 25 percent over less than ninety days. Later that year, still trying to keep the share price from falling, Maxwell bought another seventy-five million pounds of Mirror Group shares via Goldman Sachs, bringing the total to £344 million.

A 51 percent holding of shares in Mirror Group Newspapers was pledged to banks to secure loans to the "private side" companies—but the market value of these Mirror Group shares continued falling. By late October, the private-side companies had sold off all available assets except shares in Mirror Group Newspapers and Maxwell Communication Corporation. Observed the DTI investigators in formal British understatement, "At that time the pressures became severe. Maxwell was instructed to repay two loans to Goldman Sachs, but Maxwell was fully margined and had no way to repay those loans." Lehman Brothers also instructed Maxwell to repay loans—and also received no payment.

As Goldman Sachs began selling the Maxwell Communication shares it held as collateral into a declining market, according to the DTI, "the imminent collapse of the empire was inevitable."[10] It came just seven months after the flotation, and Mirror Group Newspapers suddenly had to obtain loans from its bankers because so much money had been taken out of it by Robert Maxwell. Employees were laid off. Pensioners suffered losses. "Goldman Sachs . . . bears a substantial responsibility in respect of the manipulation that occurred in the market."[11]

While the whole of Maxwell's story is, in its own tawdry way, quite fascinating, the crucial question that emerges for Goldman Sachs can be tightly focused: How did the firm get so far off the straight and narrow that it preferred to pay a quarter of a billion dollars rather than risk a public confrontation?

Events that don't seem to make sense can sometimes be explained by recognizing the importance of antecedents. Dick Menschel "went limited" and left Goldman Sachs in 1988, and Bob Mnuchin did so in 1990. While both men were remarkably capable, Mnuchin and Menschel did not like each other and could not work together, so the two parts of the stockbrokerage business—sales and trading—were, for many years, run quite separately. After they left, the two separated parts were combined into a unified equities division under the leadership of Roy Zuckerberg and David Silfen.

Over the years since Gus Levy's death, Mnuchin had been recognized as Eric Sheinberg's "rabbi," the powerful senior who would watch out for and protect him. Mnuchin respected Sheinberg's skills as a trader who was good at working a market and who would always keep his mouth shut. And in a firm whose organizational fibers were "family" loyalties, Mnuchin and Sheinberg had both been "sons" to Gus Levy, and Mnuchin instinctively knew the duty of sibling loyalty. Sheinberg was absolutely loyal to Mnuchin. There was something else: Sheinberg was intensely committed to Goldman Sachs. As one of the partners explained, "The firm was Eric's first love."

As he was going limited and leaving the firm, Mnuchin spoke to Silfen, who was taking over as partner in charge of trading: "Eric made partner before you did, so try to be sensitive that he won't feel right about reporting up to you. He's very good at trading difficult blocks and international stocks. Don't make the reporting relationship too hard for Eric. Give him some room to do his thing his own way—and to feel good about his situation. Always remember: He was senior to you."

Indeed, Sheinberg had introduced Silfen to L. Jay Tenenbaum, who had hired him, so on a personal level it wasn't easy for Sheinberg to report to Silfen now as his supervisor. Silfen set the guidelines that Sheinberg and other trading partners could work within with the understanding that Sheinberg would always call if ever he had need or reason to go beyond those guidelines. Then Silfen said: "Eric, we go way back together—back to the sixties. So no surprises, okay?"

From New York City, Sheinberg had been supervising a group of Eurobond traders he had hired in London. Once a month, he would fly to London, take his traders, who had come from working-class families, out at night, get them drunk enough to loosen up, and learn all he could about what they were doing

and how they were doing it. During this period, Goldman Sachs was invited to compete with nearly a dozen other dealers—some British and some American—on a large trade for the £331 million stock portfolio held by Phillip Hill Investment Trust. The competition included the who's who of London finance, so a winning bid, if it was also profitable to the firm, would be a highly visible signal that Goldman Sachs was on the scene and a factor to be recognized. Sheinberg worked hard on pricing the numerous individual stocks in the portfolio, made his bid—and won.

Robert Maxwell called the New York office from London to congratulate Sheinberg, who modestly offered to visit when next in London. With gusto, Maxwell urged him to do so and suggested they could do much more business together. Maxwell soon began placing orders with Sheinberg, always calling personally and talking about markets and prices. Sheinberg enjoyed being the expert, and Maxwell enjoyed sharing views on trades and trading strategies. They were both markets-and-trading junkies and were soon speaking on the transatlantic phone two or three times a day. When the management committee decided to move a cluster of smart, young up-and-comers to London, they decided that Sheinberg, while older, would be included.

Sheinberg's special interest and expertise was in trading convertible bonds. Gus Levy and L. Jay Tenenbaum were both "convertible guys" and appreciated what Sheinberg could do as a convertibles trader. Because trading spreads were narrowing in New York and the business was getting less profitable, Sheinberg's plan when he moved to London was to work the European markets where spreads were still wide and good profits could be created at low risk. He had made major money for the firm in the past, but his stature in the firm and his percentage of the partnership had both been significantly reduced. Once, Sheinberg had very nearly been squeezed out of the firm, but when he went to John Weinberg, for whom he had worked in bonds, to complain that it wasn't like Goldman Sachs to do such a thing, Weinberg reversed the decision. Now, Sheinberg wanted to make a major comeback and was determined to do the same "money spinning" in London that he had done elsewhere—this time by making American-style markets in British stocks.

If he could find the opening, Sheinberg knew he had the skills to make a major impact. He could even be the one to help Goldman Sachs establish itself as a

major factor in the City—and then across Europe. As he took up his new position in London, a series of subtle factors came into alignment whose composite danger would become clear—but only in hindsight. He arrived in London when Goldman Sachs had not yet developed the necessary experience as an international organization, and nobody had had much direct experience in the London market from which to appreciate the clues and subtleties that experts might pick up.

Always clearly on the make, Maxwell was keen to do business. So was Bob Conway, a young Goldman Sachs investment banking partner who was new to London and unusually good-looking, engaging, and bright—but not protected by skeptical instincts. Transferred to London in the early stages of the firm's buildup there, Conway's nearly impossible mission was to break into investment and merchant banking in a market that was already overserved and had neither interest nor appetite for new "alternative" bankers, particularly Americans. Realistically, Conway would have to find the unusual company or unorthodox executive to get a start on making a breakthrough.

Conway "found" Maxwell the same way a raccoon "finds" a trap or a fish "finds" a hook. Conway wanted to please others, and when he helped in Dun & Bradstreet's sale of the OAG airline guide to Maxwell, Maxwell was pleased and said so. Maxwell, who was always doing deals, began courting Conway, inviting him to glamorous parties and events—and all the while, Conway was courting Maxwell as a potential breakthrough client. When the management committee voted "no" on doing investment banking business for Robert Maxwell because he had a reputation of not living up to his commitments, Conway was looking for someone to take over the relationship and see if other kinds of business could be developed instead.[12] He spoke to Peter Spira, who had just joined the firm from S.G. Warburg. As Spira recounts, "Mindful of the report by the Board of Trade in 1972 castigating the gentleman in question, and also benefiting from the sense of smell acquired at Warburg's, I refused point blank. On the following day, Bob Hamburger put his head round my door to say that he had been asked the same question and what should he do? My reply was unequivocally that he should not touch the account with a barge pole, either proverbial or otherwise."[13]

Conway encouraged Eric Sheinberg to develop his relationship with Maxwell, and soon it was Sheinberg's turn to be invited into the glitz and glitter of Maxwell's parties. Like every new entrant to an already established market,

Sheinberg had no chance, of course, of waltzing into the most prestigious, most dignified accounts and persuading them to change the way they did their business or the firms they used. He knew he would have to get started as best he could, working with innovative products, disruptive initiatives—and marginal customers. In the firm's still "stovepipe" reporting structure, operational units in London did not report to a locally based executive in the City, where a sense of the market might have warned a manager of potential trouble. Finally, Sheinberg was a loner—he even played golf alone—and the London partners didn't care for him as a person, so they quietly went their separate ways. None of the other London partners wanted to work with Maxwell—and they felt they didn't need to compromise, because Goldman Sachs had already won the big British Gas privatization and was confident it could win British Petroleum. Maxwell, however, really needed Goldman Sachs to legitimize himself.

There were other factors too—some within Sheinberg and some within Goldman Sachs. In one unusual habit, he checked all trading tickets every day, saying, "There are no friends in the business and I don't trade on the basis of friendship." With his penchant for secrecy—he often retreated to a private office and closed the door, speaking over the phone with accounts in a hushed, confidential way—Sheinberg was unusual, particularly within a trading organization that emphasized teamwork. Routinely avoided by the firm's other traders, isolated and opaque, he was often cantankerous and made it immediately clear to everyone to stay out of his way and leave him alone. When Maxwell called, Sheinberg insisted everyone leave his office and then closed the door.

The firm was rapidly getting larger and larger, doing business in numerous different countries, and becoming more formal and systematic. Goldman Sachs wasn't the same anymore: The firm was going through a period of major multidimensional change and moving rapidly away from the small, close-knit family unit that Levy had created and Sheinberg had known and loved. But some of the old habits of personal loyalties, rabbis, and leaving partners free to build and run their own businesses persisted, particularly among the old-timers. Sheinberg had been passed over in favor of the young MBAs and PhDs who were using increasingly sophisticated computer models and were part of a technology revolution moving toward modern Wall Street. They looked down on Sheinberg as just another out-of-date, over-the-hill "intuitive" trader. Sheinberg resented those self-confident,

well-educated, socially adept young traders who were moving up into positions of power within the firm and taking up responsibilities greater than his. Now he had to get approvals from people who were really his juniors. He hated it—but quietly.[14]

Sheinberg was glad to be asked to develop the firm's London trading operation. He was always interested in figuring out new markets, and not only was London a new market for him, there was lots of talk about a major restructuring—known as Big Bang—of the securities markets in the City. Such major change would disrupt established relationships and established ways of doing business, giving new firms like Goldman Sachs a unique opportunity to break in and build up. Sheinberg and others anticipated that London would go, as New York had gone in the 1960s, from a pure agency brokerage business model to a mixed market with both agency and principal trading. To the extent the "mixed" market developed, it played right into Goldman Sachs's strengths: extensive experience with block trading; deep understanding of how to take risks; knowledge of how to coordinate sales and trading; and plenty of capital. Best of all, if everything went right, London could be the chance Sheinberg had been looking for. London was his chance to make a major personal comeback. If he made a real success in London, he'd be back on top.

He was on to something. Before Big Bang allowed British brokers and dealers to combine, all listed securities trading was pure agency execution of orders, with no capital at risk in market making. Brokers in London did not make markets—only jobbers did and only on a modest scale—so the brokers had almost no capital and no experience with making markets as risk-taking dealers. Even after Big Bang, British firms were cautious about block trading. But Goldman Sachs and the other American firms took the initiative, committing substantial capital and taking deliberate, managed risks to make markets in listed and over-the-counter stocks. London's institutional investors soon learned the considerable convenience of executing large orders through experienced market-making dealers who were ready to risk capital in all sorts of markets to facilitate large block trades at specified prices.

"Eric did a lot of trading when and where he could," recalls Bob Steel. "When he got to London, we were small and outsiders. In those days, people in the City cared a lot about where you went to school and how you got there. And they wasted no love on Americans trying to muscle in on their business, particularly since it really wasn't a very big business. Offices were shabby, trading was all

agency business, and there was too little business to share—and we Americans were there! So Eric nosed around, looking for people who might like to do business. He particularly looked for ways to break into the British-share business, and maybe into Continental shares." One way to break into the London market was to do portfolio trades, which Goldman Sachs understood well from years of experience in New York, but portfolio trading was entirely new to the Londoners. That's how Eric Sheinberg had met Robert Maxwell.

Where Sheinberg was cautious, Maxwell was charismatic and larger than life and made things happen. Sheinberg checked him out and found he was doing business with Cazenove and all the other establishment firms, but his contact at Cazenove said something that later proved prescient: "We do business with Maxwell, but not *risk* business where we would be dependent on his judgment of a situation. It's dangerous to have clients who could be adversaries."

Sheinberg had gone to London at the same time as the "A Team" of strong, young leaders who were determined to break into that very establishment market as the strategic salient from which Goldman Sachs could then expand onto the European Continent and realize John Whitehead's vision of being a global investment bank. The campaign would begin with stockbrokerage, and stockbrokerage would be led by institutional block trading. Sheinberg's mission would be to build up block trading—using as little firm capital and taking as little risk as possible. The best way to do this had already been demonstrated by Gus Levy and Bob Mnuchin: Link institutional trading with the transactions of corporate wheeler-dealers; get in the middle of the action; and "let the games begin." Block trading as a business to pursue was new to the City and familiar to Goldman Sachs. Sheinberg saw Maxwell as his "elephant"—a major account that would make his comeback within the firm.

"We were infatuated," remembers Steel, who shared an office with Sheinberg. "Maxwell was our ticket of admission to the party. We knew we were good at trading, and Eric knew he was very good at trading. The big trading accounts are often 'unusual,' and they're never Girl Guides. The more business Eric did with Maxwell, the more interesting it was to all the rest of us—all except Gavyn Davies, Goldman Sachs's chief economist for Europe, who knew how to read people like Maxwell and who would have nothing to do with him." Simon Robertson, who had many years of experience before joining the firm from Kleinwort Benson, had the same view: "That man is bad news. Diesel-fume him!" Sir Win

Bischoff, then head of the leading London merchant bank Schroders, recounts a similar view: "In our morning managing committee meetings, we took the view that if one of our eight members said no and the others yes, we would go ahead. But if *two* said no, *we* said no. Maxwell came up three times, and each time, we had a majority in favor, but two or more opposed, so we would not act for him."

Sheinberg shared Maxwell's interest in Israel and was delighted and dazzled by the glitter that Maxwell always showered around himself in London: movie stars, champagne, big cars, helicopters, politicians, fancy dinners. During an evening at Sotheby's for a charity auction of Ronald Reagan's doodles, Sheinberg's guest posed to a newspaper reporter as a Goldman Sachs economist and, continuing the bluff, agreed on the spot to do an informal interview on the UK's economic outlook. "Eric was an accident waiting to happen when he crossed paths with Maxwell," explains Steel. "Eric saw Maxwell as his ticket back to significance in the firm and told others to 'stay away from *my* account,' even though everyone at Goldman Sachs knew the policy was that all accounts were always the firm's accounts." Sheinberg and Maxwell developed a separate relationship—dealing on their own.

Sheinberg often dealt directly with clients who particularly liked to trade—people like Robert Maxwell, who enjoyed the excitement of making large trades in public markets and regarded themselves as quite skillful. While Maxwell might have several others involved with him in setting up a particular trade, he would not consider himself committed to a trade until he personally said the decisive words, "You've dealt."

Sheinberg set up large margin loans against Maxwell's stock and then more loans against the pension funds' stock, getting authorization to do this by arguing that with six-day settlements, "if the stock collateral starts to go down, we'll sell the stock. There's no exposure to Maxwell. We get to shoot first!" With a margin account, the firm would always be in control, so trading for Maxwell would be okay even though underwriting was not.

Sensing opportunity, Sheinberg became a market maker in Maxwell Communication Corporation (MCC). Sheinberg and Maxwell each believed he would always be controlling the other. Sheinberg appreciated that Maxwell was a clever and experienced customer dealing in large size and operating at the edges of legality, but he just *knew* that as smart as Maxwell might be, he was even smarter about trading and markets, and was certain he would always be in control. Meanwhile, Maxwell respected Sheinberg's trading skills but also knew that he was not telling

Sheinberg everything—and some of his secrets were crucial. Skillful and experienced as he was in trading, Sheinberg's excessive self-confidence made it possible for Maxwell to out-trade him.

Sheinberg was making good profits trading in MCC shares and was steadily developing the firm's reputation as an effective institutional block trader. With his skills and connections, he was establishing Goldman Sachs as a clear leader in bringing large-scale, American-style, capital-at-risk block trading to London. And his largest account was with Robert Maxwell, whose declared intention was to buy companies and build up a global media business. Things were going well. "Everyone wanted to meet Maxwell," recalls Steel. "We all wanted to get admitted to the party too." Maxwell could be the key client for the firm as it tried to build up its investment banking business.

Bob Conway was ambitious to build up Corporate Finance, so he urged John Thornton, already a stellar vice president, to work with Maxwell on taking the Berlitz language schools public. "Maxwell gave us the Berlitz underwriting," recalls Conway, "a very big deal and a landmark for us: a UK share underwriting for a British company with most of the stock taken up by London-based institutions." Like crossing the equator, this was a signal event in the firm's recognizing that it could make it in London.

The partners of Goldman Sachs thought they knew enough about Maxwell to protect themselves. "We knew Maxwell had been declared—in public by a British supervisory body—as unfit to manage a public company," recalls Peter Sachs. "We knew he was comparable to Victor Posner," the acquisitive American who was eventually barred by the SEC from serving as an officer or director of a public company. Conway was confident the firm could safely take Berlitz public for Maxwell for two reasons. First, taking it public would remove Berlitz from Maxwell's direct control, and second, with some care, Goldman Sachs could insulate itself from Maxwell. As usual, hope was father to the thought and, as usual, the linkage was mostly imaginary.

In early 1991 Maxwell bought another £105 million of Maxwell Communication Corporation shares—largely through Goldman Sachs, which was then doing over half the trading in MCC shares. In April 1991, fifty-five million pounds of MCC shares held by the company's pension funds were sold to two offshore units controlled by Maxwell. The sale, which was not properly reported in

London, was executed in New York through Goldman Sachs. During 1990–91, Maxwell bought an astonishing four hundred million pounds of MCC shares—largely through Goldman Sachs.

In April 1991 Maxwell turned to outright theft—and got Sheinberg's unwitting help in return for a relatively small £110,000 commission on an agency trade, with no questions asked. Goldman Sachs bought twenty-five million shares of MCC from two Maxwell-controlled pension funds on April 26 for £54.9 million and, with financing through Bishopsgate Investment Management, Maxwell's private company, they were bought the same day by two Lichtenstein trusts—secretly and indirectly controlled by Maxwell—so they were now available as collateral for desperately needed bank loans.

Maxwell arranged an IPO of 49 percent of Mirror Group Newspapers for April 30, 1991. This was accompanied by extensive marketing in America and on the Continent, where Maxwell's unsavory reputation was less well known. The funds raised were used to pay down bank borrowings. Knowing that more than two-thirds of Maxwell Communication Corporation shares were owned by the Maxwell entities (the legal limit was 70 percent) and that a total of 80 percent was owned by investors who would not sell, Sheinberg believed he could catch short sellers in a serious lack of liquidity and then squeeze the bears—making a major killing for Goldman Sachs. When Maxwell reached the 70 percent limit, he guided Sheinberg to other "friendly" buyers acting for trusts in Lichtenstein through Dr. Rechsteiner in Zurich. Again, Sheinberg—proud of being Brooklyn-born and streetwise—did not ask key questions even though a market-savvy observer could have intuited that the buyers were controlled by Maxwell.

Goldman Sachs continued to act for Maxwell in the spring of 1991, and MCC's share price rose as the planned IPO was done through "advisers of the highest reputation."[15] The firm's exposure to Maxwell was for a total of $160 million in shares, foreign exchange deals, and a holding of OAG preferred. This was so large that David Silfen told Sheinberg he had to reduce the exposure.

In August, Sheinberg offered Maxwell another large block: 16.7 million shares. Maxwell balked at an outright purchase, but made an attractive counterproposal: He would buy those shares at a large premium over the current market—but only months later. This offer became a Goldman Sachs put option to sell 15.7 million MCC shares at £2.03, well above the current price of £1.71.

The put option had one particularly significant feature: It expired on November 30, only two days after the two-month period in which Maxwell was not allowed to buy shares—and the very day that was the end of Goldman Sachs's fiscal year, when all positions had to be marked to market. During the life of the option, MCC shares declined to £1.39, giving Sheinberg and Goldman Sachs a powerful incentive to buy shares they knew they could sell to Maxwell at £2.03. The put option was at such a low premium that it was clearly just a deferred purchase—assuming Maxwell had the money to honor his commitment. Sheinberg should have known that Maxwell was propping up MCC's share price. Goldman Sachs could, of course, threaten Maxwell that if he didn't buy the shares, they would be dumped on the market, reducing their price and value as loan collateral.

Meanwhile, Maxwell owed Goldman Sachs ninety million dollars in a margin account. But he didn't have the money and couldn't borrow it either. In New York, three Goldman Sachs partners who were chosen because they were independent, fresh faces and outside the chain of command—Ken Brody, Bob Katz, and Bob Hurst—went to see Maxwell at his penthouse suite at the Waldorf Towers to tell him in no uncertain terms that he absolutely had to pay up. Maxwell took them out onto the roof terrace, where they explained what he must do: Reduce the exposure *now* or we will reduce it for you by selling the collateral. The wind was howling, so voices could hardly be heard. Maxwell looked straight at the trio and said, "If you must shoot me, shoot me!" On the way down in the elevator, Brody asked: "Why do you suppose he wanted to go out on the deck?"

"So whatever he said could not be picked up electronically," said Hurst. "He must have thought we were wired!"

On October 22, 1991, Maxwell urgently requested a meeting at Goldman Sachs, but Bob Katz, general counsel, says, "We were not interested in a meeting. The only thing we were interested in was getting paid. The deadline had passed. There was nothing to discuss."[16] Desperate, Maxwell walked unannounced into Goldman Sachs's New York office, where he met with Brody, who reminded Maxwell of the story about the sultan's dog being taught to talk *if* execution were deferred one year.* Maxwell was given one more week, but could not deliver the money.

* The condemned man promised the sultan he could teach the sultan's dog to talk. Asked by a fellow prisoner why he had made such an outrageous promise to such a cruel and vindictive sultan, the man explained: "Well, in a year, I might die anyway or the sultan might die . . . or that dog might talk!"

Inside observers were surprised that Goldman Sachs, which is usually so strict about documentation, had accepted merely verbal assurances from Maxwell that the secretive trusts were independent of his control. Realistically, Goldman Sachs could have been sued as a conduit, if not as a coconspirator, when Maxwell embezzled the pension funds, because Maxwell sold Mirror Group's pension fund's shares via Goldman Sachs and directed where the proceeds were to go.

Maxwell was guilty of market manipulation and artificially supporting the share price of Mirror Group through purchases by the Lichtenstein trusts he controlled. Sheinberg was accused of enabling fraud: He either knew or should have known that the trades he was executing for Maxwell were part of a scheme to deceive investors by supporting the stock price to protect the market value of the shares being used as collateral for bank loans. Either Sheinberg was negligently abetting a fraud or he was a victim. If Goldman Sachs did not know or guess what Maxwell was doing, it was, to quote Sidney Weinberg's comment in a different context, "not very bright"—or as current partners said, *stupid!*

On Monday, November 4, 1991, Gene Fife of Goldman Sachs called Eddie George, the deputy governor of the Bank of England, to inform him that an announcement would be made on the fifth that Goldman Sachs would be selling Maxwell Communication Corporation shares to liquidate the loans. Goldman Sachs was, at long last, closing out its complex financial dealings with Robert Maxwell. The next day, Robert Maxwell would be dead.

Goldman Sachs finally negotiated a civil settlement with the liquidators representing the pension funds three and half years later in which, without the firm's admitting guilt or liability, $254 million was paid into the pension funds. (Another $156 million was paid by Lehman Brothers and the accountants.) The negotiations that concluded with this better-than-expected result were handled by Gene Fife, the partner in charge of the London office who, with quiet West Virginia charm and considerable time and attention, had developed a wide network of friendly, respectful relationships throughout the British government and British industry.

Recognizing the importance of expert advice, Fife retained as his public relations adviser Peter Converse of Shandwick Associates. Converse advised that

Goldman Sachs should contribute two million dollars to a public-interest group that would study all aspects of the matter. Far more important to the final outcome, Converse—whose brother later served in John Major's cabinet and who had useful contacts at all levels of government—helped advance the selection of an unusually widely experienced, careful, and objective public servant, Sir John Cuckney, as the principal investigator. Cuckney had been knighted for his career in intelligence in MI6, Her Majesty's secret service, which reports directly to the prime minister.

Fife met with Cuckney many, many times. While it was always "Sir John" for Fife, what began as "Mr. Fife" for Cuckney eased over a year's time into "Gene" as these two men sized each other up, learned to understand each other, made careful appraisals of each other's values, and jointly explored the information that was becoming increasingly available to them. Each meeting began with a quiet admonition: The rules must be clearly understood; no notes are to be taken—and this meeting never took place. Each time, Cuckney paused until Fife had nodded. The central question on their agenda was easy to say, but hard to decide—partly because the consequences of getting it wrong were enormous and enduring, partly because any decision would be final and irreversible, and partly because the basis for judgment would necessarily be entirely qualitative.

Fife's goal was clear: Avoid a prolonged public flailing of Goldman Sachs and reach agreement on the size of a financial settlement that would not cripple the firm. Avoiding an indictment was paramount. The consequences of a criminal indictment and conviction would have included suspension from trading, grievous losses of business in the United Kingdom and around the world, large penalties in numerous additional civil suits, investigations by the SEC in America, and an albatross of shame with all sorts of "pariah" consequences for the firm.

Fife's objective was to build the evidence and understanding in Cuckney's mind that would enable this experienced career intelligence professional to make the objective judgment that Scheinberg's behavior was an aberration—not at all representative of Goldman Sachs as a firm and in no way indicative of the way Goldman Sachs would behave in the future—and that both the United Kingdom and London's market would be far better off to have Goldman Sachs "wounded, but not killed."

Like a father's evaluation of the character of a prospective son-in-law, the

process would take time and repetitive exposures. Their discussions fit no particular pattern, often revisiting familiar ground and sometimes turning quickly to new topics. They were always probing for greater understanding of each other, of the facts, policies, and practices of Goldman Sachs, and of the people. All their meetings were in person; they never discussed matters by telephone.

While Cuckney and Fife were meeting over more than a year, Sullivan & Cromwell, the firm's principal U.S. law firm, and in-house counsel were gathering facts. In the end, they came to a definitive conclusion: Goldman Sachs should settle. The case must not go to trial.

Knowing time was running out, Fife and Cuckney met yet again, hoping they could come to closure. Both men were acting on their own. Neither would or could go back to his principal for any approvals. Both men knew before their meeting began that the money involved in a settlement would be very large—surely record size. Both men were pleasantly surprised by the brevity with which they reached their accord. In the end, Cuckney trusted Fife and decided Goldman Sachs was more valuable to Britain alive and chastened by a major civil penalty than mortally wounded by a criminal conviction. Goldman Sachs would contribute $254 million to the Maxwell-plundered pension funds. Large at it was, the penalty could have been much larger. The management committee was braced to accept anything less than five hundred million dollars as generally acceptable for Goldman Sachs.

As they shook hands warmly, Sir John smiled and said, "Gene, I think you might be interested in this document," and handed Fife a formal criminal charge. "Had we been unable to agree to terms as we have just done, it had already been decided that our negotiations would have been terminated completely and Goldman Sachs would have been formally charged this day."

New trustees were appointed for the raided pension funds, which had lost approximately six hundred million dollars due to Maxwell's maneuvers. They promptly launched a major lawsuit against Goldman Sachs, Lehman Brothers, and the accountants who had represented Maxwell, seeking an enormous recovery. The firm was in the worst of all possible situations as foreigners—all too easily accused of greed-driven market manipulation at the expense of thousands of now-impoverished pensioners. Partners of Goldman Sachs could easily imagine the scene outside the Old Bailey courtroom: pensioners on crutches and in wheelchairs being photographed and giving statements for the front pages of London's

sensationalizing newspapers. As today, newspaper coverage in London could be relentless, with seven morning papers and two evening tabloids that followed up on the stories featured in the morning. The competition was vigorous. The Maxwell story and the firm's involvement could sell a lot of papers. As it was, the aroma from Maxwell noticeably hurt the firm's business in the UK and across Europe over the next year or so.

Through it all, the partners were deeply embarrassed by their own question: "How could we have let that happen?" The lesson was clear: Nobody can ever be allowed to operate outside the clear reporting lines of decision or the chain of command. The firm had stayed far too long with the old ways that might have sufficed several years before for a much smaller "family" firm in a slower-paced market. For a major firm dealing in the fast, global capital markets, formal risk controls were mandatory, and the real test of a risk-control system would be that it caught not only what you would not expect, but also what you would have thought not possible.

"With Robert Maxwell, supervision was lax," acknowledges Jim Gorter. "We didn't have the necessary checks and balances. A trading relationship that started out okay got bigger and bigger and became so different in composition that it was not okay. In the end, it cost us a lot of money. Ours is a very complex business. When it surges forward in volume—*and* speed *and* complexity—the business can suddenly outgrow the control system. And when that happens, mistakes get made. Not all of them are caught, and some of these mistakes really bite you. We were lucky to be caught out so few times. The two major dangers that come from within a firm are arrogance—and counting the profits."

So the Maxwell fiasco had one good result: much stronger and more rigorous risk controls—and *no* exceptions. It also strengthened Jon Corzine's case for public ownership because in a public company, those heavy costs absorbed painfully by the partnership would simply be written off as a mere "stroke of a pen" accounting charge. The Maxwell affair soon led to the partnership being converted to a limited liability partnership or "LLP"—another rung on the ladder to an IPO.

Partners had mentally reserved for the Maxwell settlement, but the amounts had been based on estimates. With the settlement, estimates would shift into hard numbers. Inside Goldman Sachs, the immediate next question was which partners

would pay the $254 million. The settlement was treated as a "dated account," and partners from prior years got hit with a "chargeback" requiring them to contribute to the settlement.

Jim Gorter and Fred Krimendahl negotiated on behalf of the various partnership classes. Throughout April 1995 input was sought from general partners, limited partners, and retired partners. The management committee decided to allocate 80 percent of the settlement cost to those who were general partners in 1991, 15 percent to those of 1990, and 5 percent to those of 1989.[17] In a memorandum to 164 partners, the management committee took the position that "this decision, in our judgment, should meet the appropriate expectations that anyone who has been a general partner should have developed regarding how a matter such as this would be handled if it ever arose."[18]

It was, and could only be, rough justice. Getting past a settlement and 100 percent back to business was particularly important because at that time Goldman Sachs was making a huge commitment of talent and treasure to its international expansion. A persistent Maxwell cloud would have been a costly burden.

The $254 million settlement was not the end of the costs of Maxwell. Accountants and lawyers were sure to bill substantial fees for their services in sorting out the details of Maxwell's depredations, and the Financial Services Authority fined Goldman Sachs £160,000 for violating financial reporting requirements on three transactions.[19, 20] The firm also lost more than ninety million dollars in loans to and unsettled transactions with Maxwell, and was excluded by HM Treasury from the third round of privatization by British Telecom, known as BT3. The total cost to Goldman Sachs was on the order of five hundred million dollars.

At the end of November 1995, Eric Sheinberg, then Goldman Sachs's longest-tenured partner, went limited. He had joined the firm in 1960 and had become a partner in 1971.

Her Majesty's Government, through the Department of Trade and Industry, published findings of fact in 2001. Among them: Maxwell "parked" controlled investments by selling them to the MCC pension funds. Some of the transactions were so complex and numerous that even with 20/20 hindsight, the

diligent DTI investigators were obliged to acknowledge: "We have been unable to obtain a rational explanation for these sales and purchases."[21] In 1986–87, pension-fund money was fairly regularly lent by the pension funds at Maxwell's command without any form of security. Maxwell would decide the price and timing specifics of a transaction with Sheinberg and then instruct Sheinberg to call Dr. Rechsteiner and pretend to arrive independently at exactly the same terms. In placing thirty million Maxwell Communication Corporation shares in Japan via Nikko Securities in October 1989, a series of obfuscating transactions enabled Maxwell to avoid disclosure. A key step in the process involved Goldman Sachs. Six months later, Sheinberg saw that the shares Nikko had placed were coming back into the London market and, knowing Maxwell "had a fixation about the price of shares," saw a trading opportunity: He could buy on dips in the market knowing that Maxwell would buy any large block he assembled at a higher price and thus at a good profit to Goldman Sachs. One sizable block was accumulated in early August 1990 and then sold by Goldman Sachs. On two occasions Maxwell sold large put options to Goldman Sachs—for over thirty million shares—which enabled the firm to accumulate shares in the market with the certainty that it could sell the shares to Maxwell at above-market prices, a stratagem to support the share price. In September large share purchases were made by the pension funds. By far the largest, for seventeen million pounds, was done though Goldman Sachs.

Goldman Sachs's considerable ability to put a less negative spin on newspaper stories was demonstrated by its initial public statement after the DTI investigative report was released: "A spokesman for Goldman Sachs in London said Friday that the report 'correctly concludes that Goldman Sachs wasn't acting in league with or on the basis of any agreement with Robert Maxwell.' He added that Mr. Maxwell 'intentionally and successfully deceived' the firm. We deeply regret this and with the benefit of hindsight, and with the information now available to us, we would have acted differently."[22]

Noting that Maxwell's son and others were acquitted after a long trial, the DTI inspectors said, "In view of the acquittals in the criminal proceedings, we decided we would proceed in a manner that did not, and would not be seen to, call the acquittals into question. Nonetheless, conduct can be blameworthy without being

criminal. We do not make legal determinations. . . . Where, therefore, we attribute responsibility, we do so in that context, and in terms of blame . . . the primary responsibility rests with Mr. Robert Maxwell. Goldman Sachs were the Investment Bank with whom Mr. Robert Maxwell principally dealt when purchasing . . . shares and bears a substantial responsibility in respect of the manipulation."

Kevin Maxwell testified that Goldman Sachs had advised his father to conduct a multimillion-pound share-support operation to boost MCC's share price, but apparently the firm made the operation ineffective by conducting its own trading operation.[23] Sheinberg's testimony to the DTI inspectors often differed significantly from comparable testimony by Kevin Maxwell and others involved in the particular trades. Usually, the key difference was whether or not Robert Maxwell was the decision maker. Sheinberg often said Maxwell was not involved. The others repeatedly said he was the *only* person involved. Either way, a Goldman Sachs partner was intimately involved, and both Sheinberg and the Goldman Sachs partners in supervisory roles should have known better.

As an informed partner summarizes, "The final number may have seemed large to many, but those on the management committee were all relieved that it was finally settled. Gene Fife did an outstanding job of managing that potentially explosive and hurtful issue." Still, since virtually none of the partners had had anything remotely to do with Maxwell, they understandably were upset at having to ante up millions of dollars— and some were somehow angry at Fife.

Years later, Gene and Anne Fife were in London, catching up with friends, seeing shows, and enjoying a vacation. Staying at the Cadogan Hotel, they received an envelope with an invitation to come for tea at the House of Lords the next day at four o'clock—from J. Cuckney, who by then had been elevated to a life peerage. Arriving at the House of Lords, they were surprised to be greeted by former Labour cabinet minister Frank Field and his staff of six as well as Lord Cuckney. After warm greetings, the group went into the drawing room for tea, and Lord Cuckney said, "We gather together to say to you that the Maxwell matter is now closed—and to thank you, Gene, for the very fine way you conducted yourself through what must have been for you a most difficult proceeding. We shall always be grateful. Thank you, Gene."

26

MAKING ARBITRAGE A BUSINESS

Risk arbitrage is based on the simple idea that if there are two market prices for the same thing or two equivalent things, they will converge at some point as though pulled together by a rubber band. Arbitrageurs take disciplined actions to create profits by capturing differences in prices for the same item in different markets or of different but interchangeable items in the same market. The price differences they exploit are caused by market inefficiencies or mistakes caused by imbalances of supply and demand due to differences between *uncertainty* and *risk,* which differ in ways only experts usually care about. Arbitrageurs increase market efficiency and—indirectly and unintentionally, as Adam Smith famously explained in *The Wealth of Nations*—they increase the consistency and fairness of markets and therefore the confidence investors have in markets; that helps improve overall economic performance. Arbitrageurs are working in free, competitive markets that are open to everyone, so to earn profits they need to see what others do not see, to see more clearly than others do, or to take actions others would not have considered.

For example, in 1988 Equimark, a small Pennsylvania bank holding company with ten million shares trading at $6, issued an equal number of rights

to buy ten million shares at $4. The stock quickly dropped by one-third to $4, and the market price of the rights—which were offered to shareholders without cost—dropped by half, from $2.50 to $1.25. Reading the prospectus carefully, Frank Brosens made an interesting discovery: Shareholders were not limited by the number of shares they owned, but could apply for as many rights as they wanted. All the other shareholders applied for sensible amounts, for a total of 8.5 million new shares—less than one new share for every old share. Brosens did not. He submitted a very different application. Working with lawyers to be sure of every step, including setting up a new corporate entity so that the bid would not be directly by Goldman Sachs (which would have violated the Glass-Steagall Act then restricting interactions between investment banks and commercial banks), he entered a bid for rights to buy all ten million shares. Of course, the total bids far exceeded the total available, so the firm's bid was prorated back down. But with zero market risk and virtually no capital tied up, the firm collected a $1 million profit on this one position—and made a nearly infinite rate of return.

Clarifying the separation between risk and uncertainty is important to understanding arbitrage. With a large enough population of independent events of the same kind, a risk analyst theoretically knows the odds of each possible outcome with what is correctly called "actuarial accuracy" before having to make his decision. And given a table of possible payoffs and the probability of each, a decision maker is conceptually able to calculate the probabilities of all possible specific outcomes. That's why actuaries can, for a large population, predict patterns of mortality with such precision and accuracy. Given enough independent events, a rational and informed decision maker can virtually predict the future. Uncertainty is different: While you may have plausible expectations, you really don't know the odds and you may not know the payoffs, and while you know both are probably changing, you usually don't know the speed or sometimes even the direction of the change. Uncertainty, like the probable mortality of an individual, is greatest for a sample of one—or any unique occurrence.

Understandably, most investors dislike uncertainty so much that they try to avoid it or protect themselves from it, particularly with one-off disasters like a major fire, a serious accident, or an early death. So it can be profitable for those who are well informed, skillful, and broadly active in the risk markets to absorb all the specific uncertainties investors so dislike. Insurance companies earn profits by

making a market between an individual's uncertainty and a population's true risk. In the capital and money markets of the world, risk arbitrageurs provide liquidity for investors who are reluctant to hold on to an investment that obliges them to accept uncertainty such as whether a proposed merger will or will not be consummated at a particular price on a particular date. Arbitrageurs earn high returns on their capital because the work is so difficult to do well on a scale that involves enough independent events to enable the arbitrageur to profit reliably on the gap between uncertainty and true risk. Potential competitors are discouraged because, while profits come in small percentages most of the time, losses can be sudden and awful. Skeptics liken it to picking up nickels and dimes in front of a steamroller.

Three factors are crucial for success in arbitrage: extraordinary, unemotional rationality or objectivity in all decisions and actions; superior access to information; and the ability to understand that information and think unconventionally and rigorously about it. Arbitrageurs live in a sea of changing information, estimates, rumors, fears, and hopes that drive markets and change prices, amid which they make bold decisions with tens of millions of dollars at stake.

Risk arbitrage, a specialty within arbitrage, centers on making rational judgments of the appropriate prices of the securities to be offered in a takeover if and when it actually goes through, knowing that deals sometimes get rejected as inadequate by the target company or its shareholders, and that deals may get broken up by antitrust lawsuits that are sometimes contested successfully, by competing offers (sometimes from "white knights" brought in by the target company), or by adverse changes in market prices. Individual transaction profits are often rather small—because markets are not *that* inefficient—but the best arbitrageurs earn a high rate of return on their capital by rigorously avoiding mistakes, running a diversified portfolio of commitments, and moving capital from one situation to another, always striving to maximize current-period returns. "Arbitrageurs need to be totally rational, have no ideology, be dispassionate, and have a team that is balanced, thoughtful, and decisive—changing their actions as the facts change," says Frank Brosens. Arbitrageur Dinakar Singh adds, "The only things that count are the specific facts on the yellow pad and logic. Emotion is in the market, waiting to be discovered by objective analysis."

Mergers, particularly contested takeovers, are unique events dependent on human judgment and frailties. They are replete with legal, financial, and

competitive problems and consequent market uncertainties. The risk arbitrageur is always dealing with uncertainty and never dealing with actuarial accuracy about risk. While there may be general patterns, each situation is unique. Fortunately, over time, many unique situations—if correctly analyzed component by component—can be understood as part of a universe in which, although each merger is unique, there are patterns of repetition in some of the components. Experienced arbitrageurs can increase their average profitability by increasing the depth and detail of their knowledge of each specific situation in the search for exploitable patterns. Arbitrageurs do not strive to be right so much as to be more nearly right—or less wrong—than the informed consensus represented by market price.

In the 1980s, Goldman Sachs would have a portfolio of eighty to one hundred arbitrage positions. Some would be held for as little as three or four weeks, and others for a year or two. With five or six people in research and three or four in trading, the arbitrage unit was closely knit. Now the unit has over twenty people. Every position is regularly reviewed and evaluated in the context of the whole portfolio of arbitrage positions. About 5 percent of positions result in losses. Rates of return have been substantially reduced by competition—from 25 percent annual returns in the sixties and seventies to 18 to 20 percent in the eighties and then, in recent years, to less than 15 percent. If the market is 85 percent "right" about prices and an arbitrageur—with more or better data and better insight or greater objectivity—can be 90 or even 95 percent "right," that comparative advantage will be his source of hard-earned profit.

Nothing is known or certain in risk arbitrage. Everything is estimates and probabilities, and stock market prices are determined by the always-changing estimates of the unfolding future as perceived by many different kinds of investors, each with different objectives, skills, and information. All the moving parts are changing—sometimes significantly and suddenly. Information, insight, and perspective are vital to successful arbitrage operations, and all arbitrageurs are in competition will all other arbitrageurs. Since information is useful only when fresh or unique and therefore not already reflected in the market prices, arbitrageurs are in frequent contact with many, many potential sources of information by making dozens of calls every day. Useful, original information, which is essential to making money, is never just given. It is *exchanged* for other valuable informa-

tion in a fast-paced bartering process; each side in a relationship keeps a running mental estimate or record of value given versus value received.

Merger arbitrage is dominated by uncertainty: How will the market today and tomorrow value a variety of unusual, newly created debt and equity securities? Will the government try to disallow a merger? Will it succeed? Is the accounting correct? Will ABC Corporation issue a competitive bid? How might XYZ Corporation respond? Are other arbitrageurs or hedge funds—often the major short-term market movers—favoring ABC or XYZ? In merger arbitrage, the stakes are large, the profit margins are thin, and the market reactions to small changes in perceived probability come quickly. Arbitrage always requires a style of detached intensity because it requires making many specific decisions after appraising the risk-adjusted, anticipated future market values of publicly traded securities. These estimates depend on gathering, sorting, and appraising incremental insights on many, many dimensions. Arbitrage situations are never in black and white, but rather in subtle shades of gray that are always changing. Nothing in arbitrage is ever both highly profitable *and* simple and clear—or easy.

During the postwar years, securities arbitrage came in three main categories. First was pure arbitrage, where two markets for exactly the same security or commodity differed temporarily because of local supply-demand imbalances. This enabled an arbitrageur to make a small but certain profit by selling short in the higher-priced market and buying long in the lower-priced market in equal amounts. The classic illustration: The shares of Royal Dutch Shell trade on both the Dutch and British markets and the prices might differ slightly, creating a pure arbitrage opportunity to sell in the higher-priced market and simultaneously buy in the lower-priced market. J. Aron conducted pure arbitrage in gold when the price in London or New York City differed slightly from the price in Tehran or Baghdad or Singapore.

The second type of arbitrage—Gus Levy's specialty—was based on the breakup of public utilities and railroads emerging from bankruptcy. Arbitrageurs made markets in "when-issued" securities—securities that were announced but not yet issued. There were inherent uncertainties in any yet-to-be-issued security's market reception, and uncertainties cause price discounts. Arbitrageurs could

make markets in these when-issued securities and profit from their willingness to put their capital at risk while estimating—hopefully accurately—the fair market prices of the future securities. This was not a big business, but it could be quite profitable for the few skillful arbitrageurs who specialized in it.

During the Depression, most railroads went into bankruptcy. Then, with all the profitable traffic volume of World War II, they piled up huge cash positions, and many railroads filed plans with the Interstate Commerce Commission to come out of bankruptcy. But since they'd been in bankruptcy for many years, there were only limited markets for their common or preferred stock or their bonds. Similarly, when the 1937 Utility Holding Company Act limited utility holding companies to owning properties in contiguous states, the larger utility holding companies had to break up. But nobody knew for sure what the parts were really worth; a valuation was needed for each separate security on a when-issued basis. This uncertainty gave market makers and arbitrageurs like Levy many opportunities for profitable trading.

The key to success in arbitrage is unemotional detachment in evaluating each alternative. What are the regulatory hurdles? How will each regulator frame its questions? Into what context will the regulator put this particular issue? Which are the best lawyers for advice on regulatory actions or antitrust? The answers will differ according to the industry involved. Goldman Sachs had an advantage in retaining the best lawyers. It was large enough as a fee-paying client on a regular basis to get attention from the very best.

If the market estimates the probabilities at 93 percent and the firm accurately estimates them at 97 percent, it can profit on the 4 percent difference. Such small differences do not explain the emotional roller coaster that can hit arbitrage. In 1997 risk arbitrage at Goldman Sachs made $75 million in two months, increased that to $400 million, then went to zero followed by a loss, and then rebounded to end the year up $50 million. The group agreed: *Lock it in and count your lucky stars!*

The third type of arbitrage—merger arbitrage—began to become important in the sixties as the conglomerates bid against one another for corporations to take over. Merger arbitrage was a small business in the fifties because there were few mergers and most were friendly deals in which the principal uncertainty was how the Antitrust Division of the Justice Department or the Federal Deposit Insurance Corporation would react. Gus Levy had a network of Wall Street pals

who would take arbitrage positions when a merger situation offered attractive prospects of profit. They exchanged ideas and information regularly, particularly during weekend get-togethers at the Century Country Club in Purchase, New York. But for them, arbitrage was never more than an interesting sideline. They relied primarily on scuttlebutt, tips from friends, and what would today be called inside information. In those days, using such information was still considered okay. The boundary line defining what was inside information moved and would move again as markets changed, business practices changed, and risk arbitrage changed in volume, complexity, and pace.

Once a successful securities salesman, or customer's man, L. Jay Tenenbaum had concentrated on selling securities to Jewish refugees in New York. He soon became the number two "producer" at Goldman Sachs, behind only Jerry McNamara, a Catholic who worked the Catholic community. Tenenbaum began working in arbitrage part-time and proved he had a flair for engaging anyone in conversation, often leading corporate executives to say more than they probably should and to provide more useful insight than they may have realized.

As his block-trading and corporate-finance activities grew larger and faster, Levy needed help. Never easy to work for, he was particularly hard on Tenenbaum and demanded action.

"L. Jay, did you see that merger announcement in the morning paper?"

"Yes."

"Well, what are you *doing* about it?"*

Tenenbaum was soon in charge of the trading room, where block trading was one important unit. Other units included arbitrage, over-the-counter trading, retail brokerage, and convertible bonds. Levy saw arbitrage as an opportunity to build a regular business. He focused on organizing it as such, and built arbitrage into an important business for the firm. Goldman Sachs had strengths that could be marshaled. Increasing skills in investment research meant Tenenbaum could quickly get up-to-date, experienced insight into the business strategy of

* Levy wasn't the only one telling Tenenbaum what to do. Levy had invited Tenenbaum: "L. Jay, if you ever need anything, just tell my secretary," Charlotte Kamp. When Tenenbaum first tried to take advantage of Levy's offer by asking, "Charlotte, will you take a letter?" he got an immediate response: "Will *you* take a *walk?*" Tenenbaum typed his own letters.

a company that was suddenly put in play. The firm's institutional sales force was in constant contact with portfolio managers at all the investing institutions and could quickly find out what each institution was doing about a proposed merger, or thinking it might do. In trading, the firm had strong connections with all the major institutions and was seeing more order flow than any of its competitors. Finally, the firm had an extensive network of corporate contacts—competitors, customers, suppliers, former executives—and was developing a reputation for being, more than most, on the side of corporate management. So if Company A was being pursued by Company X or Company Y, Tenenbaum had many ways to make contact and start a conversation with knowledgeable people, develop that conversation to increasing specificity on important aspects of a deal, and keep it going as more and more aspects of the deal's possibilities came into focus. While separated, arbitrage became the Goldman Sachs trading department's single largest and most important account, providing valuable order flow because Levy had established himself and his firm at the crossroads of the acquisitive conglomerates, institutional investors, and arbitrageurs.

The major participants in the stock markets of the sixties and seventies—performance-driven institutional investors—were larger, faster, and more aggressive in both buying and selling than any investors ever seen before. But the biggest change was in the corporate world, particularly the conglomerates—multi-industry corporations whose business strategy was to buy low-priced companies, restructure their operations, spin off some parts, and refinance other parts to drive reported earnings per share higher and higher. With rising earnings, the acquiring conglomerate's stock's price-earnings ratio would stay high enough to enable the conglomerate to buy still more companies. Conglomerates were frequently in competition with one another to acquire any company put in play by another conglomerate's initial takeover bid. On the prowl for takeover targets, Litton, Teledyne, Studebaker-Worthington, LTV, Gulf & Western, NL Industries, CPC International, United Brands, Norton Simon, and others retained smart, creative lawyers, hired "innovative" accountants, used publicists, and hired the most skillful and aggressive investment bankers. At the peak of takeover activity, several new acquisitions were announced every week and changes in deal terms of one or more contested acquisitions were daily fodder for the newspapers.

Because merger activity was subject to antitrust regulation and the government's antitrust policies were far more restrictive than they are now, Tenenbaum developed a network of experienced lawyers, particularly those who had previously served in the Antitrust Division or on the staff of the Federal Trade Commission, and would war-game the possibilities and probabilities with them, striving to get an edge or insight. Antitrust law could be interpreted differently by the Justice Department, the FTC, or the FDIC, and court rulings could differ from one court to another. Small differences in facts or in ability to interpret facts could be worth millions. As Tenenbaum explains just one of hundreds of factors, "The Antitrust Division had injunctive powers, so they could stop a deal for as long as a year with an injunction—and no deal can wait a whole year. But the FTC did not have injunctive powers, so it really mattered where the government would put the responsibility for each proposed merger."

Tenenbaum developed a highly profitable business with 20 percent average annual rates of return, limited only by the amount of capital that a midsize, capital-constrained firm like Goldman Sachs could commit to arbitrage. Partners learned to respect Tenenbaum's moneymaking capabilities even if they never expected to understand them fully. "I told L. Jay I couldn't fathom or understand the way he thought," recalls partner Fred Weintz. "But I knew he was brilliant, and so I said, 'If I ever start a new firm, I'll want *you*!' He thought so differently. I told my [client] companies, 'I don't know what he's talking about, but *he* does—and you should do what he says.' "

The capacity to encourage others to talk is essential in arbitrage, where every competitor is always looking for incremental information and assessing the probabilities of deals going through *or* being delayed *or* being blocked. An arbitrageur might start by saying, "I've read your public announcement and want to be sure my understanding is correct." Then, as the conversation develops, he might ask about various aspects of timing or specific features of the deal, increasing his knowledge and understanding of the always-changing situation. The key to success in merger arbitrage is the ability to find out significant information so that you *know* you are the best informed factually, and then to combine subtle clues into an actionable perception of reality.[1]

Tenenbaum could pick up some additional commission business by showing his hand to institutions that would be discreet and would do all their arbitrage

trading with Goldman Sachs—outfits like Irwin Management, which managed the family fortune established by J. Irwin Miller, the chairman of Cummins Corporation. Tenenbaum built a network of two dozen like-minded institutions that did arbitrage trading in the hundreds of thousands of shares. At a commission of 40 cents a share, these institutional co-investors generated significant incremental commissions and added substantial throw weight to Tenenbaum's positions, increasing the odds that the acquirer he favored would prevail in contested takeovers—which increased his profits as an arbitrageur.

When Bob Lenzner, who worked for Tenenbaum in arbitrage, left Goldman Sachs in the late sixties, Tenenbaum needed an assistant and had just started looking when the great investment manager Marty Whitman called: "L. Jay, I know you're looking for an assistant. I do business with Alex Rubin, who has a son at Cleary Gottlieb who wants to leave the law and is having serious talks with Felix Rohatyn over at Lazard Freres. You should meet this kid."

Over lunch, Tenenbaum asked Robert Rubin: "Are you serious about your career? Because if you're serious, you'll want to come to Goldman Sachs. Felix Rohatyn is a big shot—and that means you'll just carry his briefcase. I'm a *little* shot—with no briefcase. I've got more deals than I can possibly handle, more than four hundred this year, so you'll soon have deals that are your own—and you'll be working with . . . Gus Levy." Rubin joined Goldman Sachs in arbitrage with the clear understanding that he could and would manage his own account on the side.[2]

The volume and complexity of mergers were not the only changes affecting merger arbitrage. The rules on what was okay and not okay had been changing too—partly through legislation, partly through regulation, and partly through judicial decisions. The direction of change was consistently toward requiring more disclosure to ensure more fairness to all investors. In addition, there were major changes in the chances of violators' getting caught as regulators developed increasingly complete electronic access to data on who bought or sold what and when. But while the rules were clear and the transparency high in such areas as public offerings, retail stock brokerage, and government-bond dealing, they were still unclear at the other end of a very wide spectrum—risk arbitrage.

Bob Rubin was perfectly suited to arbitrage as it developed in the sixties and

seventies: increasing scale, increasing numbers of deals and deal makers, increasing complexity in the terms of offerings, and increasingly frequent changes in terms as competing potential acquirers tried to outmaneuver one another. While Rubin was clearly brilliant, conceptual, and numerate, his greatest strength was an almost eerie calm under pressure. As the pressures intensified—provoking others to tension, angry outbursts, and mistakes—Rubin's calm rationality kept increasing. Under the pressures of a market that was going against him, Rubin seemed to gain focused concentration and to achieve an extradisciplined rigor and objectivity in his reasoning. If the markets went even harder against him, he simply took his calm, coolness, and rationality up to an even higher level. The more intense the pressure, the more calm and rational he would be. "Rubin was the coolest cat in the whole world when the market was going against one of his positions," recalls Bob Steel. "Where everyone else saw nerve-racking chaos, Rubin recognized opportunity to create new order and saw where to take specific action. He was often in very insecure situations, but he showed no personal *feeling* of insecurity. There was no sign of fear, just cool analysis and deliberate action."

Rubin brought disciplined probabilistic process and later sophisticated "quant" analytics and mathematical models to Goldman Sachs, developing risk arbitrage into a repetitively very profitable proprietary core business. This business was passed on to Bob Freeman, Frank Brosens, Tom Steyer, Eric Mindich, Eddie Lambert, Danny Och, Dinakar Singh, and others who expanded the firm's capacity, extended into options and then all sorts of derivatives, and took risk arbitrage international, starting in London.

Rubin was not a quant and never studied advanced mathematics, but he had a fine intuitive, almost aesthetic sense of the concepts. He genuinely liked solving puzzles and managing problematic new things like options, convertible securities, and risks. Of all the people involved in arbitrage in the early days of the Chicago Board Options Exchange, only Rubin ever came even close to heading Goldman Sachs.

As mergers and acquisitions activity accelerated during the late 1970s and through the 1980s, Rubin understood the strategic importance of detached, rational analysis and the ability to take decisive action based on it, so he recruited several key people with that same calm, analytic detachment. Arbitrage became known as the area where the very brightest people worked together. It developed

into a power node of creativity and profitability within the firm.[3] "Most of the information that risk arbitrageurs work with is not hard information," says Tenenbaum. "It's all *soft*—changing estimates of changing probabilities." That's why people like Marty Siegel of Kidder Peabody built networks of contacts to exchange information and why Bob Freeman participated in some of those exchanges—exchanges that, as we shall shortly see, proved disastrous.

Arbitrage people are—and are known to be—Wall Street's most capable people, but what really differentiates arbitrage is that it's dignified. There's no shouting. The very best people work very hard without any flash and in flat organizational structures. The facts are king. You always start with the facts—all the facts you can possibly get—and then you develop a logical line of reasoning or argument, and then—and only then—do you develop an opinion. Opinions always come last. Facts, analysis, and logic matter. Ego has no role in analysis or in developing an opinion. Age and experience do not matter—once you're on the team.

When William F. Baxter, a Stanford law professor, agreed to become the head of the Antitrust Division under Ronald Reagan in 1982, he did so on one important condition: that antitrust regulation be based on market economics rather than legal precedents. This change greatly increased the size of the "relevant" markets that merging companies were considered to compete in and greatly reduced the risk that the Antitrust Division would declare a merger in restraint of trade. This change led to an enormous increase in corporate merger activity, particularly hostile takeovers. The increase in the volume of takeovers was more than matched by the simultaneous increase in the complexity of the securities offered and by the probability that whenever a target company was put into play by an initial acquisition attempt, one or more other acquisitive conglomerate corporations would make a competing offer for the same company.

Rubin's calm rationality became increasingly important to the firm as pressures intensified in many ways. With an enormous increase in both the number and the scale of mergers and hostile takeovers, and in the intensity of competition between aggressive conglomerates, the opportunities and the challenges for risk arbitrageurs expanded substantially. So did the firm's capital commitments and risk exposures—exposures to major gains *and* to major losses. The deals done were not just larger than before but also far more complex as two, three, or

even more competing corporate acquirers offered competing packages of cash, stock, convertible preferred stock, convertible bonds, or bonds with warrants attached. Each of these complex securities required sophisticated credit analysis to determine how it would be evaluated and priced in the future, as circumstances changed and then changed again. Adding complexity, the preferences and valuations of major arbitrageurs and institutional investors and their probable votes on proxy issues all grew increasingly important. Institutional investors not only held major share positions and had so lots of votes but could also add to or buy new shares if they believed ABC Corporation was making what would be the winning offer. So the institutions' investment decisions would affect both the market valuations of specific securities and the probable outcome of the final shareholder vote on the competitive offers. That's why the leading conglomerates designed their offering packages for their multiple acquisitions to please the institutions and the major arbitrageurs. As John Maynard Keynes memorably explained, in guessing who will win a beauty contest, a smart man does not pick the girl *he* thinks prettiest, but rather the girl *others* will think prettiest.

Bob Rubin wanted to find great moneymakers and develop them into great leaders. He and Frank Brosens were happiest when younger, newer people thought they were wrong (or not quite as right as they might be) or had a better idea. Encouraging or even requiring open debate as a way of developing each person's maximum growth is clearly not as efficient as issuing orders, but in the long run will encourage creativity and be more effective at protecting against loss—particularly the cataclysmic loss that could have gone unforeseen.

On the day of the October crash of 1987, Goldman Sachs's risk arbitrage unit took substantial losses, eliminating most of its year-to-date gains.* Rubin stopped by and asked quietly: "How'd you do today?" The only answer was obvious: "Terribly! We lost a fortune!" After all that day's market punishment, the arbitrage unit had taken its losses, cut in half the size of its positions, and was hunkering down, wondering what might come next.

Rubin smiled and continued: "In today's meeting, the management committee agreed unanimously that we have 100 percent confidence in you as a team and

* A competitor, Smith Barney, to avoid flowing its own losses through its income statement, fired *everyone* in its risk arbitrage business that very day so it could avoid showing the loss as a charge against earnings in its income statement. Accounting rules allowed a company to tuck away the results of "discontinued operations" in a footnote.

in the way you run your business. So, if you want to double up on your positions, go right ahead."

Rubin was saying, *It's your call*—that the people who had just lost a fortune were trusted to do what was right for the firm. Rubin's message and the importance of his getting full approval from the management committee were important.

"After that," recalls Frank Brosens, "we didn't hesitate to take action when we saw an attractive opportunity. We were bold while people at other firms were getting caught in the trap of worrying about the impact of their trades on themselves as individuals and on their careers—and staying worried for months and months. With our aggressive stance, we produced a record year in 1988!"

After several years of increases, by the late 1980s Japan's Nikkei stock index had developed a price momentum of its own that could not be justified by earnings fundamentals. Goldman Sachs, a few other dealers, and several large hedge funds believed that the Japanese stock market was seriously overpriced. Deciding to take a hedge position in favor of the inevitable correction, Goldman Sachs went long the S&P 500 and short the Nikkei index on the proposition that sooner or later, the remarkable spread in valuation would have to narrow substantially. The world's two largest markets just could not really be so different indefinitely.

However, markets are not always rational, and instead of making the "inevitable" profit, the firm—and all the other rational bettors—took serious losses during the 1987 crash in American stocks. Inexplicably, the Nikkei declined much less than the S&P and then rose much more rapidly—as though it had escaped economic gravity. As a free thinker with commercial instincts, persistently searching for profits, Rubin asked his favorite question: Why? Rubin's further questioning went something like this: Assume the Nikkei *was* overpriced at 26,000. Did that mean it couldn't go even higher—even a lot higher? And wasn't it impossible to *know* how far up its price might go? So even if the Nikkei appeared badly overpriced now, that didn't mean it couldn't get *more* overpriced for reasons that strictly rational Westerners might never understand.

In this cross-cultural context, it made little sense to bet heavily against such a possibility. *But* if you made your bets with put options—instead of simply going short the stocks in the Nikkei average—you could limit your potential losses, and

this could change the risk-reward balance significantly. Eureka! Inventive Bob Granovsky was asked to develop the required put options by creating a new kind of derivative security through the firm's equity capital markets operations.

Japanese insurance companies were buying twenty-year notes to get their slightly higher yields and, in exchange, were giving up some principal at maturity equal to any loss they might have taken in the Nikkei; they accomplished this by writing "European-style" puts—in yen—on the Nikkei average at the price on the date of issue. (European-style puts can be exercised only on the last day of the put contract, while "American-style" puts can be exercised at any time during the life of the put option, which is often a year and sometimes even a decade. With an American-style put option, if the price of the underlying security goes way down early in the option's life, a dealer can buy the stock, locking in his profit on the option and simply holding it to maturity.) In 1988–89, Goldman Sachs established a position of more than $300 million in Nikkei puts. As the Japanese market declined—eventually falling from 36,000 all the way to 12,000—the value of that position rose exponentially.

The arbitrage group decided to look for a way to list an options-based instrument that could be sold to U.S. retail customers. Goldman Sachs was not yet a public company, so to list the options on a stock exchange, another creditworthy institution would be needed to stand behind and guarantee the offering. This was arranged with the Kingdom of Denmark providing the backstop, and Goldman Sachs issued American-style puts denominated in U.S. dollars.

Recognizing that Merck produced an extraordinary series of major new drugs during the 1970s and 1980s because it institutionalized creativity as a deliberate part of its organizational strategy, Goldman Sachs wanted to do the same thing in risk arbitrage and then in other areas of trading—to make it normal to be abnormally creative. Frank Brosens knew that if you could, either solo or in teams, see something that was new and different or recognize a real change in the way something worked, it would probably be feasible to find ways to make a profit. And if the change was significant, the profitability could be dramatic. If you created or exploited change in an imaginative way, you could move a "commodity" business into a "specialty" product with stunning profitability during the period of early change—the period of change before others caught on to it. Into the 1990s, the firm risked its own capital only on the two main kinds of arbitrage—risk arbitrage

and fixed-income arbitrage. Then the foreign-exchange department started taking risks with firm capital. Now every area of the firm does.

"Bob Granovsky was a key player in this," recalls Brosens. "An unusual character at only five foot seven, with a big Afro-like head of hair, a beard, and a nasal voice, he was incredibly creative. He could take any analysis of a new product idea right through big brick walls. He was unstoppable on the mechanics of making things work. However, on selling his ideas to others, he had problems, so that's where teamwork came in again and again." The people in arbitrage who are really effective commercially—and make the most profits—clearly have flair. Arbitrage now makes profits averaging $1 billion a year.

The best arbitrageurs can zero in on the key drivers with no pride of authorship, always asking the right questions and triangulating to the most useful and relevant answers, gathering and sorting the insights and information from others. What are the key players in the deal really like? Will they draw a line in the sand or are they pragmatists who can be flexible in developing a solution, able to differ on the "right" price and get past roadblocks to do a deal? How can we think differently about what could go wrong? Each deal is unique; what risk is not included in your own thinking? If ABC Company is making a hostile tender now, what are the odds of a different, competitive offer being made?

Into this swirling storm of competition came a new kind of organization—leveraged buyout (LBO) funds, organized for the purpose of executing leveraged buyouts, takeovers, refinancings, and restructurings. They raised capital—billions of dollars from large investing institutions, particularly public pension funds. The senior partners of Kohlberg Kravis Roberts, one of the leading buyout firms, came well versed in the ways of Wall Street, having worked together at Bear Stearns. They knew they were on their way to creating great personal fortunes, and they knew the best way to get the most help from Wall Street—by interesting the best people at the best firms in going all out for KKR. This was easily done. Every senior in Wall Street knew that KKR would be a highly profitable client, so when Henry Kravis called the head of any firm to say, "Your man Jack Smith is doing great work for KKR, and we want him to continue working closely with us," this was virtually a command, and Smith's firm would be very

well rewarded. Moreover, Smith knew about the call from Kravis to his boss right away and knew how much it could accelerate his career, so Smith went all out for KKR. And so did his colleague Jones, who was also ambitious to succeed and hoped to do so well by KKR that his boss would also get called. So did all the other young stars at all the major firms; as a result, KKR continually got—and gets—the best of the best and the first call with investment information.

Creative moneymaking ideas will always find a home. For example, if a company's management, working confidentially with an investment banker as adviser, almost did a management buyout (MBO) and then decided not to proceed because arranging financing was too difficult, that idea for a possible MBO could easily become an idea for an LBO. That could be passed along by the knowing investment banker to active conglomerates or LBO firms like KKR that might decide to take action, spewing big fees and lots of business to the originating firm. It's only natural that every Wall Street firm is always looking for ways to serve KKR and Carlyle, Clayton Dubilier, and other private equity firms. And the arbitrageurs at every major Wall Street firm have every incentive to know, understand, and work closely with the major buyout firms, making sure they have close, frequent contact—closer and more frequent than any other arbitrageur, so that they have greater access and an information edge.

Legal espionage is central to everything arbitrageurs do: going right up to the legal limit to learn more sooner than the market knows, to get a competitive edge. Superior information and evaluation are the only legitimate advantages they can ever have when betting tens of millions of dollars that their estimates are better than the market's. The boundary line on inside information for arbitrageurs has always had two problematic characteristics. First, the line was never clearly delineated, and, second, the line was never fixed or constant. As Steve Friedman often said, "The sidelines of the playing field—the boundaries—keep shifting inward: You never move, but suddenly you're out of bounds."

Rules were not the only things that changed. Volume, pace, and scale were all changing, and new people with different attitudes and values were coming into arbitrage. One of these was an arbitrageur named Ivan Boesky who ran a fund that did nothing but merger arbitrage. Boesky was different.

As an experienced arbitrageur who was there at the time said, "Back in 1984, Bob Rubin told us: 'Nobody's to talk with Boesky—period. That guy is trouble.' Bob Freeman would not have been capable of making that call."

. . .

Complicated problems occur in all markets, so while the number and size of U.S. arbitrage operations has increased enough to dilute the possible rate of return, outside the United States the arbitrage opportunities increased even more rapidly," says Eric Mindich. "Markets opened up in Europe, Asia, and Latin America *and* in new instruments: derivatives, complex debt securities, currencies, and more, in every market area. The growth in the supply of opportunities has outpaced the growth in arbitrage assets."

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J'ACCUSE

At 10:30 on the morning of February 12, 1987, in a light snow, Special Deputy U.S. Marshal Thomas Doonan and two armed postal inspectors went to the twenty-ninth-floor trading room of Goldman Sachs, located partner Robert Freeman, the firm's head of arbitrage, and told him to go to his glass-walled office, where they pulled down the blinds and announced, "You are under arrest" on charges related to insider trading. They searched his desk and files and confiscated his Rolodex. Federal marshals roped off the trading area and began carting away documents. "Everyone was in total shock," recalls partner Geoff Boisi, who was there.

Freeman called Lawrence Pedowitz at Goldman Sachs's law firm to tell him. Pedowitz did not believe what he was told. "Bob, I'm about to go on vacation, skiing in Utah. This *is* a joke, right?"

"No, Larry, I'm serious. There's someone from the U.S. Attorney's Office named Tom Doonan. He's here to arrest me."[1]

"Let me speak with Tom." Pedowitz and Doonan were friends from their time together in the U.S. Attorney's Office.

"Tom, Bob is a really fine person. You don't need to put handcuffs on him."

Freeman was led out to the elevator where, despite Pedowitz's request, he was handcuffed and taken to a waiting car while Doonan remained to search Freeman's office. Freeman was arraigned at the federal court in Foley Square. Goldman Sachs's chief of security, Jim Flick, drove there, arriving in time to toss a raincoat over Freeman's handcuffed hands as TV crews, photographers, and newsmen rushed in. Freeman realized how distressed he was when asked his Social Security number: he couldn't remember. His passport was confiscated; he was fingerprinted and photographed, and bail was set at $250,000. He was then released. Asked why Freeman had been handcuffed, John Slavinski, a senior investigator with the U.S. Postal Inspection Service, seemed surprised by the question and said it was standard practice in a field that sometimes included arresting violent criminals: "We have to protect our agents at the time of arrest."[2]

A block and a half away from Goldman Sachs's headquarters, Richard Wigton had the same experience at Kidder Peabody. Wigton, known to his friends as Wiggie, could not believe what was happening to him and thought it must be some kind of a bad joke. He had never even heard of postal inspectors, so he told the federal agents to get lost. They promptly handcuffed him. A Kidder colleague, Tim Tabor, was also arrested—so late in the day that he had to stay overnight before posting bond.

After being booked, Freeman returned to Goldman Sachs and went directly to the management committee meeting room where Bob Rubin, Steve Friedman, and Pedowitz were waiting. "That liar!" he exclaimed. "That liar! I didn't do anything wrong." And to Rubin, his mentor, he said, "It's not true, Bob. It's just not true."

In Tokyo, Goldman Sachs partner Jim Gorter was asleep in his hotel when Hank Paulson called him and said he had to go out to Narita Airport to meet a jet-lagged John Weinberg as soon as he got off his plane from New York and tell Weinberg that his partner Bob Freeman had been arrested and charged with insider trading. Twenty years later, Gorter would say, "I remember that as clearly as the day Sidney Weinberg called me at the Chicago Club to tell me I was being made a partner."

Freeman, forty-eight, was formally indicted April 9 on federal charges of conspiring to violate securities laws.

Immediately after Freeman's high-profile arrest, Goldman Sachs retained outside lawyers to conduct an internal investigation. All trading records were examined, and Freeman was interviewed for eight weeks about every aspect of his trading to reconstruct the past two years—all with particular attention to trades and calls to or from Martin Siegel of Kidder Peabody, his accuser.

The theatrical arrests and dramatized bookings were trademark methods of New York's politically ambitious U.S. attorney Rudolph Giuliani. As a prosecutor, Giuliani had been an unusually visible law-and-order associate attorney general in the Reagan administration. He then advanced in 1983 to become U.S. attorney for the Southern District of New York. He was determined to make that office far more aggressive and attract much more media attention. He never seemed to worry about losing that office's carefully earned and widely respected reputation for integrity and diligent, first-quality investigations. Quickly breaking with the publicity-avoiding policies of his recent predecessors, Giuliani actively sought press coverage and mastered the skills of using well-timed leaks to favored reporters to get the most impact and the most personal attention—and get articles published that could burrow inside a suspect's mind and mess up his thought process. Other ways to get inside a suspect's mind were also used by Giuliani's organization, including anonymous phone calls and letters.

In addition to changing basic policies and procedures in the U.S. Attorney's Office, Giuliani strategically focused his staff and the resources of his office on organized crime and narcotics—two very visible areas—made high-profile arrests, and got extensive media coverage. A prosecutor exercises substantial public power and can have an important, even dominating private agenda, particularly if the personal objective is to win an important public office.

Prosecutors negotiate. Most prosecutions never get to trial; they are settled out of court. Working with limited resources, prosecutors know they can usually accomplish more by negotiating settlements than by going through expensive trials. Giuliani based his own preferred style of "negotiation" on confrontation, surprise, and intimidation, believing that people move and can be moved further when they are surprised or scared.

. . .

The curious series of events and motivations that led to the specific charges against Bob Freeman developed over more than two years. In 1985 Beatrice Companies' senior management, frustrated by the lack of investor interest in their food and consumer products conglomerate and the resulting lackluster market performance of Beatrice's common stock, decided to "do something." They held exploratory conversations with Goldman Sachs about a possible leveraged management buyout. During these discussions, Beatrice stock was "gray-listed" at Goldman Sachs—put on the firm's rigorous restricted trading list. When nothing developed from these exploratory talks, Beatrice was taken off the gray list.

Then, on October 16, 1985, Kohlberg Kravis Roberts & Company, having retained Marty Siegel of Kidder Peabody as investment banker, offered nearly $5 billion for the company—then the largest-ever LBO bid—and Beatrice was suddenly in play. On October 20, Beatrice's board of directors met and rejected KKR's offer as inadequate.

On October 29, KKR raised its offer from $45 to $47 per share. As arbitrageurs normally do, Freeman moved quickly to establish a significant position, knowing he could develop a specific strategy as he studied the situation. He bought Beatrice stock aggressively—for his own account (to a total of $1.5 million), for family trusts, and for the firm's arbitrage account. The firm's account soon held a whopping 1,360,100 shares of stock and 4,074 March call options.

On October 31, reports in the press indicated that KKR would not increase its offer, and there were rumors that KKR's offer might even be withdrawn. Freeman called Henry Kravis of KKR that day and was told, "Everything is fine. We're not pulling out."[3] Freeman quickly bought another ten thousand shares of Beatrice for his personal account at $41.60.*

On November 12, KKR increased its bid to $50—$43 in cash and $7 in securities—an offer the Beatrice board of directors accepted on November 15.

On December 20, KKR announced that it had arranged financing, and the

* Arbitrageurs traded not only for the firm's account but for their own personal accounts as well, often in the same securities. Gus Levy and L. Jay Tenenbaum did. Bob Rubin did, quite profitably for several years. And Bob Freeman did. When Rubin and Friedman went to reorganize and run the fixed-income unit, Freeman and Rubin continued to exchange ideas on trading as they had been doing for years. Changes had been coming to the markets and in the laws against trading on insider information—and further changes have been made in the years since Freeman was arrested.

market price firmed. In private, however, KKR became convinced during the first week of January that the price was too high to finance the enormous total package. Freeman was still buying Beatrice: He held 1.4 million shares and call options worth $66 million for the firm's account as well as 2,500 shares and call options for himself. These amounts were large; the Beatrice position for Goldman Sachs exceeded the firm's $50 million limit on "friendly" takeovers, and Freeman's personal positions in Beatrice were 40 percent of the family assets he was willing to put at risk.

On January 7, Freeman bought 22,500 shares—shares he had just sold—in order to maintain position in his own account.[4] Trading volume was heavy: Beatrice was the second most active stock that day on the NYSE, but despite the volume, the price edged down. As Beatrice's stock sagged in the market, Freeman started making phone calls. Dick Nye, the respected arbitrageur at First Security Corporation, who the day before had sold—through Goldman Sachs—a block of 300,000 shares of Beatrice, offered his reasoning: no hard news, no specific reason, just a little nervous so a little cautious; the deal was close to closing, and the remaining spread between market price and deal value was pretty small, so the risk-adjusted return on holding until the deal closed just didn't look all that great.

Freeman called Henry Kravis, who gave no indication of problems, but his tone of voice made Freeman suspicious: "He was very abrupt and appeared anxious to end the conversation quickly."

During the morning of January 8, Freeman decided to close out his personal position in Beatrice and to cut the firm's holdings down to the $50 million limit. Then he spoke with Bernard "Bunny" Lasker, who was a longtime floor trader on the NYSE; a permanent member of the exchange establishment, well connected socially and politically; and an active participant in risk arbitrage. Lasker's view: The deal could possibly be in some trouble.

Finally, Freeman focused on Marty Siegel, who was a star in M&A at Kidder Peabody. Freeman and Siegel had met in person only once, but they spoke by telephone almost every week and were used to contacting each other for useful information and insights. Siegel was truly unusual: movie-star good-looking and remarkably articulate and charming. He could sell almost anything to almost anyone. One of the youngest in his class at Harvard Business School, where he cheated unnecessarily at touch football, he was one of the top graduates.[5,6]

As Freeman would later recount, "I told Mr. Siegel that I had heard there was a problem with the Beatrice LBO. He asked from whom I had heard this and I answered, 'Bunny Lasker.' Martin Siegel said, 'Your bunny has a very good nose.' "

Freeman thought that was a curious semiconfirmation of an unknown difficulty, perhaps a delay in the deal's closing date. For the next half hour, he and his colleagues in arbitrage exchanged possible interpretations, trying to figure out what Siegel's cryptic remark might mean. The conclusion they came to was not correct. It was what scientists call a false positive.

Knowing that KKR had carefully developed a Street reputation for always completing its takeovers, Freeman and his colleagues in arbitrage figured KKR must be delaying the closing date. After all, it was an enormous LBO and KKR may have decided to take more time in arranging the very large bank loans.

Freeman felt that, if what he thought Lasker meant was correct, postponement would spread the expected gain out over a longer period of time, which would reduce the daily rate of return. He decided the resulting expected rate of return would now be too low, so he chose to sell the calls he had bought for the firm, and left in effect his earlier sell orders.[7]

At 1:45, KKR announced that its offer was being changed—not in timing, but in structure—to $40 in cash and $10 in securities. This was a different action than Freeman and others had expected. Beatrice common stock dropped sharply to $44.25, down $4. Even though his conclusion had been wrong, by trading that morning Freeman had avoided personal losses of $93,000 and an estimated loss for the firm of $548,000.[8] Ironically, even if Freeman and his colleagues had understood Lasker's remark correctly, they would have gotten it wrong again. Once they heard how the deal structure had actually changed, they estimated that the change would cause the stock to drop by only 25 to 40 *cents*—certainly not by four dollars a share—not enough to justify selling the Beatrice stock or calls.

The government would argue that after hearing Siegel's "bunny" comment, Freeman should have known he was now legally an insider—even though he seriously misinterpreted the information—and pulled his order to sell.[9]

The usual test of insider information is whether an informed investor who gets that information would know how it would affect the market price, giving him an unfair and improper advantage over the company's other investors. If it took Freeman and his colleagues half an hour to decide—incorrectly—what Siegel's comment

probably meant, was the information sufficiently informative to be illegal insider information? If the interpretation that Freeman and his colleagues made was wrong, and if they would not have taken any action if they had gotten the likely price change right, can they still be guilty of a crime of trading on inside information? Did it matter that Siegel never remembered the bunny comment?

Goldman Sachs would defend Freeman. He was a partner, a member of the firm family, and had made a lot of money for the partners. Other reasons for defending Freeman were important too. If Freeman was found guilty, the firm's reputation could be hurt badly, and reputations matter greatly on Wall Street. (Later Long-Term Capital Management and Bear Stearns would be wiped out because the confidence of others fell away.) The fines and penalties coming from civil suits could be enormous. A public offering of Goldman Sachs shares that had been very much under consideration was impossible with a major risk of legal liability unresolved. Licenses to operate a securities business could be suspended or revoked. Recruiting could be impaired. New-business and client relationships—particularly internationally—would be handicapped at best, and hurt badly at worst.

Since anyone could be subpoenaed and deposed about what he had said or heard or thought, it was better to overcontrol contact with Freeman. Weinberg, Friedman, Rubin, and Pedowitz ran a tight strategy on defense, reporting every week to the management committee but limiting discussion to a small circle of people and minimizing the number who had any direct communication with Freeman.

Context is important to understanding specific events, particularly events involving ethical judgments. With the explosion of takeovers, mergers, divestitures, and financings that increasingly flourished during the 1960s, 1970s, and 1980s, the world of arbitrage changed so much that it got destabilized. New people came into the business, the economics changed considerably, the pace of action accelerated, huge personal profit-making opportunities came within easy reach, and the old rules were bent or pushed aside. Another important change was an influx of independent arbitrageurs. As a competitor reflected years later, "Everyone in arbitrage was in a situation you could only appreciate if you were there at the time to see it and feel it yourself. Everything was changing: Solid corporations were coming apart or being taken apart, companies in very different

businesses were combining together or forced together, every retail broker was talking up what he'd heard might happen, and otherwise sensible people were believing all sorts of stories. Everything seemed in flux. You'd have to understand the context to understand any specific situation."

In the late seventies and the eighties, substantial changes in corporate financial strategy and substantial changes in the capital markets combined to create a continuous Chinese firecracker of serial takeover explosions. Institutional investors, already the dominant forces in the stock market, competed aggressively to achieve superior investment performance, because recent performance attracted lots of new business. With many institutions holding large blocks of stock in most public companies and quite ready to sell at a profit, conglomerates whose main business was buying, reorganizing, and selling smaller companies could win a takeover competition simply by offering to pay 20 percent or 30 percent above the market, often financing all or part of their purchases with low-cost debt.

As the best arbitrageurs must, Freeman was always looking everywhere for insight or perspective—for an edge. As one partner recalls, "If Bob Freeman called me and asked me to check with a particular institution to see how deal X was being seen at that account, I knew that 'my' fishing line was only one of twenty or thirty or more lines Bob would have out in the water—all being worked very carefully."

As more and more companies got involved in takeovers—often in competition with other conglomerates and often with complex packages of common stock, preferred stock, convertible preferred, convertible bonds, bonds, and cash—the volume of offerings created a smorgasbord of new securities that the markets did not immediately price correctly. This produced a rich array of opportunities for arbitrageurs to make significant profits, so the number of arbitrageurs and the scale of their operations mushroomed. Arbitrageurs became an important force in the market and altered both corporate finance and institutional investing; they connected two dynamic groups that had been separated into one complex, interactive, interdependent new business with unfamiliar players, few reliable rules or codes of behavior, and lots of intensive competition—all at faster speeds and on a larger scale than ever seen before. Fortunes were rapidly made or lost. Deal makers went from obscurity to notoriety, and new players quickly became forces to be reckoned with. As so often in such revolutionary situations, hard prices dominated soft values—soft values like integrity, quality, and trust.

Trading spreads are widest and profit opportunities greatest near the edge that divides activities that are okay from those that are not okay, an edge that moved and then moved again, as laws, regulations, and judicial decisions changed the boundaries of what is and is not inside information. Ivan Boesky was known on the Street to be very close to the edge or just over it. In time it would be shown that he was way over the edge and a serious, repetitive criminal. Rubin and Freeman agreed well before Boesky got into trouble that while Goldman Sachs would continue to execute orders for Boesky, it would not discuss arbitrage situations with him.

"Everybody does it"—second only to "This time it's different" as an escape from reality—spread its tentacles wider as rules and regulations got tested again and again by clever, highly motivated people seeking incremental competitive advantages. Established norms of conduct got rubber legs. If knowing the price of everything and the value of nothing defines cynicism, Wall Street was becoming a crowd of cynics. Two who demonstrated how cynical and then criminal some could be were Michael Milken and Ivan Boesky, leading figures in the web of scandal that finally enmeshed Robert Freeman.

On May 25, 1985, a letter from a jilted woman in Caracas, Venezuela, arrived at the office of Richard Drew, vice president in Merrill Lynch's large compliance unit. The letter accused two Merrill Lynch brokers in Caracas of insider trading. An internal investigation showed that the pair were mimicking the trades of a third broker, who had been in their same 1982 Merrill Lynch training class but had moved over to Smith Barney. The Caracas brokers were paying the third broker a percentage of their profits, and *he* was mimicking the trades of his largest account: Bank Leu International's branch in the Bahamas. Sharing profits was not allowed at Merrill Lynch, so the two Caracas brokers were terminated. At Smith Barney, where supervision and compliance were not so strict, the third broker was merely informed that he had been reported, and the matter was dropped. As a Swiss bank subject to Switzerland's strict secrecy laws, Bank Leu would insist on ensuring absolute confidentiality for its clients. Bank Leu was sure to do nothing. The story could have died then and there if Drew had not taken an extra initiative.

Merrill Lynch takes compliance quite seriously, so Drew passed the information to Gary Lynch, who, at only thirty-five, had just become the SEC's director of enforcement. Lynch had been concerned about an increasing epidemic of trading on insider information that was causing stock prices to run up just before corporate takeovers were announced. Most inside-information abuses involved just one stock, but this time was clearly different. Lynch was particularly impressed by the large number of stocks showing the suspicious trading pattern: twenty-eight. He decided to investigate.

The trades certainly indicated illegal use of insider information, but to get to the original source the SEC staff would have to break through the cordon of secrecy at Bank Leu. The Smith Barney broker had been in frequent contact with a specific Bank Leu officer who handled the secret account of a certain "Mr. Diamond." The SEC would later learn, after careful investigations and difficult, complex negotiations over many months, that "Mr. Diamond" was Dennis R. Levine.[10]

Dennis Levine was on the make. He wanted to have all the usual external signs of success, but he had neither the talent nor the drive to do the work that might enable him to earn what he wanted to have. On the other hand, he had enough low-level charm to ingratiate himself with some, particularly those who were not paying close attention, and an ability to objectify others, including his wife and closest associates.[11] Levine was clever enough to identify sufficiently gullible young professionals he could seduce into joining his network, and clever enough to set up and operate a system for twelve years that might never have been uncovered if only each person in the network had followed his explicit instructions. But they were all human and they didn't. As a result, instead of "No one will ever know," the network and Levine were discovered—but only just barely.

Contrary to Levine's instructions, there being no honor among thieves, most trades had been executed through just one broker at Smith Barney. That broker saw how consistently and quickly "Mr. Diamond's" stock picks went up, so he decided to mimic them in his own account and to share in the profits made on the tips he passed along to his two training classmates at Merrill Lynch's office in Caracas.

When he first heard about the SEC's inquiries, Levine was unshaken. He advised his account officer at Bank Leu to parry the SEC's request for an expla-

nation with a simple cover-up statement that he was basing all the decisions on available investment research—research that Levine would now provide retroactively. While initially intimidated and frightened, Bank Leu's officer agreed to the plan. Shrewdly, Levine also advised the bank to retain the services of Harvey Pitt, a former SEC general counsel now in private practice, to represent it in any legal or regulatory confrontation with the SEC.

Bank Leu's officer went, he thought secretly, to New York to meet Pitt. However, U.S. Customs, alerted by the SEC, recorded his entry into the United States and his intended address: the Waldorf-Astoria Hotel. When SEC agents suddenly accosted him in his hotel room and handed him summonses demanding his personal trading records and Bank Leu's records, he was frightened. He called Harvey Pitt, asking what to do. Pitt took over, telling the SEC that Bank Leu would produce documents showing that trades were made in dozens of accounts. Pitt then flew to the Bahamas to get the supporting records from Bank Leu, but they could not be produced. Learning this, Pitt nearly quit; however, he agreed to continue if Bank Leu stopped all trading for the "Mr. Diamond" account. Pitt urged the bank to try to offer up Levine's still-secret identity in exchange for immunity for the bank and its officers—if the SEC would agree.

Pitt contacted Lynch at the SEC and told him that what he had previously asserted as fact was not true. If a "status player" on Wall Street—not Bank Leu's officer—had initiated the trades, would the SEC accept his identity in exchange for immunity for the bank and its officers? If so, the bank would seek permission from Swiss banking regulators to disclose the status player's name. Of course, the Department of Justice and Rudy Giuliani would have to agree too, so that both civil and criminal cases would be combined. After discussion and consideration, the SEC agreed. Now it would be essential to gain agreement with the U.S. Attorney's Office.

In Giuliani's office, Charles Carberry was new to the fraud unit and not very interested in cases of trading on insider information; he thought such arcane matters should usually be left to the SEC. However, Carberry also thought the Bank Leu situation was so systemic and different that it threatened to corrupt the whole stock market. After listening to Pitt and the SEC lawyers, he agreed to go along with granting immunity for Bank Leu in order to focus faster on the status player.

To penetrate Bahamian secrecy laws, a delegation of SEC and Justice Department lawyers called on the Bahamian attorney general, argued that securities transactions were really not "banking," and got his okay. On Friday, May 19, 1986, Pitt reported to Gary Lynch at the SEC that the status player was Dennis Levine. A warrant for Levine's arrest was immediately made out.

Over a dozen years, Levine had recruited a circle of junior associates at prominent law firms and investment banks into a loose network of informants. Trading on the insider information filched by these associates, he parlayed his secret account into trading profits that had accumulated to $10.6 million. That's not all. He gained a reputation for somehow having a special feel for the market during corporate takeovers. In just nine years, Levine's annual income had multiplied more than a hundredfold, from $19,000 to over $2 million.

Levine had recruited his clandestine network of associates partly by selecting and enticing weak, susceptible young people; partly by using secret bank accounts and coded messages that lent their activities an air of mystery, adventure, and gaming the system—a big change from the inherent boredom of their routine daily work; and partly by assuring them that they, like him, would make millions and never get caught. Increasingly ensnaring them as they went further and further down the primrose path, Levine was also showing and describing to them the obvious benefits: his handsome apartment, his luxury cars—a BMW *and* a Ferrari—and his fast-growing bank account. To young, impressionable, naive, and struggling associates, it must have seemed like a sure thing, fascinating, lucrative—and safe.

All that changed suddenly at 7:30 on the evening of May 20, 1986, when Levine turned himself in and was formally arrested and incarcerated in the Metropolitan Correction Center in a cell with two drug dealers. Next day, he posted bail of $5 million and retained Arthur Liman as his defense attorney. Still detached from reality, Levine somehow thought he would find a way out. He was wrong.

Liman negotiated a plea bargain with Giuliani's Carberry and got Levine's charges reduced to four felonies, including two counts of tax evasion, with a maximum of twenty years in prison, in exchange for full cooperation in convicting his four co-conspirators and—far more important—for information that would lead to the conviction of a much bigger figure, a prominent arbitrageur who was extensively engaged in trading on insider information. Carberry agreed, and

during interrogation Levine identified Ivan Boesky. As a result of his remarkable cooperation, Levine's sentence was reduced to only two years in prison and a fine of $362,000 in addition to his SEC fine of $11.6 million.

Ivan Boesky was not a nice man. He was a demanding bully in his office and over the telephone, bought and sold boldly and in bulk, and ran a $700,000 loan from his mother-in-law into a fortune. He enhanced or fabricated his education, most particularly leading people to assume he must have gone to Harvard because he used the Harvard Club of New York City extensively. (Actually, he was a member because, after making a large gift to the Harvard School of Public Health, he was taken onto its board of advisers, which, as he probably knew before making the gift, qualified him to apply for club membership.) He did go to law school—at the seldom-heard-of Detroit College of Law—and graduated five years later in 1964, but couldn't get a job in any law firm. Susan Silberstein, daughter of a wealthy Detroit developer who owned the Beverly Hills Hotel and other properties, married him. The couple moved to New York and Ivan worked in arbitrage for several different firms before setting up Ivan F. Boesky & Company in 1975. Seeking public recognition and approval, Boesky published a book on arbitrage, *Merger Mania;* was the subject of a feature article in *Fortune;* became an adjunct professor at Columbia and NYU; and was identified as one of America's richest people by *Forbes*.

In May 1986, Boesky was chosen by seniors at the University of California, Berkeley, to deliver their commencement address. He flew out in a private plane, arrived late for the precommencement festivities, and left abruptly right after speaking. Most of his address was boring, but he got applause for saying: "Greed is all right, by the way. I think greed is healthy. You can be greedy and feel good about yourself."

On June 10, 1986, in a highly unusual memorandum to Goldman Sachs employees, John Weinberg said, "We normally don't respond to newspaper articles, but this morning's article in the *Wall Street Journal* deserves an exception. You should know that we have no knowledge that anyone at Goldman Sachs is being investigated by the government in connection with insider trading or any other matter. Neither the SEC nor the U.S. Attorney has contacted us in connection with such an investigation. Based on our enquiries, we have not uncovered any facts that would warrant such an investigation."[12]

People at the firm began to wonder: Even at Goldman Sachs, if there was smoke, could there also be fire? Less than a month later, on July 3, David S. Brown, a thirty-one-year-old lawyer and vice president in the firm's mortgage-backed securities department, resigned from Goldman Sachs in a letter delivered by his attorney. For $30,000 cash, he had sold information about pending takeovers to a college friend, Ira B. Sokolow, formerly of Shearson Lehman Brothers, who, for a total of $90,000, had sold tips on fourteen takeover bids to Levine, who made $1.8 million on them.

Goldman Sachs said it was "shocked and dismayed at this development,"[13] which made it the fourth Wall Street firm—after Drexel Burnham Lambert, Lazard Freres, and Shearson Lehman Brothers—to be caught in the largest-ever insider trading scandal. Sokolow and Brown both pleaded guilty to two felony counts apiece, with each count carrying a possible fine of $250,000 and five years in jail. Brown paid $145,790, but kept his Ninety-fourth Street home, $65,000 in cash, and a $10,000 IRA. He was sentenced to thirty days in jail, three hundred hours of community service, and three years of probation. Newspaper articles noted that "a senior figure in the arbitrage community was also being investigated."

In late August 1986, Boesky's trading records were subpoenaed by the SEC and Boesky too retained Harvey Pitt as counsel. Pitt pleaded with Gary Lynch for a bargain, asserting it was not in the government's interest simply to prosecute Boesky. There was a much more important opportunity. Pitt proposed the following grand bargain: no criminal prosecution in exchange for Boesky's paying a major fine, leaving the securities business, and fully cooperating in revealing a complex and extensive pattern of behavior and relationships that was equivalent to the nefarious scheming revealed by the legendary Pecora Hearings, which had led to the 1933 and 1934 Securities Acts and the establishment of the SEC.

Since no deal with the SEC would succeed without Giuliani's agreement, Pitt put the same question to Carberry on the Tuesday after Labor Day. Carberry took it to Giuliani, who could give him only five minutes because he was preoccupied with a high-profile case on political corruption that he had decided to prosecute himself. Carberry explained that without a bargain, it would take two years to investigate and then try Boesky, and even then a conviction was uncertain, but Boesky's cooperation could lead to "interesting" possibilities. Giuliani

and Carberry quickly agreed to negotiate a plea, but it would have to include at least one felony and a giant fine. Carberry suggested a record fine of $100 million, partly because it was a big, memorable number and partly because it was close to the SEC's total annual budget.

As negotiations approached a conclusion, Pitt refused to provide names. Then, after the government broke off negotiations in frustration, Pitt did give names: Michael Milken of Drexel Burnham Lambert; Martin Siegel, who by then had moved to Drexel Burnham; and Boyd Jefferies of Jefferies & Company. On September 10, the SEC approved the bargain, and a week later, after he signed his plea agreement, Boesky was enrolled as a U.S. government agent. His debriefing lasted several weeks. Secrecy was vital if Boesky was going to obtain incriminating evidence. Wearing a wire, he went to Los Angeles to meet Milken and tried unsuccessfully to develop a conversation with him that would include incriminating information. Boesky made it clear to investigators that he was dependent on Milken, and said he also suspected others on Wall Street of insider trading.

On Friday, November 14, at 4:30 p.m., U.S. attorney Rudolph Giuliani in New York and SEC chairman John Shad in Washington held simultaneous press conferences to announce the investigatory success of the decade. Estimates of Boesky's illegal trading profits rose to $300 million. Press and TV coverage was phenomenal—but not always triumphant. Many complained that Boesky had been punished far too lightly for what he had done and the way he had done it. When told the government had given Boesky two full weeks before making any announcement so that he could liquidate his arbitrage positions and raise the money to pay the fine without disturbing the markets, arbitrageurs were angry: Boesky's massive liquidation was, to them, the largest insider-information trading ever done.

In November 1986, Martin Siegel got a mysterious call about "the letter." Puzzled at first, he realized he had not been out to his Connecticut home for two weeks, drove there, and found the mystery letter, which declared the writer "knew" and demanded money. Siegel consulted a lawyer and soon heard that the U.S. Attorney's Office knew all about Siegel and Boesky.

Siegel broke down, saying he was guilty and wanted to do right. That day

he told his wife and retained Ted Rakoff, who had headed the securities fraud section at the U.S. Attorney's Office. He also heard the reports of Boesky's plea agreement. Siegel told Rakoff he wanted to plead and make amends.

The SEC insisted on a tough financial settlement, apparently chastened by the press's reaction to its previous "leniency" with Boesky. Siegel decided to move his family to Florida, where homestead laws prevent creditors from seizing a debtor's home; he bought a $3.5 million house in Ponte Vedra and a two-million-dollar prepaid whole life insurance policy from First Colony Insurance Company, from which he could draw $180,000 annually tax-free for spending. Rakoff and the U.S. Attorney's Office agreed to a reduction from four felonies to two in exchange for Siegel's producing the head of arbitrage at a major firm.

Freeman was an easy mark. He and Siegel had spoken often; Freeman was habitually helpful and generous with his time, spending long hours with investment bankers at his own firm—and even at other firms—discussing how arbitrageurs would most probably evaluate alternative deal structures and terms. In the complex takeover battles of the era, understanding how arbitrageurs would evaluate different packages of securities would often be decisive in a tightly contested takeover battle. Freeman's insights and advice were highly valued, particularly since he was head of Wall Street's largest arbitrage operation, with up to $1 billion of committed capital. Other arbitrageurs had been distancing themselves from Siegel and not returning his phone calls. They were uncomfortable about working with someone who was so obviously interested in exchanging sensitive information, repetitively offering "something juicy" now in informal exchange for "being helpful" in the future.

Siegel's decision to finger Freeman was easy. He didn't really know Freeman. They'd met only once briefly. Their phone calls—three or four a week—were about trades and deals and markets. Friendly, but nothing personal. Siegel always had many contacts and acquaintances but had never developed true friendships and had no personal loyalties. His focus had become entirely on making more money. He wasn't about to have everything he had always wanted taken away from him now. The guy he needed to accuse had to be in arbitrage, so an arrangement to swap inside information on deals would have been both possible and believable. Freeman was a big fish in a big pond as head of arbitrage at Wall

Street's biggest arbitrage department in one of Wall Street's most prestigious firms. Nobody else came close.

Bob Freeman going to prison versus Marty Siegel? Easy call. Better him than me.

Investigative reporters for the *Wall Street Journal* projected the distinct possibility that Freeman and Siegel had been participating in an extensive pattern of conspiracy, feeding each other sensitive inside information and making substantial profits—with Beatrice being only the tip of a large iceberg.

But were some or many of the "revelations" just clever plants by Siegel to help him plea-bargain? "It seemed to those of us who were involved," recalls a retired Goldman Sachs partner, "that James Stewart, who wrote a series of apparently well-informed articles for the *Wall Street Journal*, was reporting the story the way Siegel would want and had become, effectively, Siegel's mouthpiece." Or were the leaks coming from Giuliani to increase the pressure on Freeman or to garner more publicity for his campaign against insider trading or to build his public recognition for a political future?

As a team player, Freeman would be expected to advise Goldman Sachs bankers on how arbitrageurs would react to various hypothetical moves and terms of offer in a contest for control of a target company. Did Freeman cross over the ill-defined line between legal and illegal? "Clearly *not* okay today, but rules and standards about what's okay change over time, particularly in arbitrage. Bob Freeman is exceedingly rational and objective, well suited to the constantly changing set of probabilistic judgments needed for success in merger arbitrage. I spoke with Bob almost every day. In deals where Goldman Sachs was the investment banker, if I hadn't formulated my own view on what to recommend to a CEO and Bob asked me for my perspective on the deal, anything I said would be absolutely hypothetical, but it would help him see how other people would reason when given a particular set of facts," explains a partner.

Outside lawyers were retained to conduct an audit for Goldman Sachs, but the firm's records and recordings could show only one side of thousands of trades—what *was* done, but not *why* it was done—and arbitrageurs were always dealing in shades of gray. In meetings between lawyers for the firm and Freeman and lawyers for the government, Goldman Sachs's lawyers focused on the firm's

long-standing reputation for integrity. As Pedowitz explained, for every allegation by Siegel there were highly credible alternative explanations.

In February 1987, the New York Stock Exchange required its members to tighten internal controls and report quarterly that employees' personal trading had been legal.[14] Goldman Sachs and other firms sharply restricted personal-account trading, barred short-term trading in stocks and options, and required employees to hold purchases for at least thirty days. Rubin and Friedman had attorneys and auditors evaluate every division's practices to be certain that all systems precluded improper conduct.

The government immunized Goldman Sachs arbitrageur Frank Brosens, but his testimony before the grand jury was yielding little when the prosecutor asked if he could remember anything else. Brosens repeated the bunny story. This made absolutely no difference, because the story had been known by both sides for two years. Still, government lawyers would focus here, asserting that when Siegel, who was clearly an insider, confirmed Lasker's estimate, Freeman should have instructed the firm's traders to stop selling Beatrice, because from the moment he got Siegel's confirmation, Freeman had legally become an insider too.

In a memo to the staff, the management committee explained that "our lawyers tell us that the law underlying this charge is exceedingly technical, and that while there is a factual and a legal basis for Bob to plead not guilty, the facts are very unusual and very unlike any other criminal securities case that has previously been brought." If Freeman fought the lawsuit all the way, he ran the risk of several years in prison among hardened criminals. Moreover, he would be putting his family's fortune at risk because civil suits could follow any criminal finding, and the awards for damages in a civil suit, though difficult to predict, could be very large. As Freeman later said, "The atmosphere was extremely poisoned for anyone who had anything to do with the eighties. There was no sympathy."[15] If Freeman insisted on going to trial and the jury found him guilty on a criminal count, that could immediately put the firm at risk for civil suits.

Since complexity characterizes arbitrage as a business, it is perhaps poetic that complexity came to characterize Freeman's prosecution and defense. The complexities went beyond those expected of negotiations between government lawyers and former government lawyers now in private practice. Giuliani's young, relatively inexperienced lawyers were dealing with ill-defined laws; they

were understaffed and overwhelmed by work. They had thousands of documents to study, knowing that important parts of any firm's arbitrage operations would deliberately not be documented and that some of the documents may have been planted after the fact to give an appearance of careful research that might divert investigators' attention from decisions that might actually have been made on privileged information.

It took two months to go from Freeman's arrest to an indictment. As Paul Curran, counsel for the firm, noted with deliberate scorn, "It would appear the government is now doing an investigation *after* his arrest." On May 12, 1987, the government requested a two-month delay in the trial date, admitting it had proceeded too quickly and pleading for more time to prepare its case. This request was refused by the court, so the government pleaded not that it had too *little* information, but that it had too *much* in the fifty cartons of documents and transcripts of sixty interviews, and maintained that it was on the verge of breaking a major insider trading scandal involving nine megadeals in 1984–85—if only it had more time. Again the judge refused. Then on May 13, Giuliani's staff lawyers asked that the case be dismissed without prejudice and promised to seek a new indictment based on an eighteen-month conspiracy between Freeman and Siegel. Giuliani spoke of "the tip of the iceberg."

Dick Rosenthal, Salomon Brothers' partner in charge of arbitrage, called Freeman to volunteer as an expert witness: "I can explain it so clearly to the jury that they'll know they understand." In yet another ironic twist, a month later and long before the trial, Rosenthal was killed while flying his own airplane.

Another complexity was Giuliani's adroit use of the media to build pressure on Freeman and Goldman Sachs by trying the case in the papers, particularly the *Wall Street Journal* with its strong record of rigorous investigative journalism. James Stewart and Daniel Hertzberg, both Pulitzer Prize–winning reporters, who had been out in front of the story all along, alleged a "detailed catalogue" of misdeeds by Freeman in relation to Siegel.

Goldman Sachs would surely benefit from a change in the way the case was proceeding. "An idea came to me in the middle of the night," recalled John Weinberg. "Who could better represent the best of Goldman Sachs in a private conversation with the federal attorneys?" Who better, that is, than John Weinberg? Chairman David M. Roderick of U.S. Steel had done something like this when

Carl Icahn was threatening a takeover raid on Big Steel. Roderick invited Icahn to come for a meeting once a month for several hours of high-level talks. During those talks, Roderick went on and on about all sorts of things for hours, until one day Icahn called to suggest they meet not monthly, but every two or three months—and then even less and less.

"I asked Larry Pedowitz of Wachtell Lipton what he thought," recalled Weinberg. "He wasn't enthusiastic because he could see the risks, but he agreed it was an interesting idea. So I went alone to see Rudy Giuliani at the DA's office—after asking that he invite all his group heads to be there too. What a break! Here were eight guys—all from Brooklyn. So I told them about the history of the firm as a family firm and about my dad and the troubles we had dealt with and what the firm meant to us, that we care very greatly about integrity and doing the right thing and accepted no hanky-panky. And after an hour and a half about the firm, its history and values, I laid it on the line. 'If you can write out on a piece of paper something I can believe makes a real case that Bob Freeman did anything really wrong, I will personally *kill* him—and I'll bury the bones so nobody will *ever* find them.' "

Trying to calm Weinberg , Giuliani quickly cut in: "That's okay, Mr. Weinberg. That's okay." Then Giuliani left the meeting, and the U.S. attorney's lawyers began to shift from concentrating on a prosecution to arranging a settlement.

A careful review of actual trading obliterates the "case" against Freeman. It was, apparently, contrived by Marty Siegel and, thanks to his remarkable skills of presentation, accepted by both James Stewart and Giuliani, who became parties to a sad and painful injustice to Bob Freeman. Stewart is a wonderful writer and anyone reading *Den of Thieves,* his 1991 book on these events, would find it convincing. To the extent that he was relying on Siegel as his source, Stewart was depending on a spellbinding storyteller with a compelling ability to recall names, dates, numbers, and other facts. Apparently Siegel was feeding the same story to the U.S. Attorney's Office, which in turn was "independently" confirming Siegel's story to Stewart.

The most important and distressing allegation against Freeman was that he was supposed to have engaged in an eighteen-month conspiracy with Siegel to

exchange insider information. Siegel's story was accepted by the prosecutors without an independent investigation of trading records or crucial telephone calls and became the core of the government's case. Before looking into the alleged components, some background will be helpful. Siegel was one of the era's most blatant abusers of insider information, taking hundreds of thousands of dollars in briefcases filled with cash and using secret passwords in exchanges with Ivan Boesky, the felon who would pay the record $100 million fine. Siegel was not recognized for what he really was by anyone at either Kidder Peabody or Drexel Burnham[16]—except in retrospect, when he would be seen as a con man of enormous charm. With major prison time in prospect, Siegel was highly motivated to be, and, particularly to be seen to be, an unusually cooperative government witness.

Given his extraordinary ability to recall specific names and dates, his charm, his motivation, and his amoral indifference to the consequences for others, Siegel was in a good but imperfect position to invent and articulate a believable alternative reality. His main problem was that he had no access to hard data on trades. He had left Kidder Peabody and was attacking that firm and Goldman Sachs, so they obviously would not help him in any way.

Siegel had an important advantage going for him. For years, he had been a major source of information and insight for Stewart and Daniel Hertzberg at the *Wall Street Journal* and had developed an unusually close relationship with Stewart, who wrote not only a series of articles that seemed wonderfully on top of the whole seamy story of insider trading, but also the best-selling *Den of Thieves*. The book told the story in considerable and convincing detail—with one major problem: For the section on Freeman, Stewart apparently relied heavily on Siegel and on Rudolph Giuliani's office, which in turn relied on Siegel as a major source. A careful review of the trading records clarifies the major problem: Siegel's story was a string of lies.

The "conspiracy" was supposed to consist of several parts, each based on a different corporate takeover. The first and originating phase of the supposed conspiracy involved Walt Disney Company. Corporate raider Saul Steinberg had acquired a position and was rumored to be about to bid for a takeover. According to Siegel, Freeman told him in June 1984 that he liked the stock. Siegel, who was managing a secret arbitrage account as well as leading an M&A unit—a combination never allowed at other firms—claimed he called his Kidder Peabody colleagues and told them to load up on Disney stock.[17] When rumors circulated that

Disney might pay "greenmail" to Steinberg, Siegel allegedly consulted Freeman, who supposedly assured him that that would never happen. But then Disney did pay greenmail, and its stock fell, causing a major loss for Kidder Peabody. This supposedly caused Siegel to be angry with Freeman. When he called Freeman, Freeman allegedly said he had sold his own stock before the announcement. Supposedly this made Siegel furious and so embarrassed Freeman that he began supplying Siegel with insider information on other deals to make amends.

Unfortunately for Siegel's conspiracy allegations, Freeman and Goldman Sachs owned no Disney stock in June 1984. At least as important, trading records show that Freeman and Goldman Sachs did not expect Steinberg to succeed. On June 6, to block Steinberg, Disney agreed to acquire a company called Gibson Greetings. Here the two Wall Street firms' actions diverged: Kidder Peabody aggressively bought Disney stock while Goldman Sachs bought Gibson Greetings. Kidder Peabody expected Steinberg to prevail; Goldman Sachs expected him to fail. Since Freeman would not have had any reason to see Disney stock as a "buy," he would have had no reason to suggest it to Siegel—so there would be no remorse for Freeman and consequently no motive to start a conspiracy.

Another chapter in the "conspiracy" involved Continental Group, a Goldman Sachs client, which was the target of a June 1984 takeover bid of $50 per share by Sir James Goldsmith. Accepting Siegel's recollection that a call from Siegel to Freeman was on a Friday several days after Disney announced it had paid Steinberg greenmail, the actual date must have been June 15. Allegedly, Freeman told Siegel, "They'll sell the company [Continental] anyway," and then Siegel told Wigton and Tabor to buy Continental. However, by June 15, Kidder Peabody already owned 20,000 shares of Continental, and a broad search for a white-knight bidder had been in full swing for more than a week—with one of the candidates a major client of Siegel's. It's not plausible that an M&A maven like Siegel would not have known that Continental was for sale.

In Stewart's book, one alleged conversation is highly dramatized. Starting with Freeman allegedly saying, "It doesn't matter. They'll sell the company anyway," the book continues, "Siegel was astounded. Coming from a partner in the firm representing Continental, this sounded like inside information. He hung up the phone and gazed out over the late-spring panorama of the Connecticut coast. He knew that, in his conversation with Freeman, they had just crossed an unspo-

ken line . . ." Nicely told, but since Siegel had to know—one of his major clients had just signed a confidentiality letter with Continental—he could not have been astounded. More important, Continental Group was gray-listed at Goldman Sachs by Investment Banking and any inside information would certainly have been kept from Freeman in Arbitrage.

By the NYSE close on June 25, Kidder Peabody had gradually accumulated 299,400 shares of Continental Group (not 2.5 million as Stewart's book says), and it later bought another 70,600 shares. For a major firm's arbitrage unit, this is not the urgent pattern of buying that would indicate the use of insider information. More important, Freeman did not get involved until *after* June 25. In Stewart's book, Siegel claimed that Freeman assured him that West Coast financier David Murdock would top Goldsmith's bid, but this doesn't compute because Murdock did not decide to bid until early on June 29, the day *after* Kidder Peabody's final purchase.

In Siegel's version and in Stewart's book, a takeover battle for SCA Services, a waste management company, appears to be an alarming example of a conspiracy, but the detailed trading records contradict that appearance. Siegel claimed that Goldman Sachs had taken a "massive" position and that Freeman was worried about possible antitrust problems and insisted that Siegel provide helpful information. Siegel reluctantly said talk of antitrust was just a ploy to get a higher price and encouraged Freeman to increase his position. In contrast, records show that Goldman Sachs never held a "massive" position, but rather bought only 10,000 shares for $208,000—less than half of one percent of the firm's $50 million policy limit—and only bought that small position five days *after* the press reported that four different companies were interested in bidding for SCA. Finally, there was no basis for an antitrust problem: Thousands of companies are in the waste management business, and all the public companies combined held only a tiny market share.

In August 1984, the battle for SCA heated up, and Goldman Sachs bought shares on August 9, 10, and 13—after SCA said on August 3 that it was considering all options to "maximize shareholder value." Waste Management Inc. announced a tender offer at $28.50, and Goldman Sachs bought another 123,500 shares. Specific details matter. The critical conversation described in Stewart's book—on the basis of which Freeman allegedly made a quick profit using Siegel's

insider information—supposedly occurred on August 13, before the announcement later that day that, Stewart writes, "sent the stock price roaring, just after Goldman Sachs acquired another 57,000 shares." But trading records show that Goldman Sachs did not buy any shares between the time of the alleged conversation and the announcement. Interestingly, Boesky *was* buying a massive position in SCA. He brought 395,000 shares in fifteen minutes before the announcement, paying just under $23.50 per share, or $4 less than Goldman Sachs paid when it bought shares *after* the announcement.[18]

St. Regis comes next. Stewart writes that Kidder Peabody was buying the paper company's stock based on leaked information from Freeman and that David Murdock, Freeman's friend, represented a new threat to the company. Actually, it was Rupert Murdoch, not David Murdock. Since Freeman had never met or spoken with Rupert Murdoch, the name switch is significant. (Curiously, Stewart got the right Murdoch in his own February 12, 1988, *Wall Street Journal* article.)

At the time, St. Regis was on Goldman Sachs's gray list of restricted stocks, which is controlled by partners in investment banking to be certain that no inappropriate trading will be done. Stewart mistakenly attributes control of the list to a "low-prestige compliance officer . . . who wouldn't dare challenge the trading of a powerful partner like Freeman." In the book, he goes on to say that Freeman did trade anyway. But under Goldman Sachs's strict internal controls, that would never have been permitted. (When St. Regis was not on the gray list, Freeman did trade for the firm and for his own accounts—in compliance with firm rules.)

Storer Communications was rumored as a likely takeover candidate in early 1985, and on March 19 Coniston Partners filed an SEC 13D report showing it held more than 5 percent of Storer's stock and declaring that it planned to wage a proxy fight for control of the board of directors as part of its plan to liquidate the company. Freeman *bought* Storer shares, believing Coniston would win a proxy fight and liquidate at $90 to $100 per share. While Goldman Sachs bought, Kidder Peabody *sold* Storer. Siegel immediately began representing Florida Power & Light in a possible white-knight acquisition of Storer, and Kidder Peabody arbitrage subsequently accumulated a sizable stake in Storer while Siegel also had inside information from his client KKR, the eventual acquirer.

In Stewart's book, Siegel claims that he asked Freeman's permission on April 15 to mention Storer to KKR. But this was two weeks *after* Siegel, representing

KKR, had held meetings with Dillon Reed, the firm that represented Storer. (Of course, in M&A, investment bankers do not ask each other for permission to talk to their own clients.) In another date switch, Stewart's book has Siegel telling Freeman secret information on April 20–21, 1985, that caused him to go on a buying spree on April 17. If true, this would have Freeman buying on insider information several days before he received it.

More interesting is that during the week of April 22 Freeman and Goldman Sachs *were* buying stock and calls—exactly opposite to Kidder Peabody's *selling* during the same week. At the start of that week, Kidder Peabody held Storer stock worth over $25 million, all of which was sold that day and next. This 180-degree difference makes it hard to believe there was any collusion or "tipping." Siegel was right to sell and capture profits—if he could be legally or ethically right to sell when, as KKR's investment banker, he had insider information about KKR's strategy—while Freeman would lose money on his trading.

Unocal was put in play on April 8, 1985, when T. Boone Pickens made a hostile tender offer to pay $54 cash for 50.1 percent of the company's stock and, if he got that done, $54 in high-yield bonds for all the rest. Unocal, which had been selling below $35 a share, jumped to nearly $50. To ward off Pickens, Unocal offered on April 16 to pay $72 for 50 percent of its own stock, or 87 million shares. The government's complaint against Freeman alleges that Freeman told Siegel in April that Unocal would announce a partial buyback of its own stock and that the offer would exclude Pickens, and that he specified how many shares Unocal would offer to buy. According to the complaint, Siegel used this information to craft a clever trading strategy: Buy enough put options to cover the shares in Kidder Peabody's position that would not be accepted in the buyback and would therefore trade at a much lower price than it had paid.

Actually, from April 16, when Unocal announced the repurchase plan, to April 24, Kidder Peabody did the opposite. If Siegel had been tipped about Unocal, the correct strategy would indeed have been to buy Unocal puts before April 23. Actually, Kidder Peabody *sold* Unocal puts and bought 150,000 shares—its largest purchase—apparently believing that Pickens would prevail.

Ironically, Stewart observes that "Unocal showed how important seemingly arcane details of financial transactions can be" but 130 pages later minimizes the significance of an error in the government's affidavit in which Doonan,

transcribing a colleague's notes, said the Unocal information was passed in April rather than in May. Stewart sees the damage to credibility that the senior people at Goldman Sachs claimed this difference of a month created as "all out of proportion to the degree of the inaccuracy," but the shift from April to May takes all the excitement out of the information being "inside." By May, Unocal's defense strategy was completely public, and all Kidder Peabody's trading was done after the April 16 public announcement.

Not only was the percentage-proration factor not known to Freeman before it was publicly announced, but this information was public before Kidder Peabody traded. The proration factor was announced before the market opened on April 20, and the settlement between Mesa Petroleum and Unocal was announced later that day. During the next two days, Kidder Peabody sold 46,600 "when issued" shares of Unocal.

Beatrice was the only deal where Siegel's allegations could not be directly refuted. Curiously, Siegel never recalled the bunny exchange. If there had been a conspiracy, it would have made no sense to be indirect. It was standard practice for M&A bankers to confirm those aspects of a story that were favorable to their clients' interests, and KKR would have wanted Beatrice's price to fall.

On *Face the Nation* on February 22, 1987, Giuliani said, "We wouldn't go with a case unless we obviously had confidence in it . . . I'm saying that I don't know of a case where you rely on just one witness and really expect that you are going to be able to win it so I think you can be confident that there's more than just one witness."

Five days earlier a *Wall Street Journal* article by Stewart and Hertzberg had said, "It is known that Mr. Siegel is not the principal witness against Mr. Freeman." Three and a half years later, the U.S. Attorney's Office would inform the court that Siegel was indeed the only witness.

A retrospective study would describe the situation this way: "Never well conceived to begin with, the case against the trio began to crumble as soon as defense lawyers got a look at its details. Here was a virtual conspiracy of strangers: Tabor didn't know Freeman, and Freeman didn't know Wigton. Moreover, instead of subpoenaing the men's trading accounts to see whether Siegel's assertions were true, the prosecutors had simply arrested the men. When they finally did get around to checking the documents, the information in them proved nothing."[19]

Siegel *was* a gifted story teller, he *was* speaking to prosecutors who had

recently been uncovering conspiracies in the Mafia and in drugs. Once the prosecutors had accepted the conspiracy story, they were committed to a very cooperative witness and to a compelling story that fit with Boesky and Milken and Levine, and looked like a straight shot at a prosecutorial success ideal for launching a political career.

Freeman and his lawyers had to prove a negative and show that the Goldman Sachs trading was not triggered by inside information, not illegal, and not based on Siegel's alleged tips, but rather on astute analysis of public information, a much less interesting and often more complicated alternative.

Freeman clearly got too close to Marty Siegel. If other arbitrageurs saw Siegel for what he was, why didn't Freeman? To be fair, why didn't Siegel's colleagues at Kidder Peabody or Drexel Burnham Lambert, who saw him much more often—both on stage and off? He was that good at being convincing.

Compared to Boesky and Siegel, who both deliberately, frequently, and knowingly violated the spirit and letter of the law, the worst that can be said about Bob Freeman is that he went too close to the edge when he called Marty Siegel looking for extra insight on Beatrice, that like many others he was fooled for years by Siegel, and that he was a target of opportunity for an ambitious prosecutor in an era when Wall Street was under dark suspicion.

At five o' clock on a morning in December 1987, a task force of fifty federal marshals, heavily armed and wearing bulletproof vests, with helicopter searchlights overhead, raided the Princeton, New Jersey, offices of a small hedge fund named Oakley Sutton (taking the middle names of its two principals, James "Jay" Sutton Regan and Edward Oakley Thorp, the latter the author of a classic book on how to win at blackjack).[20] The marshals collected three hundred boxes of files and records, apparently hoping to determine whether the firm "parked" stocks for Milken or traded inside information with Freeman in its investment unit called Princeton/Newport Partners.[21] Sutton was a Dartmouth friend of Freeman. They had continued their friendship.

Regan and colleagues at Princeton/Newport were convicted on sixty-three out of sixty-four charges—after only two days of jury deliberation, clearly indicating that other juries wouldn't be intimidated or baffled by complex financial

cases. This convinced Freeman to agree to negotiate a settlement. Said one of his lawyers, "When Bob heard the Princeton/Newport decision, the fight just went out of him." While almost all of those convictions were later reversed on appeal, Freeman did not know what would happen.[22]

The U.S. Attorney's Office began the case with understandable conviction. Just as had happened in its narcotics and Mafia prosecutions, each falling domino of insider trading pushed over the next domino: Levine, Boesky, Siegel, and then Freeman. As the case against Feeeman got weaker and weaker, the political need for closure got stronger and stronger. Giuliani was running for mayor of New York City as a law-and-order candidate and, knowing his case against was not strong, needed a settlement before the November election. This added time pressure. In the end, both sides wanted to put the case behind them; both needed a pragmatic way to close the issue. The talks were accelerated when the Princeton/Newport defendants were convicted because of Freeman's immediate reaction to this news. In September 1989, to limit his losses, Freeman pleaded guilty to one count of the seventeen outstanding. He would be sentenced the following April 17. Freeman's maximum prison term could be five years.

In November 1989, U.S. district judge Pierre N. Leval refused to accept the government's 120-page sentencing memorandum (in which prosecutors wanted the judge to consider other instances of alleged insider training in Storer Communications, Unocal, St. Regis, and Continental Group) and Freeman's lawyer's 800-page response.[23] He asked both parties to confine any reference to insider trading to the one instance on which Freeman had pleaded guilty.

Citing sentencing guidelines that had been put into effect *after* Freeman's events, prosecutors said Freeman should have to serve thirty to thirty-seven months and pay a heavy fine to reflect "the magnitude of the crime and the absence of any excuse." Freeman's attorneys, Robert Fiske and Paul Curran, argued that his crime did not warrant *any* time in prison and, further, that leniency was appropriate because Freeman had suffered from the government's "precipitous and highly publicized arrest."

Judge Leval said, "Arbitrageurs who disregard the law and their practices undermine the integrity of the marketplace. It is precisely because of these facts that the court cannot treat the matter as one of small importance."[24] He continued, "I have received scores of letters that speak very eloquently in favor of a man

who is obviously a human being of value. The particular crime was a matter of temptation, an indiscretion, all of which took place so far as I can see in a matter of minutes."

In imposing the sentence, Judge Leval described Freeman as a "very chastened person," noting that letters to the court described him as "generous, responsible, and honest." The judge said Freeman did not require "punishment of a serious nature." Still, Leval felt he was compelled to look beyond Freeman's character and assess what impact the sentence would have on preserving the integrity of the financial markets, and for that reason he believed incarceration was necessary. Reading slowly from a yellow legal pad, Judge Leval said, "It has astonished me to read in the press that conduct—illegal conduct, criminal conduct—of the nature before me should be condoned or treated as a trifle because it's done every day." Calling Freeman a man of "eminence, power, and wealth," Judge Leval said, "I cannot pass a sentence that would give the world a message that when people in those positions violate the law, the court would treat it as trivial whereas when a common thief steals a few dollars, that calls for jail time."

Because it was limited to the single Beatrice case, Freeman's lawyers described the settlement as a "vindication," but an SEC official retorted: "The guy is a convicted felon. We obtained full injunctive relief against him and a ban for three years from the industry. That doesn't sound like vindication to me."

On August 17, 1989, Freeman had resigned from Goldman Sachs after nineteen years and pleaded guilty to a felony—not insider trading, but mail fraud. The Supreme Court's fairly recent decision in *Carpenter v. United States*, 484 U.S. 19 (1987), had established that anytime an employee or agent deprives his or her employer of exclusive possession of confidential business information, an embezzlement in violation of the federal mail-fraud statute has been committed if someone somewhere uses the mails even in only an incidental way. Under this interpretation, Siegel and Freeman had in effect embezzled a form of property—confidential information—from a client: Beatrice. A charge of mail fraud gives the prosecutor a tactical advantage because the materiality of the information is no longer as relevant; it's enough that the information constitutes "property." The mail-fraud statute now has a civil injunction provision that would give the prosecutor an alternative to criminal indictment.

Freeman paid $1.1 million (twice the losses avoided by his trades plus seven

years' interest) to the SEC and agreed to stay out of the securities industry for three years. After nine months of discovery and pretrial, Freeman agreed to four months in prison—he was actually sentenced to one year, with eight months suspended—and a fine on a nolo contendere plea with a prearranged agreement to leave the securities business and perform four hundred hours of community service.[25] (Other "insider" convictions had resulted in lifetime prohibitions.) Freeman was not obligated to cooperate in the government's investigation and was understood to deny any other wrongdoing.

Freeman's prosecution showed the degree to which the line between what was civilly actionable and what was criminal was rapidly disappearing. The case was never criminal until Freeman and Giuliani's office needed a way out. The plea bargain accomplished that.

Martin Siegel was designated a "very cooperating witness" who "spent countless hours" and was identified as a "credible and reliable" witness. Siegel's lawyer, Ted Rakoff, made a case for leniency, and Assistant U.S. Attorney Neil Cartusciello made an unprecedented, even stronger case for leniency. Judge Robert Ward spoke at length about the importance of Siegel's cooperation and the importance of such forthrightness for successful law enforcement. Adding a statement about the importance of deterring white-collar crime, Ward said he had considered a sentence of eighteen to twenty-four months, but had concluded that Siegel must serve time—though less than Freeman. He settled on sentencing Siegel to two months in prison, five years on probation, and community service at a computer camp.

Bob Freeman served out his four-month sentence (with time off for good behavior, it came to 109 days) mostly mowing the grass on the golf course at Pensacola Naval Air Station, during which time he lost the thirty pounds he had gained after his arrest. "Saufley [a federal prison at the naval facility] was small and did not have the same homosexuality and violence that higher-level prisons have," said Freeman. "But it was not a country club, and this was not a country club experience." Freeman did his four hundred hours of community service and then spent two years settling his civil suit with the SEC. In the summer of 1993—six and a half years after his arrest—he was legally free of suspicion and accusation.

As it turned out, Freeman made a mistake in calculating his odds. Like any good arbitrager, he calculated the odds and decided on the facts and probabilities as he saw them to plead and settle for one year in prison. His calculation was accurate but not right. Had Freeman waited another year, he would almost certainly have been let go, and all charges would have been dropped—as happened to Kidder Peabody's Wigton and Tabor, who had been accused by Siegel of trading on inside information from Freeman.

Freeman's real penalties were the distress imposed on his family, the cloud of suspicion that would hang over him—*Oh yeah, Freeman. Isn't he the guy who got caught trading on inside information?*—having to leave a high-paying job at Goldman Sachs and not participating when the firm went public.

28

BUILDING A GLOBAL BUSINESS

"Most of us really didn't know much of anything about Europe or the UK or London," recalls Gene Fife, who was going to London from San Francisco in 1985, only a few months after triple bypass surgery and in the first year of a second happy marriage.[1] Fife had no budget and no authorization to hire people, didn't know Europe, and didn't know any partners who spoke a language other than English.[2] No division head in New York had any international experience, so Fife would have no knowledgeable supporters. Fife was chosen, according to Jim Gorter, because in establishing the firm's investment banking business in California, he had demonstrated the ability to build business almost from scratch with little help from headquarters in New York—and that was what he was expected to do in Europe from a headquarters in London. It would be challenging.

"Goldman Sachs was not Goldman Sachs in London," recalls Fife, in his understated West Virginia way. While John Whitehead had made an articulate conceptual case for international expansion, the firm seldom sent top people overseas because the management committee didn't believe in the business potential

and didn't want to incur more cost than necessary.[3] With a few stellar exceptions—particulary in stockbrokerage, where strong leadership was already showing what could be accomplished—the firm had two kinds of people in London: people it couldn't or didn't want to fire who had been told to move there or leave the firm, and people who were content to work with second-tier people.[4] London was considered just a cost center, so the strategic objective had been clear: Keep the costs low enough that London's losses would be tolerated. This, of course, produced a strategy designed for—and doomed to—only very limited success. The London office had had no overall vision beyond simply selling American stocks, U.S. government bonds, and some Eurobonds for U.S. corporations like Ford. None of this was, or was even hoped to be, more than marginally profitable, and it led nowhere. It was clear to Fife that massive change was needed, particularly in investment banking. "Our challenge was to replicate Goldman Sachs in London and across Europe so the firm looked, felt, and tasted like Goldman Sachs as much as McDonald's is McDonald's in Frankfurt, Germany, or Toowoomba, Australia. To do this global branding, we had only one choice: Our standard must always be excellence." The firm would have to become truly international in capabilities and commitments.

This meant first, that many people in the London office would have to go and, second, that it would be nearly impossible to recruit people with the expertise the firm would need to make consistently astute moves and avoid "outsider" mistakes. In addition to these strategic challenges, Fife would also encounter specific problems. Shortly after his arrival in London, he got a disturbing call from the manager of Claridge's Hotel: "Two of your young people who have stayed at Claridge's for some weeks have this day been required to leave our hotel. They have made a deliberate shambles of the room in which they have been staying, and they have been intolerably rude to our staff. We will not permit such arrogant behavior. From now on, Mr. Fife, they are persona non grata at Claridge's. This hotel is *not* a playground." Nor did it fit with Fife's mandate.

In 1986 the management committee made a major strategic commitment to Europe, sending ten top performers to develop a comprehensive strategy for the firm's business in London and across Europe. Each New York division had its own "strategy" for London. Fixed Income was selling U.S. government bonds and Eurobonds

to Europeans—at very low profit margins. Investment Banking and Debt Capital Markets were selling sovereign bonds "won" by competitive bidding against Japanese firms that cared only about volume. Goldman Sachs bankers were pleased when the firm won a Eurobond mandate for an important U.S. client and "only" lost $300,000. Goldman Sachs was losing $100 million annually in London, and all the other U.S. firms were losing money too. But change was in the air. So was opportunity.

Turning to the first of his challenges, Fife could have fired everyone, but that would have been unnecessarily hurtful for the individuals and for the firm, so he developed a different plan. Meeting privately with each banker, he said, "Not a word will be said here or anywhere, but you need to find another job that really suits your capabilities and interests much better than your present position. Take the time you need to do it right, and in not more than six months be sure you have completed your search so you can resign from the firm and move along with your career. We'll help you, but your next job is your choice to make and it's your responsibility to make it—just as it's our choice to do this with dignity and consideration for you as a person."

Fife's gracious way of dealing with people paid off: There were no unpleasant stories in the London newspapers about massive layoffs at Goldman Sachs. And one of those obliged to leave would call Fife a few years later to say, "A newspaper reporter is trying very hard to get some dirt—*any* dirt—on Goldman Sachs." The caller gave the reporter's name and paper so the firm could preempt the adverse story before it got printed—a lesson for Leo Durocher that nice guys sometimes win.

In late 1985, Woolworths UK was being raided by another retailer named Dixons. Goldman Sachs had signed a contract with Woolworths to keep that company's stock price up at an agreed level, and Woolworths had agreed to indemnify the firm against any losses. This agreement was customary practice in London at the time—but the provision for reimbursement was illegal. When Fife found out, he called Woolworths' chairman to say, "This agreement is against the law, and we as a firm will not do what we have agreed to do. We urge that you should not either." People at Goldman Sachs were angry: They knew this change meant they would lose money if they continued to support the market price of Woolworths' stock. The chairman agreed with Fife, and Goldman Sachs kept

the Woolworths account. A year later, one of London's storied merchant banking leaders—Morgan Grenfell—was stunned when caught in the same sort of illegal operation in the Guinness affair, a scheme to prop up the price of the brewing company's shares; with this violation, that firm was on its way to being out of business, and its CFO was sent to prison. Fife explains, "Leaders should always set the bar high—very high—and then find the way to meet that standard. Trust and consistent execution make you the preferred supplier. Any compromise on standards, and you're sowing the seeds of your own destruction."

In London, Fife insisted, "We need strong people in each line of business—bonds, stockbrokerage, banking, and M&A—strong, experienced young stars." Easily said, but certainly not easily done. It was a fight for every person and for every dollar to pay salaries. Jim Gorter was, for a brief period, the firm's designated "international coordinator," so Fife went to him with his problem. Gorter agreed that Fife could cherry-pick his people. Knowing that Bill Landreth wanted to return to the States after ten strong years in London, Fife asked for a suggestion to head European equity sales. Gorter proposed Bob Steel in Chicago as a guy with the guts to go—even though his wife was pregnant. For Fixed Income, Fife tried Rick Garonzik, but he said, "No, thanks." So Fife asked Jon Corzine if he could have John Farmer, who was working in California for Corzine. Corzine had already tried to get Farmer to move to New York and was sure he would never move, but Fife knew that Farmer's wife treasured summer vacations in France and, while not interested in New York City, was far from parochial. The Farmers were delighted with the chance to live in London. Farmer's commitment convinced Garonzik to change his mind a month later and agree to go too. For banking, Fife wanted Peter Sacerdote, but Geoff Boisi vetoed that and instead offered Don Opatrany, who proved effective and a strong team builder. Fife recalls, "Each man was a true culture carrier, and all were prepared to make a serious commitment and talked openly about staying ten years—a crucial difference from the prior two- or three-year tours. This small group of strong performers gave me the nucleus we could build from."

David Fisher, a leading analyst at the world's leading international investment manager, Capital Group, was guest speaker at Goldman Sachs's equities divisional conference in 1985. Richard Menschel asked him, "So, David, if you

were going to build a strong research effort in Europe, what would you do?" Fisher had no trouble with that question: "Send some guy like Jeff Weingarten to Europe and let him figure it out." Weingarten, an all-star beverages analyst, had had a fight with research director Lee Cooperman, so he was eager for a change. He was soon on his way—with some advice from Cooperman: "Hire a few high-profile superstars and cover the rest with smoke and mirrors."

Weingarten knew recruiting in London would be hard: If, by analogy, S.G. Warburg came to New York and offered him a position, why would he leave Goldman Sachs? His case for joining an American firm would have to marshal a series of strategic reasons that astute analysts would find compelling. Fortunately for Weingarten, Big Bang had the City of London in turmoil, and mergers were making—or threatening to make—some talented analysts redundant. So analysts were looking for strong firms—firms like Goldman Sachs.

Leading British firms expanding onto the Continent invariably thought of having two separate research departments: one covering companies in the UK and another covering Continental companies. This gave Weingarten a decisive opening: His strategy would be pan-European. Investors wouldn't care about geography: They would want the best ideas industry-wide. Another advantage that Weingarten had going for him: Goldman Sachs analysts could link with investment bankers, which would enrich their expertise and their career opportunities. Weingarten's strategy was to concentrate on the very best analysts and to focus within this group on those who liked to work hard and would get excited about building something new and different as part of a winning team committed to building a strong European presence. Within a few years, Goldman Sachs was the first American firm to break into Europe's top ten in research.

"Our first priority is to generate significant profits," said Fife. "After that, our priority will be to elect partners so we can make the decisions and the moves that will enable us to continue earning profits." He knew he would need support, so to show the still skeptical management committee that Europe represented large opportunity, Fife went to the Guildhall Business Library, took *Fortune*'s list of the world's largest corporations, and showed how, over the years, European corporations had kept moving up in the rankings and how rapidly they had grown. Fife also knew he could sure use a local, experienced guide for the climb.

Realistically, the people of Goldman Sachs were so far out of touch with the

British market that they didn't know the white hats from the black hats, or which lawyers were best at which legal issues, or how the British government worked. "We were in London physically," recalls Fife, "but we were clearly outsiders and certainly not part of the City or even knowledgeable about London. And none of the established firms had any interest in our ever finding out how the City really worked." His first challenge would be getting accurate information and reliable understanding of London's realities. His second challenge would be in recruiting. Fife was determined to build for the long term—a major change in strategy.

Not only was Goldman Sachs almost unknown in the UK, but most of the people it already employed there were not going to attract outstanding new people—quite the opposite. Adding to the problem facing Fife, Americans had a reputation as short-timers who visited fairly well but had no intention of staying for the long term. A *Euromoney* cover caught the prevailing feeling in London by showing young, arrogant American investment bankers streaming off the Concorde, planning to stay for only a few days before flying back on the Concorde. They were known as "pigeon bankers," investment bankers who "fly over, dump crap on us, and fly back."

Salomon Brothers had recently terminated a large group of London employees, almost all of them British subjects, so Britons whom Goldman Sachs might want to recruit would ask, "Why should I join you, knowing that promotions, particularly to partnership, will mostly go to Americans, but that if you ever have poor earnings, you'll sack the English like me and send the Yanks safely home to New York?" Not an easy question to answer. Titles might help; since partnerships were hard to earn and "vice president" was so widely used that it meant little, a new title—executive director—was invented. To get an objective, external appraisal of why stellar university graduates were not willing to join Goldman Sachs, Fife retained a UK consulting and search firm.[5] Its report was blunt: American firms were seen to "hire up and fire down"—adding people in good times and dismissing them in cyclical downturns. In addition, American firms filled their key positions—department heads and partners—with rotating Americans, not local Britons. The search firm's report explained that Goldman Sachs could change these perceptions and establish trust only by recognizing that "people won't believe what you say—only what you *do*, and exemplary behavior will be crucial." Mere words would not suffice; the only way to counter such worries was to use convincing symbols and take action. So Fife

never even considered living in a rental flat or in the firm's handsome apartment on Chester Square.[6] He sold it and bought a substantial house in London where he frequently hosted dinners for clients and others, including Margaret Thatcher. The symbolism was powerful in England, where "home" has such great meaning. It told everyone, *The people of Goldman Sachs are here to stay*.

Fife knew he needed strength at senior levels all around Europe and was unwilling, as other firms had done, to hire "ornamentals." But he also knew it would be impossible to hire partner-level people with real ability. Moreover, each country in Europe was different in culture, business norms, politics, and customs. In France, the top graduates of the *grandes écoles* went into government for twenty years before being placed in the top executive positions of major French corporations. "We wanted to know the minutiae of how French clients saw each of Goldman Sachs's French people," says Fife. "Frenchmen who went to Harvard for their MBAs are considered 'different'—very able, but *outsiders*. The true French will be wary of them." He knew that he didn't know the inside rules and customs in each country in Europe and that he needed a way to make judgments on social, political, ethical, and cultural dimensions. He needed somebody he trusted to keep him out of trouble. In Italy, for example, bribery was endemic, and Fife was determined not to compromise Goldman Sachs's standards. Only by understanding the most subtle characteristics of each national system and the complex strengths and personal priorities of the key players—a richness of understanding that would take a lifetime to master—could Goldman Sachs compete with local banks. Fife could not afford to spend a lifetime getting going; he needed to make visible, strong progress and significant profits soon. He was trying to figure out what to do when he got a helpful call from New York City.

Eric Sheinberg was on the phone, "I know someone who's leaving the Spanish government who might be interesting for you to meet. His name is Guillermo de la Dehesa. He's a cabinet minister, and he might be interested in a job after he leaves the Spanish government."[7] Fife called de la Dehesa, liked what he heard, and arranged a meeting on his next trip to Spain. In a series of meetings over several months, the two men developed a good personal relationship and established the basis for a constructive working relationship. De la Dehesa would not be asked to open doors or make contacts, and his name would not be bandied

about by the people from Goldman Sachs.* As Fife explained, "We need you as our coach, to show us how things are really done in Spain. Be critical of every aspect of our plans and, most particularly, of our executives. Help us learn what we need to learn. We don't know the personalities or the objectives or the beliefs and prejudices of the key decision makers. We don't know the code of conduct—who really counts, how to act, what to say, or when to say it. We don't even speak the language."

Serving as a country adviser for Spain—and later Latin America—de la Dehesa would be paired with a senior investment banker. Not a mere door opener, he would provide expert advice on Spain's laws, national customs, and practices; coach the firm's bankers on social, political, and commercial dos and don'ts; and identify people to be wary of and people to focus on because they were rising in stature within the nation's inner circle. He would advise on how to develop trustworthy relationships for the long term; on how best to position Goldman Sachs over the years ahead as an important firm to do important business with; and on which law firms and accounting firms to use in different situations. And he would critique Goldman Sachs's performance and suggest changes.

Fife and de la Dehesa worked out the appropriate terms and conditions. Great men would be unwilling just to be advisers—a term that suggests mere show horses—so Fife had Sullivan & Cromwell organize a new company: Goldman Sachs International. He would be the chairman, and country advisers would be vice chairmen and be paid $100,000 a year—soon raised to $150,000—with the opportunity to earn bonuses upto $1 million based on how helpful they were to all divisions in getting new mandates and completing transactions.[8]

For each major country, Fife identified and recruited an expert adviser. "These men had distinguished careers behind them and extensive connections in government and in major corporations," he said. "To say the least, they were initially skeptical. Knowing we had very little presence in Europe or in their home countries and naturally worried that we wanted them only to take advantage

* Both men knew of several firms that had decorative but never really satisfying international advisory boards—including Goldman Sachs, where such luminaries as Henry Kissinger and Robert McNamara gathered to exchange Olympian views. These decorative advisory boards never connected to the real business of the sponsoring organization, and the experts contributed little of substance and gained little insight or understanding that was valuable or meaningful to them.

of their connections and relationships (and perhaps even drop them once we'd gotten connected), they were sensitive to the reputation—fair or unfair—that the Americans come and then go if and when the market cools." So early on, Fife emphasized that the firm was not simply looking to exploit their relationship: "We needed to know how people in each country would think and feel about different questions. We wanted people who would know when we were wrong or about to be wrong—and would tell us bluntly. While not opposed to their help on specific transactions, what we really needed and wanted was their important help on understanding, in their particular country, just how to do each part of our work correctly so we could and would become one of the truly leading investment banking firms in their country."

The country advisers—soon called international advisers—became a loose-knit group and a sounding board on business-development strategies as well as on changing economic and political environments in an integrating Europe. The country advisers would meet quarterly for two days: one day for briefing Goldman Sachs bankers on the most important developments in their countries, and one day for being briefed by the firm's bankers on the firm's latest developments—particularly its new capabilities in investment banking—with detailed insider explanations of specific transactions and the lessons learned.

Fife recalls that two years later, Jean-Charles Charpentier—"a really nice guy who had been covering France for Goldman Sachs but just wasn't right for investment banking" and had been gently let go—called him to suggest three names to consider as country adviser for France. Of the three, one was truly outstanding: Jacques Mayoux.[9] In France, the elite *grandes écoles*, established by Napoleon nearly two hundred years ago, graduate small numbers of carefully selected, brilliant students. The best of these gain the title Inspecteur de Finances, which marks them for life as great men. Valéry Giscard d'Estaing was proud to have graduated third in his class, a ranking that would be respected all his life—and all his life he looked up to the man who graduated number one: Jacques Mayoux. Having been the youngest CEO of any French bank at thirty-nine, Mayoux was now the retired CEO of Société Générale, France's leading corporate bank. Mayoux knew his rightful place: at the very top of the French power pyramid. His agreement to work with Goldman Sachs was a breakthrough, and he proved remarkably effective.

When Total, France's giant oil company, was to be privatized, Total's CEO

had decided on using Morgan Stanley. Informed of this on a Sunday, Mayoux was indignant. "What? Morgan Stanley? This cannot *be*!" He instructed his driver to take him immediately to the home of Total's CEO, where he sputtered: "You dishonor me! This underwriting will *not* be given to Morgan Stanley! This underwriting will—*bien sûr, monsieur!*—be managed by the one correct firm which is, of course, Goldman Sachs! See to it—*immédiatement*!"

Next day, it was announced that Total's giant privatization would be managed by Goldman Sachs, and Total's CEO won recognition for his astute good judgment among France's business elite. If he had not made that decision, Mayoux had made it clear that he would be marked for life as an incompetent.

"Jacques Mayoux spent 150 percent of his time on commercial cut and thrust," recalls John Thornton. "Nothing that happened anywhere escaped his attention. To call on companies he had known, we went to Tokyo, a market he knew well from many years of regular visits." One evening in Tokyo, Thornton went to Mayoux's hotel room to give him a document. The door was open, so Thornton knocked and walked in. On the floor were a dozen books on Japan that Mayoux—in his seventies—was studying so that he could, as he explained, "help prepare the ground" and develop a multistage strategy of competitive battle for business. Explains Thornton, "To develop a distinctive position, you have to get inside the system. Being well liked is just not the same thing as being really respected and on the inside."

Romano Prodi—later the prime minister—became country adviser for Italy, saying behind the scenes, "Don't do this piece of business that way; do it in the following way."[10] When it appeared that the only way to land one major transaction was to pay the customary bribes, Prodi advised Fife, who insisted that Goldman Sachs would *never* pay bribes, on a series of moves that not only led to the bribe-seekers being so boxed in politically that they couldn't block Goldman Sachs's getting the mandate but also had important observers applauding the firm and the decision to award it the mandate. Recalls Fife, "After we won that mandate, we did a *ton* of business."[11]

Nothing was obvious or straightforward about getting fully accepted at the highest levels in all those different countries," remembers Fife. Brian

Griffiths was the next to last in the first group of eight international advisers. He had served as Margaret Thatcher's chief domestic adviser and became the only Thatcher cabinet minister to be made a lord. For Goldman Sachs, he may have been somewhat less commercially oriented than others, but he knew all the ins and outs in the British government and was crucial to Fife's understanding the British context during the complex and difficult Maxwell affair.

The circle of international advisers was built one by one over three years into a formidable force. Victor Halberstadt of the University of Leiden, with an international career in academia, government, and business, had a strong "make it happen" way of working around the world. Rounding out the group was Peter Sutherland, who had recently been recommended by Thornton. As luck would have it, Sutherland, the head of the World Trade Organization and former director general of GATT, and Fife were soon seated together on a transatlantic Concorde flight and had ample uninterrupted time to develop rapport. Sutherland soon agreed to join.[12]

As Fife notes, "The more we invested in our country advisers, the more we got back from them." International advisers counseled Fife and were effective mentors to Goldman Sachs's country and product specialists. They paved the firm's way at many major companies, and when paired with an outstanding senior banker, they soon learned to become very effective commercially.

In Germany, the firm had two international advisers: Hans Friderichs, who had served as minister of Economics and as Helmut Schmidt's key adviser, and Klaus Luft of the Nixdorf computer firm. At Davos, Switzerland, Fife met Richard Breeden of the SEC, who wanted great companies like automaker Daimler-Benz to list in the United States. Breeden would help with regulations if Fife could create interest. Friderichs was close to Edzard Reuter, Daimler's CEO, and arranged a meeting in Stuttgart with him and his CFO. Fife proposed a listing on the New York Stock Exchange. When the CFO, surprised and miffed, doubted that Goldman Sachs had the necessary stature to represent mighty Daimler, Reuter bluntly instructed him: "Starting now, this and other important business will be done with one American firm: Goldman Sachs!"

Within Goldman Sachs, there was plenty of opposition to making a major commitment to Germany. As Bob Mnuchin saw it, "The markets are too small and too controlled by the locals to make any trading money." Steve Friedman said, "The big German banks have everything all tied up. We'll never break in." Opening the Paris office had been easy; Fife simply did it. Opening an office in Frankfurt met specific resistance, particularly among some Jewish partners. John Weinberg understood. Direct as always, he said, "I was there right after the war, and saw and heard things you can't even imagine."

But Fife was determined to find a way. Mark Winkelman and Jon Corzine recognized the importance of Germany for bond dealing and foreign exchange, so those divisions committed before security sales did. Fortunately, Bob Rubin was supportive and put the question in his usual probabilistic, risk-reward analytical way: "If it fails, so what? The cost will be small. We can close it off at any time. And we're big enough as a firm to try to push the envelope." Arthur Walter, a German-speaking lateral transfer from First Boston, opened the office in Frankfurt. After the Berlin Wall came down in 1989, Goldman Sachs handled many transactions involving the rationalization of industry following Germany's unification.

Fife had yet another problem—a structural problem in the way Goldman Sachs was organized. "As head of the London office, I had all sorts of responsibilities, but *zero* authority." All real power was with the division heads in New York City. If Fife had any authority at all, it came from the soft powers of communication and persuasion or was derivative—derived from making the divisional heads look good.

Challenges within the firm were at least as daunting as those external to it. On a trip to Spain in the mid-1980s, Fife learned that Telefónica, the national telephone company, would be privatized. Telefónica was so large that it would require global distribution, a task clearly beyond any Spanish organization. This may have seemed a major opportunity for the firm, but Fife's initial probing found that Telefónica's CEO held a negative view of Goldman Sachs. The feeling was mutual among many within the firm. Learning that Telefónica's financial vice president would be coming to New York City, Fife contacted New York for help. No interest: "Gene, are you sure Telefónica is a company we want to work for."

Then Fife got a lucky break. In 1987 Bob Rubin called Fife on a personal matter: "Judy and I always leave New York during Christmas, and this year we plan to go to Spain. Can you suggest the best hotel and a couple of first-rate restaurants in Madrid?"

"Sure, Bob. The best hotel is the Ritz, and I'll get you the names of a few special restaurants. While you're in Madrid, could you spare one lunch for an important prospect?"

"Gene, this is a holiday!"

But Fife persisted, and Rubin relented. In Madrid, he met first with a Spanish cabinet minister to discuss the first partial privatization of Telefónica. Later a private dinner was arranged for him and the CEO and CFO of Telefónica. It did not go well. As Rubin reported to Fife, "Gene, all he did all evening was to throw sand in my face because we do no research on his company." But Rubin had made a strong impression, and Eric Dobkin, the partner in charge of common-stock offerings, agreed to organize the syndicate and document Goldman Sachs's record of achievement in telecom underwritings. Over the next several months, the firm developed the basis for taking the mandate away from First Boston—which planted stories alleging bribery—and earned a fee of $13 million, equal to the total international revenues of Fife's first year a decade earlier. Two more large privatizations of Telefónica were underwritten, in 1995 and 1997, with Tom Tuft in charge for Goldman Sachs.[13]

To teach his colleagues in London the realities of their challenges, Fife organized a panel consisting of the CEOs of British Petroleum, Unilever, and BAT Industries to articulate how they saw Goldman Sachs's strengths and, particularly, its weaknesses relative to the competition—with special emphasis on their specific reasons for not choosing to use Goldman Sachs. It was devastating. The cold summary: When visited by Goldman Sachs bankers, the British executives limited their thoughts to just their U.S. activities, because they had learned that that was really all Goldman Sachs bankers would talk about. While they enjoyed those conversations, their most interesting and most important business challenges were spread all over the world: a financing in Indonesia, an acquisition in Argentina, a real estate lease in Hong Kong, and so on. All these business challenges were beyond the capabilities or knowledge of One-Track

Charlie, the banker from Goldman Sachs, and only a small fraction of the total fees they paid for investment banking services were for services in North America.

After jump-starting M&A successes in the United Kingdom, John Thornton was promoted and put in charge of the Investment Banking Services relationship bankers for the continental countries. "The formula we used in the UK was the right formula for country after country," recalls Thornton. "Each country had *one* main city—at most two. The pecking order is unspoken, but known to everyone—like in a small town or a secret society. Reputations are formed by actions, and people make judgments. Concepts are not complicated, but execution is, so execution is always more important than strategy in building a reputation." But when strategy is wrong, it will dominate.

During the same years, the strongest British merchant banks made an organizational and strategy blunder. While Goldman Sachs was expanding its strategic options and adding substantial, deployable resources, S.G. Warburg boxed itself in strategically by acquiring small, go-nowhere subsidiaries in Spain, France, Germany, and other countries, draining and dispersing its capital and its managerial talents.

When Thornton took over IBS in Europe, the unit had twelve people. Knowing the key to success is not only to have people who are high in both energy and ability but also to focus them on the most important people at the most important prospective clients, Thornton decided to reorganize each salesperson's efforts. "In Finland, we had a good man, but he was 'covering' 120 companies and spread way too thin. I asked him to make a list of the twenty most important people in the country and focus all his time on those twenty people. He and I both knew that would create a problem. If he focused on just twenty and any of the other one hundred did a transaction, someone at the New York divisional head office would surely be quick to demand to know why we had missed that piece of business. So I said I'd take the heat on those complaints."

Thornton sat down with each IBS man to review his list and the frequency of his calls on each key prospect. He was looking for each of his twelve people to make one or more significant calls every week. Of the 240 "priority" prospects—twenty for each of the twelve—only twenty-six had been called on even once during the

past three *months*. After that first review, the number of calls drifted upward, but still only one-third of the prospects was getting periodic visits, while one-third was getting occasional visits, and one-third was getting none. But Thornton stayed at it. After nine months, all 240 prospects were getting calls or visits *every week*. And those calls kept shifting toward more and more senior executives. Thornton kept reminding everyone, "Sure, the treasurer is important, but the CEO is more important." Thornton summarizes, "The goal was to be able to make significant calls three to five times a day—*every* day. We wanted a disciplined, systematic way to insinuate ourselves into the power structure."

Thornton joined in the hunt and aimed for an elephant. "We were doing little business with BP.[14] I figured out that John Browne was, in time, going to be really important—probably CEO—so I started calling on him. In my first visit, I realized he was brilliant, shy, and reserved. We got nowhere. In thirty minutes the meeting was *over*.

"On the second call, I took Mark Winkelman. Zip. Nothing.

"Then I invited Browne and his mother to dinner with my wife and me. Both women were sick that evening, so Browne and I were alone. I decided to open up to him, making myself vulnerable. That's when everything changed, because he saw he could trust me. The dam broke—for me. But for competitors, the barriers were at least as high as ever, and maybe even a little higher because now I was on the inside."

Browne soon advanced to CEO, and BP became a major client of Goldman Sachs.

Thornton adds, "After building the requisite relationships of trust and depth, our long-term goal was to do consequential transactions for the market leaders. You worry about what drives your client and where you can be indispensable. This takes time. Meanwhile, you have to pay the light bill. It's easy to get a mandate to sell a U.S. business for a UK company, but this proves almost nothing. The proof comes in doing real work on really key matters."

Goldman Sachs's business-development strategy was to build out in larger and larger rings, starting with U.S. transactions, such as acquiring U.S. companies for European corporations, issuing commercial paper, or selling European stock and bonds to U.S. investors. The next round of expansion was based on helping German or French or Dutch companies do deals in Europe outside their

national borders. And the highest level of business development was to win mandates for purely domestic business inside the company's own country against the leading local competition. This was done in one country after another by winning international mandates and then overservicing each client company until it decided to use Goldman Sachs for domestic business.

In Germany, Deutsche Bank was so dominant in every way in financial markets that great firms like S.G. Warburg willingly confined their German banking business to specialized one-off transactions or studies for smaller companies that Deutsche Bank really did not care about—the proverbial crumbs off the high table—always being careful not to challenge or offend the giant. Goldman Sachs took the opposite approach. It had a shocking, almost ludicrous ambition to which it was absolutely committed: *We are number one in America, the world's largest and most sophisticated market, and we* will *be number one in each major country in Europe—including Germany.*

Phil Murphy, a rising star and a strong leader, went to Germany and learned in a crash course to speak German. Good enough when working directly with clients, he was superb at organizing and motivating the people of Goldman Sachs from within—and swore and drank like the unabashed Irishman he was. Open to new ideas and new people, he was absolutely committed to the mission of establishing Goldman Sachs as the leading investment bank in Germany. However, determined resistance by the established banks was certain.

"When I was at S.G. Warburg," says Tim Plaut, who took over the firm's German business in 1999, "we won a small mandate to sell bonds with warrants as a result of several years of work with the finance director of a major German corporation. Deutsche Bank got wind of it and sent a very senior man to meet with the corporation's CEO and say, 'There has been a mistake by your finance director, who apparently did not check with your CFO and has made a very foolish suggestion to do a financing with some foreign firm. This cannot be. It would be entirely inappropriate. We share this work with only one bank—Commerzbank—and it is their turn to do the next transaction. So please make all necessary arrangements immediately for this transaction to be done with Commerz.' We were promptly excluded and, of course, the transaction was done by Commerzbank. And that same thing will happen again and again."[15]

Murphy would not listen to such advice. Murphy had a plan: Identify the thirty biggest and best investment banking prospects and make them clients of Goldman Sachs. Make a list, get everyone together, and figure out who at each giant corporation really decides which investment banks to use and which products to use. Then figure out how to break through and get to him, and decide who at Goldman Sachs can and would do it.

This, of course, was absurd, except for one reality: No firm had ever tried it. Monopolists and oligopolists are so sure they control their markets that they sometimes make mistakes. They don't always do everything right; they can get too confident, sometimes even sloppy or arrogant. They might leave openings without realizing it. They get so used to having all the business that they don't work hard enough for the *next* piece of business. And the world keeps changing—in technologies, in ideas, in priorities—and companies keep changing as people come and go. Some have new priorities, some have new ideas, some have new relationships, and many want to make their mark by doing new things. As Plaut explains, "These people are curious enough to give any interesting firm—even ones they've never seen before—at least *one* short, introductory meeting. If you tell them something new and do it effectively in a way they find interesting, they will see you again."

Murphy put one name at the top of his list—and the room full of German nationals burst into laughter. Outrageous! Never! Not a chance—*ever.* The name: Daimler-Benz.

Murphy then added another name: Siemens. More nervous laughter.

Then one of the German bankers stood to remonstrate: "You start your list with Daimler-Benz and Siemens, so I'll start with these two as representative of the realities you must learn to understand and accept. Daimler-Benz is 30 percent owned by Deutsche Bank. Deutsche Bank has always done *all* their financing—and Deutsche Bank is a jealous guardian of its business. Siemens is another example on your list. It was started in 1885, over a hundred years ago, and was actually created by Deutsche Bank. Today that bank always provides the Siemens chairman."

The Germans at Goldman Sachs were not the only ones who thought Murphy was crazy to be so audacious and presumptuous. Morgan Stanley and Merrill Lynch executives were delighted to learn that Goldman Sachs was going

down the wrong road in the wrong direction, so they would have no need to worry about *that* competitor—at least not in Germany, and probably not in all of Europe.

The German bankers insisted that John Thornton's one-on-one focus on *the* decision makers—a focus that worked so very well in the United Kingdom and Scandinavia—couldn't work in the structured bureaucracy of a large German corporation, where the CEO usually knows nothing about finance and even the CFO is not much involved in capital raising, relying instead on the finance director. And all three of those senior executives and all the directors each have a veto. So for the finance director, there's serious career risk in using a new firm for any investment banking service—particularly a foreign firm like Goldman Sachs.

Murphy wouldn't listen. He was determined.

Weekend after weekend, Goldman Sachs's investment bankers in Germany, like their peers in France, Italy, and the United Kingdom, gathered together in quasi resorts for strategic planning sessions, striving to identify the most important corporations and the best way to get to them. In these sessions and back at the office, there was no talk by any of the group about Goldman Sachs's traditional first priority: profitability. The focus now was on becoming first in the "league tables," based entirely on volume of business done, to establish Goldman Sachs as number one in Germany. Victory first—profits would come later. Corporate prospects were separated into three groups—super league, major, and important—according to how much they paid or would pay in investment banking fees on a rolling three-year basis.

Siemens was one of the first major German corporations to pay fees for investment banking services, and soon became quite a large fee payer.[16] Goldman Sachs worked with Siemens in its acquisition of Westinghouse. It took Siemens eighteen months to agree to sign the firm's fee letter, with the CFO protesting to the very end: "We will sign if you insist, but you will be off the list if you do insist and we'll never do banking business with you again." Any other investment bank might have become discouraged. Goldman Sachs got lucky. The investor relations manager soon took over as CFO. He was a man Tim Plaut had grown up with. Corzine called Plaut that day to acknowledge: "You are taking over Siemens."[17] He added: "I learned a long time ago that when somebody spits in your face, if you're really any good, you do three things: One, declare it must

have been a rain drop. Two, wipe it off. And three, renew your determination and commitment."

The next major target was indeed a giant: Deutsche Telekom. In the run-up to the selection of lead underwriters for Deutsche Telekom, international adviser Hans Friderichs quietly arranged a private meeting with Chancellor Helmut Kohl for Goldman Sachs. Later, at a special meeting of the Bundestag, Goldman Sachs bankers gave legislators a detailed briefing on every aspect of the complexities involved in the Deutsche Telekom privatization. This created the solid political base that enabled Goldman Sachs to win the mandate as the lead international underwriter for the privatization, which became a dramatic demonstration of Goldman Sachs's ascendance in Germany.

Deutsche Telekom was a stunner: the largest-ever IPO in the world, with Goldman Sachs coequal with Deutsche Bank as lead underwriters. This triumph for Goldman Sachs came after six years of persistent hard work and an important lucky break: Deutsche Telekom's capable future chairman, Ron Sommer, had previously been an employee of Klaus Luft, Goldman Sachs's other adviser in Germany. Luft had the guts to insist on coequal underwriters. "If that transaction had been Luft's only major contribution—and it could not have been done without him—it was plenty," says Steve Friedman.[18]

Chairman Hilmar Kopper of Deutsche Bank paid the firm a high compliment by saying, "Nobody irritates me like Goldman Sachs. You get mandates we have not expected you to be even *considered* for!"

Thornton's ability to conceptualize audacious business-development strategies, which worked so well in the UK and then across Europe, would be tested successfully again—this time in Asia. When he arrived, Goldman Sachs Asia had about one thousand people—and was losing money. Thornton had a key advantage: Corzine had agreed to let him select his two top people—Phil Murphy for Hong Kong and Mark Schwartz for Tokyo. "We met for three days and made a list of the ten most important things we wanted to get done," Thornton recalls. "China was central, and since we had almost nothing there it would be hardest—so I took China."

Thornton was central to the rebuilding of Goldman Sachs's Hong Kong operation. "He took charge and set high goals," remembers partner Dinakar Singh,

"and then challenged us to figure out the strategies that could and would take us there. Then he told us to go out and get the people we would need. Fortunately for us, since we had already cut back earlier, we were hiring just when competitors were firing, so we had lots of choices and could hire the very best." Thornton wasted no time following his own instruction: "On a twelve-hour flight, I sat beside a real star from Morgan Stanley. By the time we landed, he had agreed to come over to Goldman Sachs."

After leaving the firm in 2003, Thornton was an outside director of Industrial and Commercial Bank of China, by far the largest bank in China.[19] At his first meeting, the CEO proposed ratifying a business agreement with Goldman Sachs. All the bank's other directors were Chinese government officials who asked tough, critical questions: "Exactly what is the strategy?" "What is the fee arrangement?" "What are the profit shares?" And a string of others. As the questions poured out, it soon became clear that Goldman Sachs was proposing to tie up all the bank's future business without making significant reciprocal commitments to ICBC. The chairman asked Thornton to meet with him privately outside the meeting. He wanted Thornton's advice on how to salvage the deal. Thornton suggested that ICBC should renegotiate the price-to-value relationship. For example, you can get substantive, explicit commitments like having Jerry Corrigan [a Goldman Sachs partner and former head of the Federal Reserve Bank of New York] come several times a year to do seminars on risk management. Do the same in ten other areas where Goldman Sachs has expertise you can really use. Goldman Sachs was soon delivering particularly valuable services to ICBC, and the working relationship between the firm and the bank would prove to be highly beneficial to both.

Still, the experience at ICBC highlighted long-term policy and practice decisions that the firm by then confronted as a public company. Should it have separated its roles as adviser versus investor? More important, the firm would need to develop the right policy on personal investing. As individuals, Goldman Sachs partners bought shares in ICBC that they believed were sure to double—and double again. If this were ever interpreted by the Chinese as an indicator of opportunism, it would show the firm was unworthy of trust over the long term. Members of the Chinese governing elite are all about long term. As an old China hand advises, "They'll find out who you really are and will treat you that way."

Markets are anonymous, so firms can trade bonds, commodities, and foreign exchange anonymously. You need A-plus people to succeed, but you don't need to care about who loses or gets hurt. Nobody even knows you were ever there. It's an anonymous world. Relationship banking is entirely different. The record is cumulative, and clients have long memories and make choices.

29

STEVE QUIT!

In February 1994, Steve Friedman asked partner Bob Katz, Goldman Sachs's general counsel, to stay for a brief one-on-one conversation after the weekly meeting of the management committee. They went to Friedman's office, where Friedman closed the door and took Katz into his very private confidence. For the next several months, hardly anyone else, other than Barbara Friedman, would know what Friedman was telling Katz. (A month later, Friedman met Bob Rubin at the Jefferson Hotel in Washington for another confidential briefing on the same subject.)

"Bob, at the partners' monthly meeting in September . . . I'll make an announcement . . . which I'm going to share with you and you only, but first you must promise me absolute confidentiality, that you will never, ever even mention this to anyone."

Katz understood. When he came over from Sullivan & Cromwell, he had assured Friedman their conversations would always be confidential—with just two exceptions: something criminal, of course, and anything that could seriously harm the firm.

"I'm going to retire from Goldman Sachs later this year, probably in

September." He paused. "And, Bob, you have given me your word to keep this absolutely private—just you and me."

If Friedman or Katz had known what troubles lay ahead for Goldman Sachs, both would have known this would put Katz in an awkward position. As general counsel, his first loyalty was to the firm and not to any individual, even the senior partner. But coming off a great 1993, both men expected 1994 to be another strong profit year. Neither had even an inkling of how badly 1994 would unfold. Friedman believed the firm's strategy was in place. Trading wasn't where it needed to be, but it was clearly progressing. Most of his work had been done. The Maxwell matter was virtually resolved. He felt he had stayed on an extra year already to manage those issues. And he obviously had his mind made up.

Katz asked if he was certain.

"Absolutely certain. I've promised Barbara. This job is a killer, and it'll kill *me* if I stay in it—and she knows that."

Weeks later, in the early spring, Friedman and Katz had dinner together so they could talk through the specifies of transition. They chose an Italian restaurant south of Fourteenth Street that specialized in Tuscan cooking, hoping to avoid people from Goldman Sachs whom they would probably run into on the Upper East Side. No such luck. Mike McCarthy, head of municipal bonds, came over to say hello. A few days later, ironically on April 1, the firm took a major trading loss: $300 million.

After Bob Rubin's 1992 announcement that he was leaving to join the Clinton administration, David Silfen had gone to Steve Friedman to urge him to appoint another partner to co-head the firm.* "No offense, Steve, but leading this global firm has become a huge job—too big for any one person to do alone. You can't possibly be in Singapore and in Frankfurt at the same time. If you think it's too early to name successors, take Roy [Zuckerberg]. He has all the stars and bars you need, and he's great with clients. Let him help you cover the bases. Because as it's structured now, it's a killer job." Frank Brosens, the partner in charge of arbitrage, made a similar suggestion. Friedman had refused even to consider such an idea. "I was never interested in running the firm," says Silfen. "You have to subordinate your whole life to doing that job, which I would not do. With his comple-

* Michael Carroll's October 1994 article in *Institutional Investor,* "Inside Goldman's College of Cardinals," was particularly helpful for this chapter.

mentary capabilities, Roy could have taken up much of the load Steve had been sharing with Bob. And Roy was of an age that made him no threat to Jon [Corzine] or Mark [Winkelman] or any of the other aspirants." Years later, still puzzled by Friedman's rejection of the need for help, some partners speculated that he may have wanted to get out of Rubin's shadow and prove something to himself.

Friedman had already decided who should be his successor, but as he told Rubin during their dinner at the Jefferson, "I can't sell him yet to the others on the committee." Nor could Rubin persuade Friedman to stay longer at the firm. Friedman's hope had been to "give others time to prove themselves," as he said, so he had assigned tasks "to test their leadership and managerial capabilities in different ways." Winkelman and Zuckerberg were to look for ways to upgrade the firm's technology, and Corzine and Paulson were assigned to work together on Asia.

At Cornell, Steve Friedman had won the All-Ivy, Eastern Intercollegiate, and national championships in wrestling, very individual demonstrations of physical prowess and disciplined determination. Similarly, law is not usually a teamwork profession. And M&A centers on intense direct competition against specific adversaries. Successful performers are almost necessarily self-reliant loners. As the pressures and demands of his job mounted to unbearable levels, Friedman relied more and more on the one person he knew he could really trust: Steve Friedman.

Timing matters in championship wrestling and in M&A—and in changing organizational leadership—and his timing would go against Steve Friedman in 1994. Without intending irony, Friedman says he couldn't spare the time and energy during his final year to develop an effective working relationship with another firmwide leader—somehow not recognizing how much harder it would be for new leaders to achieve rapport with each other with no time for developing understanding. Given only seven or eight months, and no warning of what was going on, a "natural" succession solution was unlikely. Friedman's intention to prevent divisive politics by confining the succession selection to just one week at the end of summer would compel a decision, but not necessarily a sound, well-accepted solution. And in February, nobody had anticipated how harsh the markets would become during 1994, especially toward the end of Goldman Sachs's fiscal year in November.

Understandable as it may have been, his determination to go it alone would eventually force Friedman into a corner. He convinced himself that it would be politically too difficult to pick one or two people to work with him; he worried that underlying individual frictions and chemistry issues would fester with a long interregnum. The firm had never had a nonobvious leadership transition before, and Friedman's priority became avoiding a long horse race. But even while accepting that conviction as plausible, almost nobody believes his decision was wise or right. Not right for the firm and not right for Steve Friedman, particularly as the fourth quarter developed.

Goldman Sachs had made a killing in foreign exchange in 1993 by betting heavily against the British pound and had a fabulous earnings year that appeared to prove Friedman right. He really could do it all alone. Friedman's pay was $46 million. But as market-savvy people know, if you live by the sword, you can get whacked by the sword. Great as 1993 had been for profits, 1994 would be just the opposite: it was awful.

"By the end of 1993," explains Friedman, "I was tired—really tired—and decided that December that I would have to quit. Both Freeman and Maxwell were serious problems that took up a lot of my time. Bob Rubin and I had split the long-distance travel, but now I had it all. As interest rates went up, our risk controls proved that we could get all the ratios and correlations right—but even so, the individual traders did very badly, and we had to instruct specific traders to cut back their risk positions. We were afraid of getting caught with a high cost structure worldwide *and* too low a trading volume *and* too little investment banking business—and, consequently, seriously inadequate profits. We had to cut costs a *lot*."

In the spring, Friedman suggested cutting fixed costs, but the management committee, believing the trading problems were only temporary, voted not to cut back. After earning $375 million in December, the first month of its fiscal 1994, the firm incurred a series of poor months—even losses—as markets went against its positions. Maxwell's margin loans were still open, and the settlement was sure to cost the firm a bundle—and meanwhile was taking a lot of management's time and energy. Corzine had raised another $250 million of equity capital from the Bishop Estate, a large Hawaiian endowment fund,[1] but the trading losses dominated everyone's thinking. Large trading positions in Treasuries and the yen were hurting, and a position in gilts in London could go either way quite suddenly.

Friedman was warned that he risked being tarred forever as the guy who quit and ran when the going got really rough, but he had made his decision and was known for persistence. In August 1994, the pressures of managing a global securities business that was struggling financially were spoiling a retreat by the Friedman family to their vacation home in Jackson Hole, Wyoming. Up since 4 a.m., Friedman was working the telephones to the major debt, equity, and corporate markets of the world; absorbing the spot news that the firm's traders in London had just taken another loss of $50 million; and receiving an indignant call from an executive at John Hancock Mutual Life who told him that the insurance company was so angered by the firm's poaching one of its people that he was cutting off all its very modest-volume business with Goldman Sachs and wanted Friedman, as managing partner, to hear directly and personally of this *major* decision. Friedman had never heard the man's name before, and the insurance company wasn't even close to being among the firm's one thousand largest clients, but taking the call, and the heat, was all part of the job—and the immediate reason for Friedman's blunt summation, as a visiting partner recalls: "This job *stinks*!"

"I was never driven to get the job as managing partner," reflects Friedman, who says he had always expected to retire early enough to have a full second career. "I was driven by the mission—the need for change—and that mission was clearly being completed. Actually, back in 1990, we could see the strategic horizon: Fixed Income, while still not great, was clearly getting better and better; the global organization was in place and getting good traction in all the major markets; the culture was transformed with a new strategic dynamism; and the principal investment business was well launched—although the old guard continued to worry and fret over conflicts with clients even though we explained to them that there are always conflicts, but you could manage the conflicts with full disclosure and making the right choices. And we were making money—profits were at a new and much higher level. I had no problem running the firm except one: I was not enjoying it. Client-relations meetings were everywhere and all the time. I'd get back from a hard trip to Europe and have three different client meetings—all of them urgently needed—on *Sunday*."

As the *Wall Street Journal* blandly noted, "Like its Wall Street peers, Goldman was hurt when the yen rose against the U.S. dollar and interest rates rose

around the world. [The firm had been betting heavily against the yen's rise and was carrying huge bond inventories that plummeted in value when interest rates shot up.] Mr. Corzine concedes that Goldman 'fell prey' to the sudden shift in interest rates earlier this year. 'Like a lot of other firms, we were not fully attuned to the market,' he says."[2]

Jon Corzine and Mark Winkelman had agreed to establish two large arbitrage trades in the firm's proprietary trading account. One was a municipal-bond arbitrage. The other was in London. Both positions had been established too soon, and the markets were still going massively the wrong way on both. Corzine knew what to do: Buy more! "The worse it appears," he said, "the better the reality. The probability is strong that if we hang on, and even increase our position, this can be a real winner." Corzine wasn't listening to doubts or doubters. *But Jon, strong as that may be in theory, in the real world we could run out of capital or run out of liquidity or run out of time before your "sure thing" comes home and pays off.* As losses piled up in the fourth quarter, liquidity wasn't threatened but the firm's capital fell nearly to the minimum required by the SEC. Bob Hurst recalls, with admiration, "Jon had brass balls, and plenty of guts." But Corzine was a partner, and many other partners—including Steve Friedman—did not have his market experience, his trading expertise, or his ability to maintain calm. They saw the large, repetitive losses, and they were deeply concerned, even frightened.

"Steve was suffering from the grinding stress and strain of the job," recalls another partner. The markets were unusually difficult, and Friedman was not a deeply experienced risk manager, so he wouldn't understand how to deal with uncertainty the way Rubin always had. Where Rubin would create trust and calm, Friedman's habit of asking many challenging questions could make tensions worse. Some worried about Friedman's health. People could see that the pressure was getting to him and were saying, "You look green," or "Steve, you look gray and ashen." Others found it hard to believe he had a health problem at fifty-six. Recalls one of the partners, "No way! Steve's always worried about his health. There's not an ounce of fat on him. Steve always took special care of himself physically. I remember a dinner our key partners held at Primavera for the CEO and senior management of Sears, our oldest and one of our best clients. Steve comes—forty-five whole minutes late. Why? Because he had insisted on going to the gym first for his daily workout!"

During the first and second days of September 1994, Bob Katz called all the members of the management committee to remind them that the weekly meeting usually held on Monday would that week occur on Wednesday, September 7, because Monday was Labor Day and Tuesday was Rosh Hashanah. Attendance, as always, was mandatory. "Whatever your plans, wherever you are, whatever your commitments, *be* there!" This absolute insistence seemed unusual, particularly since, with so many people just coming back from summer vacations, the period around Labor Day was usually a quiet time of year. Bob Hurst called his friend Steve Friedman to ask what this was all about, but he could get no insight—just that it was a mandatory meeting. "Be there!"

On Sunday, Friedman told John Weinberg over lunch and then called John Whitehead to give him a heads-up. Some partners believe he also called Jon Corzine and Hank Paulson. Weinberg said the partners would live through it okay, but not the employees. As an ex-Marine, he kept his true feelings in check that first day, but later his outrage would again and again break loose in angry invective: "Yellow-bellied coward!"; "Abandoning his post and troops in combat!"; and "Cowardice in the face of the enemy!" were toward the gentle end of the spectrum of hostility Weinberg poured out at every provocation for many months. He could not contain himself. He simply could not believe that anyone would care so little for the firm or its partners as to just cut and run. Of course, Weinberg felt double-crossed too. He had identified Friedman and Rubin as his successors, and felt he had carefully brought them along so that they would have the right experience and the right recognition both inside and outside the firm. Smooth succession was an important capstone on Weinberg's own career. Now he was outraged by what he saw as the violence done to the whole concept of loyalty—to the partners, to the people of the firm, and to the ideals of his beloved Goldman Sachs.

Members of the management committee met as usual on September 7. As the firm's leaders took their seats for the meeting, everything appeared normal. As usual, Steve Friedman had his jacket off and his sleeves rolled up. Then, just as he had told Katz eight months before, Friedman delivered his bombshell to the members of the all-powerful committee: "I'm retiring, at the end of November, as senior partner. This is an absolute and final decision."

Silence. Not even a pin drop.

Then Friedman said: "This must be kept absolutely secret for all this coming

week—one day per person in this group is the longest we can keep the secret. Next Monday, the twelfth, is the monthly partners' meeting. It will be mandatory attendance, so every partner will get told at exactly the same time. Between now and next week, all this must be kept absolutely secret." Friedman went on to explain that he had promised his wife that he would leave because he was suffering from serious heart palpitations: "I had heart fibrillation at 160 beats a minute and once spent nine hours on a gurney at New York Hospital with fluid dripping through a tube." He and his wife feared he might be dying, and both agreed that if he did not stop, the job would certainly kill him. Friedman did not say that he had made that commitment to Barbara Friedman nearly a year ago, or that he had told Bob Katz back in February.

The speed to decision now required was completely foreign to a firm that had always been slow, deliberate, and methodical about changes in leadership, even at the departmental level, so that everyone could adjust and get comfortable with the change. Five days was terribly fast. Such speed assumed everyone knew everything he should be considering. Committee members recall feeling that it was not respectful of the importance of the decision, the committee, or the firm. Being rushed by an artificial time schedule felt humiliating.

Friedman broke the firm's pattern of identifying and developing future leaders well in advance, at all levels, and carefully establishing successors. No plans had been developed in the industry's most methodical firm for the most important change that could be made—the change in firmwide leadership. There would be no time for discussions of policy or strategy as context for leader selection. No time for Friedman to overlap with successors. Friedman says he chose to keep the time pressure on the group to "keep politics in the bottle," knowing the usual frictions between bankers and traders. But speedy change was foreign to the deliberate, carefully planned process of continuous adjustment that had been so important to Goldman Sachs's sense of itself and its carefully nurtured image.

Some immediately began to wonder, *By what right does the SOB quitter have any right to say anything—or be listened to?* Friedman, however, confidently expressed clear views on what should and should not be done now and, particularly, on how to decide who should succeed him. Three main questions needed resolution: How would the new "transition" leadership be decided? Internally, just how would the changes be explained to the partners and the employees?

Externally, how would the changes be explained to corporate and institutional clients?

Roy Zuckerberg, the urbane, genial, always articulate, smoothly composed senior partner and member of the management committee, was completely undone. Zuckerberg captured the way everyone felt when, an hour later, he telephoned Silfen (who had had to detour to his local hospital because a family member had had a severe allergic reaction) and exclaimed: "I'm so totally surprised, I can hardly get the words out. Steve has just *quit*. The guy came to our management committee and—with absolutely zero warning or anything—Steve *quit*!"

Friedman did not try to dictate his successor, saying, "I'm leaving. You'll be the ones working with the leader you select, so this has to be your choice. To get started, here are three questions you'll need to ask: (1) Who would you pick to lead the firm? Pick one. (2) Who do you want to work with that one leader? (3) Other than that specific number two, who would you pick as an alternative?"

Only later, as discussion developed, would Friedman's views become clear as he blocked some candidates and assisted others.

Looking back, Friedman still offers a favorable view of his thinking at the beginning of the fateful week: "I wanted to avoid anything that was political, and I wanted to give myself and other management committee members the opportunity to continue to evaluate how different people worked together. We had seen numerous firms in which the succession process dragged on and was the cause of politics and divisiveness—or a long, drawn-out transition with too many hands on the steering wheel. We were convinced our firm could avoid that." In retrospect, Friedman cites the procedural difficulty of not having a board of directors that would, in a corporation, make the decision. After his surprise announcement, the management committee spent Wednesday through Friday at the firm's headquarters at 85 Broad Street. In an endless series of tense meetings, the firm's titans—most of them wholly unprepared, though Corzine and Paulson may have been warned—tried to reach a decision on who would be their leaders.

For the first time in over half a century, the firm did not have a strong, well-accepted leader in control. Signs of politics and personal ambitions quickly began to show as individuals were looking out for their own personal interests, quickly making and remaking alliances and commitments to position themselves advantageously. Everybody knew that the financial stakes were huge and that the

firm—if it did not get too badly hurt by the persistent trading problems—was almost certain to go public: While everyone's focus was on what was best for the firm, everyone understood that when it did, those in the best positions would each be worth well over $100 million. This was no ordinary time.

A week after Friedman's surprise announcement, the firm suffered a major trading loss in UK gilts when the chancellor of the exchequer raised interest rates, foreshadowing the painful fourth quarter.

Looking back years later, Friedman is still convinced he handled the change in the best possible way: "There was no point in talking to anyone on the management committee in advance of the decision. That would have unleashed a torrent of politicking: 'I'll support you, but you're gonna need an experienced vice chairman,' or 'I'm really interested in heading up investment banking,' or any of a whole slew of deals. You'd be amazed how many people have hopes, even expectations, of getting to the top."

David Silfen was clear: He strongly wanted a successful process and transition in leadership, but he was not a candidate. He was quick to admit, "I'm really upset—not at what is being decided, but at how important partnership decisions are being made in a compressed period of time."

Roy Zuckerberg had aspirations, but he was older—a senior statesman to his friends, but perhaps too old and neither an investment banker nor a trader. He was the ultimate relationship manager—or to his detractors, merely a salesman—seen as more diplomat than leader. Some doubted he could handle the tough calls that always had to be made, but maybe he would serve as a placeholder for three or four years until John Thain and John Thornton would be ready. Bob Hurst was too young, not well-enough known across the whole firm and too new to the committee. Besides, he had never recovered from the description of him as Hurst First. Worried that the job demands would imperil his already strained marriage, Hurst had effectively taken himself out of consideration when he said to Friedman a month earlier: "Why would *anyone* want your job? It's no way to live!"

Friedman blocked Mark Winkelman, saying he was "too independent" from the firm's norms. He could have meant that Winkelman was a loner, but being Dutch, Winkelman heard it as "foreigner." The easy reason for avoiding Winkelman was that Jon Corzine, the major contender, was a bond trader—and so

was Winkelman. Not experienced with the markets' complexities or understanding Winkelman's particular brilliance, Friedman did not fully appreciate Winkelman's skill or his leadership style, which had so inspired others. Winkelman was so rational, logical, and quantitatively proficient that he somehow never recognized Friedman's discomfort with market-dependent decisions. Winkelman's native Holland is a nation where people accept blunt, confrontational disagreement, believe deeply in "loyal opposition," and enjoy stone-faced teasing and mockery—none of which were comfortable for Friedman. As some of their colleagues sensed, he and Winkelman seemed almost destined to be on different railroad tracks.

At a management retreat that Friedman had organized earlier that year, Winkelman had been asked to give a presentation on a subject that was important to Friedman. After the presentation, Friedman had repeatedly asked him the same leading question, knowing that Winkelman knew exactly what answer Friedman wanted. But Winkelman did not think that was the right answer, and would not bend. Friedman got increasingly frustrated and showed it. In addition, Winkelman had always focused on doing his work; he had not made time to become a member of the firm's social core. On the management committee, he had no devoted friends or allies.

In contrast, Corzine seemed a sure bet. He was co-head of fixed income, the firm's biggest business. He was also co-CFO, so he knew the numbers. And he was an engaging, natural leader, popular and smart.

Corzine had been on the management committee longer than any other serious candidate, and as CFO he had the broadest and best understanding of the whole firm and each division. He was close to the Bishop Estate and knew the key people at Sumitomo. He was recognized as a great bond trader who had made a fortune for the firm in 1993. And while the huge losses were in positions he had instituted, he understood them better than anyone else. "We all pretty much agreed on Corzine," recalls Silfen. "He was co-head of fixed income, which was becoming the powerful profits engine for the firm and key to overall risks, and he was CFO—clearly not an appropriate separation of powers in a line versus staff structure, but that's the way it was." At the first count, while not unanimous, Corzine had the most votes.

Friedman positioned himself to broker the final decision. Despite having stunned the group with his counterculturally abrupt leaving, he still had personal momentum from past years as senior partner and a large reservoir of goodwill from his many years of hard work and dedication to the firm. In a series of private one-on-one meetings, Friedman worked to gather a consensus. Because all were so taken by surprise, nobody had had time to pair up into alliances the way Friedman and Rubin had done. Firm leadership was too burdensome for just one person; everyone agreed on that but Corzine. If Corzine were to be chairman, the next question was who could work with him, most likely as vice chairman. Almost everyone favored himself for number two. Friedman recommended Hank Paulson as cochairman. Others were opposed. Then Zuckerberg, Winkelman, and Paulson were suggested as a trio of vice chairmen, but Paulson said he wasn't prepared to move to New York from Chicago just to be a co–vice chairman. He had agreed with his wife that they much preferred the values and the people of the Midwest and so would raise their family there.

Friedman met individually with each member of the management committee, working through the "If not you, who?" question and getting views on the optimal management structure. Then he asked that each member put his thoughts—briefly—in writing and fax it to him. While each man on the management committee may have thought or dreamed privately that he should or could be chosen, as the discussions went on and on Friedman pushed harder for "a banker" to work with and balance Corzine the trader.

The choice of Corzine as a consensus candidate provoked Winkelman to say he couldn't, after years of working as co-heads of fixed income, where the two men developed a high degree of trust in each other and shared a small office, agree to suddenly being subordinate to Corzine. "I couldn't do that," Winkelman said, even though he believed that Corzine would certainly be acceptable and could well be an excellent chairman—and that Corzine would be far more successful as chairman with Winkelman as vice chairman. Mark Winkelman and Jon Corzine knew all about each other—all the good and all the bad. "Besides, with the committee having agreed on Corzine, Mark really didn't have a chance of being chosen," recalls Silfen, "because we wouldn't want two people from the same line of business even though Mark was both rational and disciplined."

The choice of Corzine was not so much an absolute vote *for* Corzine as a relative preference for Corzine over others. Corzine, but not the other candidates, was at least acceptable to everyone. "What we didn't recognize at the time was that Jon had always wanted to be senior partner of Goldman Sachs and that that driving ambition had defined the way he built alliances and loyalties inside Goldman Sachs as a natural politician. It was in his blood," says Winkelman. Later others would wish they had asked Winkelman for more information about his difficulties in working with Corzine, but those questions were not raised as the meetings continued at the UN Plaza Hotel and at Friedman's home at One Beekman Place.

Friedman made an increasingly explicit case in one-on-one meetings at his home for selecting "a banker" to work with Corzine. He never had to be specific because, by simple observation, that somebody would have to be Hank Paulson, who was already the person most often chosen as number two. Friedman felt that only Paulson was strong enough to balance Corzine. Such a pairing recalled the success of Whitehead and Weinberg, and fitted the firm's traditional focus on being a leader in investment banking. Almost inevitably, the consensus jelled on Paulson as number two to Corzine.

However, this power pairing faced one major problem: Corzine and Paulson did not get along well, and some of their partners doubted they *could* get along well enough to succeed as co-leaders. Friedman had attempted to develop their rapport by assigning Corzine to oversee bond dealing in Asia while Paulson supervised Asian investment banking, but that had been a nonstarter because the two men found it difficult even to coordinate their schedules. They each went to Asia many times, but they did not go or work together. In addition, some worried that Paulson spoke too bluntly, too quickly, and too often to be put in a top position. For his part, Paulson still had doubts about relocating his wife and family to New York City for just a number two job.

During a meeting at Friedman's apartment on Beekman Place on Saturday, September 10, Corzine and Paulson seemed at an impasse, but Corzine, the people person, always believed he could work with anyone—anyone who would make the commitment to work with him. So he reached out: "Hank, let's go for a walk—just the two of us—and see if we can't find the common-ground basis for an understanding." During their walk, Corzine said warmly, "Hank, nothing

could please me more than to work closely with you. We'll work closely together. We'll really be *partners*." Corzine knew that was what Paulson needed to hear. They came back in an hour with what they thought was an agreement to work together.

While several different structures had been considered, Friedman made it clear in public statements that the enormous demands imposed on the firm's leadership ruled out a single stand-alone chairman such as he had been. Putting the best possible interpretation on the situation a few weeks later, Friedman said, "We were sorting out how we would work together and came to believe [Corzine's and Paulson's] chemistry would be very good, and we had a sense of optimism about it. They wanted to work together." But the compromise, like so many compromises, was inherently unstable: not one CEO and not two equal co-CEOs, but Corzine as senior partner and chairman of the management committee and Paulson as vice chairman.

On Sunday, when the management committee reconvened at the UN Plaza Hotel, Friedman formally nominated Corzine and Paulson and suggested that each man say a few words, answer a few questions, and then leave so that the others could have a discussion. (The two men went to watch the U.S. Tennis Open men's final on TV: Andre Agassi versus Michael Stich.) Approval was unanimous, even though several committee members, particularly Zuckerberg, had strong reservations about the ability of Corzine and Paulson to work together. The decision was still secret. On Monday partners were informed; on Tuesday it was made public.

Corzine and Paulson were vastly different people with different work experiences. While notoriously not a careful dresser, Paulson, forty-seven, was tightly self-disciplined in his work habits. Corzine, forty-eight, was relaxed and informal, knew the firm's operations cold, loved markets and understood taking large positions with managed risks. Paulson worked hard to control or eliminate risk and didn't understand or enjoy markets with all their uncertainties. Corzine *appeared* very open and candid; Paulson *was* open and candid, even outspoken. While both are earnest Midwesterners, Paulson is a traditional Republican, Corzine a liberal Democrat. They thought differently on almost everything and felt uncomfortable with each other's working style. Coming up in very different divisions, working with very different disciplines, and living and working in very

different cities, they had never worked together, traditionally the best bonding experience in a professional firm. Corzine had been elevated to the management committee several years before Paulson, and his fixed-income division had recently been outpacing Paulson's investment banking division in magnitude of profit contribution.

Corzine was great with people but had an awful time telling anyone any bad news. If he was supposed to tell Joe that it had already been decided that Joe was out as a partner, Corzine would call Joe, explain he'd really like a chance to talk, ask if it might be possible to get together for dinner, wonder when might be convenient, and then be deeply appreciative of Joe's making the time on his busy calendar. After their dinner, Joe would know that Jon admired and liked him a lot, and would think it was probably going to be time for him to leave the firm in a few years but that it was a decision on which he would control the timing.

Paulson would call Joe, tell him the decision was final, specify Joe's last day at the firm, and ask Joe what he would like to see included in the official announcement that would be going out on Monday.

Peter Sutherland, remarkably credentialed when he joined the firm as chairman for Europe, wanted very much to be a member of the management committee. Paulson understood that Corzine was to tell him this would not be possible. But after Corzine spoke with Sutherland, that clear, simple message had become transmuted into an assurance that Sutherland would be named to the committee after one more year. When Corzine's partners expressed their dismay, Corzine multiplied their distress by warmly saying, "Not to worry, guys. A lot can happen in a year."

At the partners meeting on September 12 Friedman made his announcement that he was retiring—not quitting, retiring. In a memo to employees the next day, Friedman wrote, "At the end of last year, I promised myself and my family that I would fill my role for one more year and then pass the baton to younger successors. When the job is done with maximum intensity, it can be more than a little tiring. . . . 1994 has been a frustrating year for all of us." In an interview, he conceded, "Yeah, I would have preferred record profits, but if you take '93 and '94 and you average them, you get a record."

"When Steve quit without doing either of two things he could have done instead, he threw open the door for any partner to quit, and several did, on very short notice—some with only a week or two's notice. Steve had two easy and far better choices," says Lee Cooperman. "First, when he told his wife, he could easily have told his partners—so successors could be chosen and work together for six months or so, and then he could say, 'These guys are so great, I'm proud to say we can turn to them even now, so I'll be leaving earlier than I'd planned. Carry on!' Or, he could have told the management committee he had to quit, picked his successors, and then overlapped with them for six months or so, and then given the same speech—'They're great; they're ready; they're the leaders'—and left early. Steve Friedman had a great career, but what he did in 1994 was wrong—wrong for Steve and wrong for the firm."

"Steve's action in suddenly leaving the firm is not at all consistent with the Steve Friedman I knew and admired," recalled partner Bob Conway. "Intellectually honest to the first degree, great mental candlepower, always seeking input from everyone and acting as 'decision central.' In my first year, I remember working on a valuation fairness opinion and needed someone to check out my reasoning and my analysis. I asked Steve, even though he was not involved, to take a look. He closed the door behind us and spent the next hour and a half going over every aspect of the valuation with me. I learned a lot about valuations in that one and a half hours, a lot about teamwork and commitment to the firm, and a lot about Steve."

The *Wall Street Journal*, in an understated articulation of the Wall Street community's surprise, put it this way: "Goldman Sachs had long prided itself on a tradition of carefully orchestrating the leadership succession process by naming heirs apparent and grooming them for a few years before they acceded to the top jobs."[3] The firm had had no experience with a forced transition—particularly when it was losing money—since the days of Waddill Catchings. This time nobody had had time to prepare for the enormous question of succession, and the firm's business was clearly in serious trouble, with those bigger and bigger trading losses. With Friedman's sudden departure, partners began to perceive a real risk of the firm's coming apart or even being torn apart by heavy financial losses and sudden defections by partners. The two main challenges were clear: to hold Goldman Sachs together, and to reassure all the firm's clients.

What does Friedman know that I don't know—yet? was the question many

partners were asking. Silfen recalls, "Many partners came into my office to sit on the couch." Despite the best efforts of John Weinberg and many other senior partners to persuade them to stay with the firm, partners' defections accelerated, setting a grim record in 1994: Thirty-four partners, from thirteen the year before, quit. Each additional partner's checking out increased the pressure to leave on the other partners. Some simply caved in. Many decided for the first time to take the calls that came with increasing frequency from headhunters. Investment bankers, perhaps because they didn't really understand how markets could take money away and then later bring it back, didn't know what to think or how to think it out. Since the year's earnings were sure to be unusually low, those who were thinking of bailing knew one certainty: They would be leaving little money on the table if they did decide to go.

In late 1994, as serious trading losses suddenly accumulated, retirements by partners accelerated. Friedman never recognized that his abrupt, unilateral retirement broke the covenant and made it socially acceptable for other partners to leave. Some gave only one or two weeks' notice. Leaving out of fear for the future and personal financial losses, they went limited. That froze the amount of their capital for the six-year payout. *What does he know that I don't know—yet?* A partner who was considered an expert on the firm's finances said, "With things going the way they are in bonds, in just twenty-eight more days, Goldman Sachs will be bankrupt and *over*," and then told Bob Hurst that he had decided to quit.

Hurst countered, "But if you do that now—and others do that now—it won't take twenty-eight days. Realistically, the firm is over *now*."

Friedman, of course, would have disagreed: Fundamentally, the firm was in good shape, the strategy was clear, and liquidity was good. There was no systemic problem. On the other hand, Friedman did not recognize how close to panic many partners were. The fear might have escalated more if hadn't been for John Weinberg's going from partner to partner urging them to stay, and from office to office around the globe telling groups with pugnacious good humor, "Well, we are not going broke today—or tomorrow," and reminding everyone that the firm had always come through the toughest times stronger, more focused, and more effective.

Notwithstanding the firm's reported 1994 earnings of $508 million, partners suffered reductions in their capital accounts after payments to retired partners,

Sumitomo, and Bishop Estate were netted out. While other parts of the firm continued to thrive—the merger business, for instance, was booming amid the frenzy in mergers and acquisitions activity—the firm had taken serious losses in trading. Partners' incomes fell by one-third. The fourth quarter was the worst. Japanese yen and Japanese government bonds both lost money, and the London proprietary trading desk was incurring serious losses. Hundreds of people were suddenly laid off. Even worse than this abrupt break with the firm's long-established understandings of "loyalty up, loyalty down" was the rough, negative way some people perceived their terminations were executed. Gone were the nice words about past efforts or achievements. As one of those terminated said, "People were just trashed." The immediate challenges were to reassure clients, continue projecting the image of a controlled process in changing leadership, cut costs, and hold Goldman Sachs together as financials hemorrhaged and partners quit.

Paulson, in interviews, generally deferred to Corzine, although he did note, "There will be a natural tendency early on to work on the things we already know. We're not locked into any pattern. I am very, very comfortable with this."

Corzine ventured: "I would say Hank and I would like to see our leadership evolve to where we could both have a meaningful view and a participatory role in the breadth of Goldman Sachs's activities. But we want to evolve to that point instead of forcing it on day one or year one or year two."[4]

Paulson had agreed to work with Corzine—in what he had heard was to be an equal partnership—but general counsel Bob Katz told Paulson: "No, Hank. Jon's offer is one and a half." Paulson chose to ignore or overlook this. He didn't want to be number two. But Katz was accurate. Corzine saw Corzine as CEO—period. He had bold ideas of what could and—having decided that Goldman Sachs was not big enough—what should be done in major strategic moves. Corzine had the "I want it" determination to be CEO *and* senior partner. He was exceedingly confident in his own decisions, as a great bond trader should be, but he didn't listen to others once his mind was resolved. This wasn't always a negative. It enabled him to stay on course during the firm's most turbulent times. In the dangerous crisis Goldman Sachs was in, Corzine would show great—and necessary—strength and courage, including the courage of his convictions. As Winkelman said, "Jon showed incredible courage and capability. He was a perfect fit to the need of those turbulent awful times."

Estimates of the equity capital that would be withdrawn by partners leaving in 1994 centered on $400 million—$150 million more than the new capital obtained from Bishop Estate. Few organizations ever survive such catastrophic losses, particularly when they come so abruptly. On the Tuesday before Thanksgiving, Peter Weinberg, Jim Weinberg's son, told partner Chuck Davis in the car going home to Greenwich how sad he was to see partners quitting. The next day, Davis went to Peter Weinberg's office: "I've just spoken to John Weinberg to tell him what I couldn't tell you first. I'm resigning."

That may have been the nadir.

On the Friday after Thanksgiving, partner Tom Tuft went to Peter Weinberg's office to exclaim: "Those guys are making a terrible mistake! We'll show 'em!" That exchange between two young partners came at what may have been the turning point. One after another, partners banded together, committing themselves even more strongly to the partnership and to Goldman Sachs. As partner Peter Fahey observed, "Steve's quitting actually solidified the partnership. The guys who stayed felt challenged to prove they could make it work. This was a big positive."

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COLLECTING THE BEST

Robin Neustein, who would later become a partner at Goldman Sachs, knew she had to change jobs when she was told in 1982 that her employer, one of Chicago's leading commercial banks, required that all after-hours typing be submitted by 5 p.m. so it could be delivered to an outside typing service that would return it the next morning at nine. To Neustein, that measured pace was not even nearly competitive. Explosively talented and ambitious to achieve, Neustein had earned both JD and MBA degrees at Northwestern, plus a CPA, and, having suffered as her father went bankrupt and died while she was a student at Brown, she was focused on earning a significant nest egg as quickly as possible: "I barely breathed until I had saved $10 million."

A friend said, "Go to Wall Street!" So she called New York City information and got the telephone numbers for the top investment banking firms on a list she'd seen in a magazine. Salomon Brothers' operator switched her to personnel. "Sorry, this year's recruiting has been completed. Call again next year." The second firm was Goldman Sachs.

"Be on my side, *please*," she pleaded to the firm's switchboard operator. "I need to talk to someone—a real person—in investment banking. I'm looking for

a job. *Please* don't send me to personnel." The operator took the initiative to connect her to an investment banker, who answered, "Tom Shattan."

"Tom, I was told to talk to you. I'm looking for a job. I really want investment banking, and I really want to work for Goldman Sachs."

"Faith Rosenfeld is managing our investment banking recruiting. I'll transfer you to her."

"Faith, this is Robin Neustein. Tom Shattan asked me to speak with you." After half an hour's conversation, things were looking good, but the bank where she was working was a Goldman Sachs client, so the firm's banker covering the account had to approve. He said no.

Then Bob Conway looked at Neustein's résumé and was interested enough to launch her into a round of interviews with twenty Goldman Sachs people in private placements and real estate investment banking. Gene Mercy made her an offer of $90,000. That was more than she had expected, but Neustein still said, "Not enough. I need more. I've been out of school for two years."

"How much do you need?"

Pulling a number out of her hat and hoping it wasn't enough to queer the deal, Neustein said, "105."

"I'll get back to you."

After two days of anxiety for Neustein, her offer was accepted.

As we've seen, the preeminence of Goldman Sachs has been built out of a multiplicity of skills, ideas, and world-changing ambition and drive. At the heart of it all has always been the ability to attract and keep extraordinary people. Of all the firm's competencies, recruiting must be the most consequential. As John Whitehead says with serene conviction, "If you don't have the best people, you can't be the best firm. But if you do have the best people and you train them rigorously, organize them effectively, and motivate them to do their best work consistently, you will inevitably become the best firm."

In most ways, all the major investment banking competitors are equals. All firms strive to serve the same customers; all firms use the same computers, telephones, markets, databases, airplanes, hotels, and office buildings; all firms are subject to the same regulations; and they all know each other and can quickly

copy each other's newest services. So with all these equalizers, how can any firm get out ahead—and stay out ahead? There are only four ways to gain and keep a significant competitive advantage: more effective recruiting, a stronger culture, a better strategy, and greater intensity of commitment.

When Neustein arrived at Goldman Sachs the norm was at least a dozen or more interviews, and many would have to be with partners. A generation earlier, recruiting had almost always been improvisational. L. Jay Tenenbaum, later one of the firm's most influential collectors of talent—he recruited such future leaders as Bob Rubin, Roy Zuckerberg, David Silfen, Bob Mnuchin, Bob Freeman, and Steve Friedman—came to Goldman Sachs in a most haphazard way during the 1950s. Tenenbaum's father had been a customer's man in a two-man securities firm in St. Louis. His father knew Gus Levy through their work together in railroad and utility holding company securities arbitrage. After Edgar Baruc's death, Gus Levy was playing golf in Boca Raton, Florida, and lamenting to his friend that Sidney Weinberg's son John had just turned down his offer to take him on as his assistant. "Why not my son L. Jay?" Why not, indeed? After serving in the 10th Mountain Division, the six-foot-one young Tenenbaum had sold ladies' dresses in Iowa, the Dakotas, and Nebraska and was a municipal bond salesman in Arkansas. Leaving for an opportunity in New York City would not require much consideration, so when his father saw him, he just declared, "Pack your bags, L. Jay! You're going to Goldman Sachs!" Tenenbaum was soon working for Levy in arbitrage.

Recruiting, particularly at senior levels, is as much about not making mistakes as it is about bringing in great contributors. When David Silfen declined an offer to head up the firm's planned effort to build a junk-bond business, Tenenbaum knew where to turn: "When Bill Bozniak in the bond department refused to have anything to do with our reselling to good customers those junk bonds we sometimes had to take into inventory to accommodate a client, we had to turn to Michael Milken of Drexel Burnham to find a market, just like everybody else." With all Wall Street dealers going to him, Milken soon had control of the market in all junk issues—and Milken knew that anyone wanting to sell junk bonds needed him and his bids. So, at twenty-four years of age, using the techniques of analysis invented by one of his professors at Wharton, Milken would call into a firm like Goldman Sachs and say, "I know you have a big position you want to sell—and we both

know you can't. So I'll buy half a million at $70." Milken knew his offer was way below the market because he *was* the market. He set the price because there was no other dealer. As Tenenbaum reflects, "Milken showed brilliance in how well he knew his market and how it worked—and how and when to be very bold."

Tenenbaum invited Milken to breakfast. But first he checked with I. W. "Tubby" Burnham, Gus Levy's old friend and the longtime head of Burnham & Company (which, after two mergers, would become Drexel Burnham Lambert). Burnham reported his considered judgment on Milken: "He is very smart, but he has larceny in his soul. If he's watched, he can be a real winner. Are you *sure* you want to offer him a position at Goldman Sachs?"

Tenenbaum said, "We can watch him over here," to which Burnbaum replied, "Well, you better watch him very carefully." Tenenbaum arranged to make Milken a compelling offer: The firm would put up the capital, and he would get a good salary plus participation in profit sharing, whereby selected nonpartner employees got to participate in the firm's profits plus a 15 percent "carried interest" in their bottom-line profits *and* a special bonus. For a young man joining the firm as a lateral hire, this was an unusually powerful offer.

"No deal," said Milken. He insisted on two things: First, he wanted his own *independent* department, and, second, he wanted to pay himself 30 percent of his profits.

"No way would we do that," said Tenenbaum. "The payout was way too big—and we knew from prior experience with an insurance-stock trader how many issues and arguments there would be over cost allocations."* Milken stayed where he was, built a spectacularly profitable business, got paid over a billion dollars, drove Drexel Burnham Lambert into a notorious bankruptcy, was convicted of breaking several federal laws, paid a record fine, and went to prison.

"No matter how carefully you screen when recruiting, some people that just don't belong will get into the firm," laments partner Joe Ellis, for many years the dominant analyst in the retailing industry. "I'm glad to say we've lost some bad

* Years later, when Tenenbaum's son called on Milken—looking for a job and armed with his father's introduction—Milken was at the top of his career in junk bonds. Milken began the conversation directly: "The job is yours if you decide you want it. I owe that to your father. If you take the job, for the next five years you'll start with me every morning at four a.m., which is seven a.m. in New York, and work until five or six p.m. Day or night, seven days a week, you're on call if I want you. I'll *own* you. After that, you'll know the business cold and will have made some real money." Young Tenenbaum did not take the job.

people, and there's nothing that strengthens the good in a firm quite like removing the not-so-good." Or avoiding the wrong people entirely. The true cost of a bad senior hire is ten to twenty times the pay package. Partner and former research director Steve Einhorn says, "Recruiting people of exceptional talent and character—good moral compass, decency, and integrity—is vital to the success of any professional firm and yet is always underestimated. We wanted to give our analysts the opportunity to succeed, and we attracted talented young analysts by showing them how they could become the number one analyst in their sector by staying here. We had a compact that if they worked hard, knew their industries really well, and gave great service to clients, the firm would never bring in a lateral hire on top of them. They knew they could go all the way if their talent and drive would take them there."

Einhorn illustrates the importance of this policy by explaining how the firm dodged a bullet in the dot-com bubble market. Jack Grubman—who shortly after became the poster boy for investment banking abuses by securities analysts—was being courted by investment bankers at Goldman Sachs as a lateral hire to cover telecom companies and do deals in that fast-changing industry. Grubman had an investment-banking-deals focus and a detached view of compliance. He wanted to be free to operate outside the organization of the research department and did not want to be accountable to the research director, and said so. Einhorn recalls, "Bringing him in over our existing analyst in the telecom sector instead of advancing the man we had trained there seemed unfair to me. Besides, he was *not* nice to work with."

Einhorn explains why he himself joined Goldman Sachs: "Niceness, intensity, and integrity are the three key words to describe Goldman Sachs—and why I joined the firm. I really didn't consider any others. It can sound almost trite, but really respecting and really liking the people you work with—not just a select few, but *all* the people you work with—is so important. Good people attract good people and very good people attract very good people and make them want to stay. I had a wonderful twenty-eight-year career at Goldman Sachs."

Hank Paulson, Bob Hurst, and others insisted that the firm should hire Grubman. Jon Corzine didn't want to confront the issue, so he withdrew from the recruiting process, and Einhorn was able to block an offer. But the second time around, Einhorn got overruled and the firm made Grubman a big offer: $25 million. Citigroup's CEO, Sandy Weill, topped the firm's offer significantly,

and Grubman, fortunately for Goldman Sachs, stayed where he was. Soon after, his employer, Citigroup's Salomon Smith Barney, paid a civil penalty of $400 million—by far the largest penalty paid by any firm in the "analysts case," where serious conflict-of-interest transgressions were uncovered.

Convinced that recruiting the best people was strategically the only way to become the best professional firm, Whitehead had set out long ago to systematically recruit the men with the greatest promise of becoming the best investment bankers. To be sure of success, he did the on-campus interviewing himself, striving to add one or two stellar people each year. In the late 1950s and early 1960s, few Wall Street firms interviewed MBAs, so Goldman Sachs had little direct competition. Determined to develop intense commitment within the Goldman Sachs system, Whitehead recruited "intensity" people who gave out clear signs of hungering for achievement. Selection was to be based on three equally weighted criteria: one-third on intelligence as measured by grades and SAT scores, one-third on leadership as shown by roles in extracurricular organizations, and one-third on ambition to achieve.

The recruiting net was thrown wide; the firm interviewed almost everyone who was interested because some might become clients in the future. On purpose, the firm's offer was—in comparison to today's $150,000-plus offers—stunningly small at $3,600, even if adjusted for inflation. Whitehead was determined never to pay more than other companies and preferred to be known to pay *less*, because if the firm could get the best for less, that sent a message that there must be something special about Goldman Sachs. Whitehead insisted on truly outstanding people, but he had no interest in egotistic "stars"—he was looking for team players who would stay for their careers. Many interviews—some deliberately tough, some deliberately easy—were used to give the candidate a cross-sectional view of Goldman Sachs and to assess whether he would be satisfied with the team concept that was rapidly becoming the required distinguishing characteristic of Goldman Sachs people.

As Bob Conway recalls, "John Whitehead *knew* that recruiting was the most important thing we could ever do, and that if we organized sooner and better and worked at it harder and with more skill, we could identify and attract better people more often. And if we did this consistently, we would build a better

and better organization and could become the best investment-banking firm in America—and in the world. As John put it—and he really meant it—'Recruiting is the most important thing we can ever do. And if we ever stop doing recruiting very well, within just five years, we will be on that slippery down slope, doomed to mediocrity.' "

Conway got memorable proof that Whitehead meant what he said. Scheduled to go with the recruiting team to Stanford Business School when an urgent matter came up with Ford Motor Company, then the firm's most important client, Conway didn't know what to do, so he went to Whitehead. "John, I'm not omniscient and I'm not able to be omnipresent. Which do you want me to do? Stanford or Ford?"

Whitehead didn't even think about it. His immediate answer, "Go to Stanford! I'll cover for you at Ford."

As Conway says, "It's choices like that that show you what a leader really believes in. And it was decisions like that that made Goldman Sachs such an effective recruiter." A vital factor in the firm's commitment to recruiting was its use of partners to do the work. When Conway was out recruiting, he always checked the other firms' sign-up sheets to see who was there to represent each of the firms. "Every time, it was the same: Goldman Sachs *always* sent the more senior team." Goldman Sachs doesn't look for top-quartile—or even top-decile—MBAs. Convinced that over the long term there is inevitably a major difference between the top 5 percent and the second 5 percent, the firm focuses on recruiting only the very best young professionals, selecting carefully for such characteristics as leadership, drive, and appetite for hard work. Starting with the 5 percent most qualified and capable, the firm proceeds to sort out the most effective team-playing contributors—initially through fifteen to thirty interviews and then through actual work experience and direct observation to find the very best 1 or 2 percent.

Methodical recruiting for Goldman Sachs began at Harvard Business School when Donald David, who had known Sidney Weinberg during World War II, became dean and joined with Paul Cabot, Harvard's powerful treasurer and Weinberg's great friend, in urging Weinberg to recruit at Harvard.[1] Weinberg quickly agreed to take one MBA each year. An early result was the hiring of John Whitehead, who was then put in charge of recruiting stellar young people for investment banking. Whitehead concentrated on Harvard Business School, partly because he had gone there, partly because it was the leading business school, and

partly because public-school dropout Sidney Weinberg was a convinced "Hahvahd man."

Goldman Sachs concentrated on outstanding students, and within this group looked for team captains and leaders of organizations because they must have had something special that resulted in their being chosen by their peers to lead. After a few years, while Harvard would always be the firm's most important source of talent, Goldman Sachs's recruiting expanded to twenty-five additional business schools.

The team intensity of recruiting at Harvard, Columbia, Wharton, Chicago, Stanford, and Northwestern was an order of magnitude stronger than any other firm's. For every one of these schools, teams of twelve to fifteen people—always led by partners—every year organized ten different visits with the faculty members who knew the students best. Over time, this consistent engagement accumulated powerful momentum.

One of the best indicators of importance within the firm is the stature of the person given leadership responsibility for the effort. In his day, John Whitehead ran recruiting. When Fred Krimendahl ran corporate finance, he also ran recruiting, and it was the same with Peter Sachs. At least as important, there was *no* delegation of recruiting responsibilities to juniors or Human Resources. At each business school, Goldman Sachs recruiters would work with the professors and with the firm's own prior-year hires from that school to identify the very best candidates to invite to initial half-hour screening interviews. Interviewing continued all day. At the end of the afternoon, the Goldman Sachs team would group together to identify the best candidates so that everyone knew which candidates to focus on when the students got to the firm's cocktail reception that evening at the best downtown hotel. During the reception, the top candidates were carefully introduced to the senior partners who had flown in for the occasion. After the two-hour reception, the team from Goldman Sachs huddled again over dinner to decide which students should be invited to the firm for more interviews. Invitations to visit Goldman Sachs's office went out the next day.

Offering salaries were carefully calibrated, based on each school's graduates' average starting salary for the year before. The firm stuck to that conservative barometer and hardly ever made an exception. For the people Goldman Sachs hired, it was rarely the highest salary they were offered. Always stressing the

long-range opportunity of a career with Goldman Sachs, the firm wanted recruits to weigh other factors, believing that those who accepted jobs because of salary were more inclined to leave later for a higher offer from somewhere else. The worst thing the firm could do was hire someone, train him for a few years, and then have him go elsewhere for more money.

Goldman Sachs was one of the first Wall Street firms to focus on recruiting carefully selected MBAs from leading schools as securities salespeople. This worked for the firm and for the recruit because at Goldman Sachs, experienced salespeople earned several times the average for salespeople on Wall Street. Recruiting for securities sales was led and carefully controlled for many years by Richard Menschel, who explained, "The secret to success is always the same. Carefully hire very good people and let them grow." Menschel devoted considerable time and care to selecting individuals who had unusual drive but would also be team players. The right people would respond well to the exacting discipline with which he managed each person's professional development, creating loyalty to him and loyalty to the firm.

Menschel was always the final interview for anyone coming into securities sales. This was his way of asserting complete control over all hiring decisions, and he made it clear that he, unlike some other department heads, had no patience for campaigning: If anyone promoted a candidate for security sales, Menschel would be sure to reject that candidate. To show job candidates just who was in charge, he would make the candidate wait—sometimes for a long time. And his decisions were as absolutely final as a papal election. When hiring picked up in London, Menschel still insisted on making all the hiring decisions, so candidates would be flown to New York, ostensibly for a day or two of interviews, but really for just that one hour with Menschel. In one peak-volume year in the 1980s, Menschel interviewed nine hundred candidates from thirty-five business schools and selected just twenty-three. His only comment: "Better people and better training mean a better product."

George Ross, the regional office manager in Philadelphia, was an accomplished talent spotter. He focused on Wharton and developed a close relationship with the dean, who gladly told Ross who were his school's best people. Ross then focused on recruiting those "high potentials," including Eric Schwartz, David Ford, Eric Dobkin, and John McNulty.

After earning a BA at Dartmouth, Lew Eisenberg did his MBA at Cornell. Soliciting Gene Mercy for United Way in 1966, he was asked if he'd like to talk with Bob Menschel about a possible opening in securities sales in Chicago or St. Louis. Having grown up in Chicago, Eisenberg was interested. The financial arrangement was careful: a salary of $6,200, the potential for earning a 20 percent year-end bonus, and—since he would be a "visitor" in New York City who would later be assigned to work elsewhere—an extra Manhattan cost-of-living allowance of $75 per week. When Eisenberg later agreed to stay in New York, Menschel arranged to have that $75, which by then had been used to pay off $2,000 in school debts, subtracted from Eisenberg's paycheck—a pay cut of 25 percent. Such tightfisted cost discipline was pervasive at Goldman Sachs in the sixties and seventies.

Extensive interviewing was becoming a firm tradition. Even in the sixties, Bob Menschel had interviewed with *every* partner because, as a "family firm," that was the Goldman Sachs way. It gave the firm multiple opportunities to assess a recruit's capabilities, interests, and personal fit with the firm and it gave the recruit an informed basis for deciding whether to make the commitment. As Conway says, "You could, of course, say that our commitment to interviewing was carried through to a fault. We took so long to make decisions with our multiple interview process that some people were lost to other firms, particularly those firms offering 'exploding' offers where the offer blows up if not accepted in a specific, short period of time." Interviews were deliberately varied in topics, tone, and content; assessment of capability, personality, and fit was cumulative.

Like everyone else who was new to Goldman Sachs, Peter Sutherland was surprised in the 1980s by the extensive interviewing process. "I learned that as international chairman, I was the thirty-second person to interview a new hire who came to us without experience and that all the e-mail campaigning I had experienced about this absolute tyro was all part of the process of, by far, the most aggressive recruiting I'd ever seen. Even more surprising to me: That extreme behavior was *normal* at Goldman Sachs. An unrelenting drive to get *all* the best people."

Partner Michael Evans adds, "Where we differ most from other firms is in the attention we pay to retention. Goldman Sachs's standards of care for its professionals are simply the best in the industry. We hire the best and work hard year

round to retain them through intensive training and mentoring." Recognizing the firm's unusual emphasis on teamwork and fitting into a consistent pattern of unrelenting work, Evans identified the potential problem: "The one possible negative of our approach is that the firm has less tolerance for nonconformist behavior."

Goldman Sachs has long understood the strong power of attraction that the most highly talented and interesting people have for each other, how engaging it can be for unusually capable people to know they'll be on a steep, challenging learning curve, and how motivating and energizing it is to be part of a winning team. Of course, large financial rewards are motivating too, and for many years Goldman Sachs has paid its people better than other firms as they develop and perform. Goldman Sachs soon learned that being explicit about its high standards, hard work, long hours, and extensive travel can be a powerful positive magnet that attracts top people with ambition and the will to excel, particularly if they believe the competition to get ahead is and will always be fair. In its annual review for 1990, the firm wrote: "We will continue aggressively to recruit the best people, to ensure that they are well trained, and to work hard to maintain a culture that both supports and motivates them. We are committed to advancing our people solely on the basis of merit. This is a major investment in terms of time and energy, but it is an exceedingly productive one."

Of course, there is a flip side, as the 1990 *MBA Career Guide* noted: "While we think we give people outstanding opportunities, we also demand much from them. Our people work long hours and weekends, sometimes in very pressured situations. Many of them travel a great deal. The demands of the job often require them to make personal sacrifices. We believe we get an unusual degree of commitment from our people because they attach a great deal of importance to our firm's shared values."

Partner Peter Fahey recalls, "We recruited intensely because we were determined to be the very best firm—*and* have some good fun. We had the process down pat." In the 1960s, the process started with recruiting the best first-year students at Harvard Business School for summer jobs at the firm. This provided the opportunity to observe each summer associate closely for aptitude, attitude, and ambition. Starting with two "summers" each year, the firm increased the

number to several dozen in the eighties. Recruiting summer associates gave the firm a low-cost option on potential hires and an effective way to evaluate each person as a longer-term candidate. All those who worked at Goldman Sachs and then returned to graduate school become part of the dragnet set to find other talented, personable, driven team players who might qualify for career opportunities at the firm.

In the late seventies, recruiting was extended to include college graduates without graduate training. "Goldman Sachs has a fixation on the accuracy of data," says Fahey. "We simply do not trust the publicly available data from sources like Compustat, so we decided we needed bright beginners to do data-entry work. That's when the associates program began. We brought in very bright graduates of the top colleges to do this work—and soon learned they could do lots of other things that were even more valuable."

As the competition for talent intensifies, recruiting is extended even further and now begins with college juniors looking for summer jobs between junior and senior years. The best of these are invited back for the three-year associate program designed for college graduates expecting to go to business school. The best of these, based on direct observation of their skills, drive, and commitment to the firm and its culture, are invited back as MBA associates. And the best of these are advanced to greater and greater responsibility. Those who do not keep up are let go in a repetitive Darwinian process of selection. The very best leadership performers, after extensive and intensive evaluation of their capabilities, drive, and commitment, become partners and take the lead in the rigorous, disciplined recruiting process. With all the evaluation and peer reviews, and direct observations, errors are few and the success rate very high. This systematic process produces 75 or 80 percent of all recruits, but room is also provided for 20 or 25 percent of recruits to "come in from left field" each year—people like Robin Neustein.

At Goldman Sachs, college graduates typically work from 8 a.m. to 6 p.m., break for a quick supper, and then work until 9 or 10 p.m. At midnight—even at 2 a.m.—the floor will still be busy. Workaholics are normal.

College recruiting is much riskier than MBA recruiting, where today most candidates have already had three years in the firm's associate program before going to business school and many have worked at the firm one or two summers while in college. Even then, Goldman Sachs spends an unusual amount of time

interviewing and evaluating each candidate. When new recruits get to Goldman Sachs, their indoctrination into the firm's culture and principles begins immediately and is seen by everyone as a high priority.

Developing senior people from within the firm has long been part of the compact at Goldman Sachs and central to the culture of teamwork; loyalty up, loyalty down; firm first; and staying at Goldman Sachs for a full career. No matter how skilled the individual performers, an all-star team is never as strong as an excellent experienced team. Performing well as a team takes time and practice, learning who does each function particularly well and who is best at helping each individual do his best and enabling the group to do its best. "Losses of strong people are very disruptive," explains Richard Menschel, "partly in the interrupted relationships with clients, but even more seriously in the internal loss of the closeness, trust, and superb teamwork and coordination that characterize the very best-performing firms." People of ability and ambition need to know that if they make their career commitment to the organization, the organization will protect them from the dreaded career-breaking risk of an outsider being brought in over them. Deep commitment comes when three levels—mental, intellectual, and emotional—combine both for each individual and for all the individuals who comprise the organization. With few exceptions—and only in unusual circumstances such as a major, rapid expansion in a new market or a new business—Goldman Sachs has almost always promoted from within.

Intensity of commitment can spill over into offensive behavior, and it did so more than once. While interviewing at Stanford Business School in the late seventies, a Goldman Sachs recruiter asked a woman candidate: "If it was important to your career—say you were working on a long, complex deal—would you get an abortion so you could stay at work at the firm?" The fury unleashed among the Stanford MBAs by this crude question was exceeded in only one place: John Weinberg's office at 85 Broad.

"But, John," said Bob Rubin, "he's so young. He's only twenty-five. He made a mistake."

"Yeah? When I was twenty-five, I'd already been leading a Marine platoon

in combat. You're not too young at twenty-five to have enough decency and judgment to know a lot better than to say something as dumb as that!"

That incident was unusual but not unique. In 1970, also at Stanford, James E. Colfield Jr. was advised that his candidacy could not be considered because he was African American. Colfield sued the firm and received an out-of-court settlement. The firm was banned from recruiting at Stanford for a year.[2]

As with any strength, consistent success can harbor a weakness or a problem. John Whitehead had a grave concern that he decided to emphasize at the annual investment banking planning conference in the late seventies: "There is one thing on my mind tonight. It worries me and I'm not quite sure what, if anything, to do about it. It has done great harm to some of our competitors and could do serious harm to Goldman Sachs. What worries me is the early indications of a serious disease that can be quite destructive in a professional service firm. We must all be diligent to prevent and eradicate it here at our firm. And that disease has a name we don't like to use, but we must. It's . . . arrogance. If any of you has *any* suggestions at *any* time on how we can prevent arrogance, you know I'd appreciate your help. Who would like to start this important discussion?"

One hand went up. Whitehead turned and looked toward the young banker. "And what can you suggest we do?"

"John, there's one really effective way to put an end to what you're worried about."

"And what would that be?"

"Hire mediocre people."

31

JON CORZINE

Many people at Goldman Sachs enjoyed Jon Corzine's easygoing, unpretentious ways and saw his unusual thick beard, habitual sweater vests, and interest in pick-up games of basketball or knockin' 'em back with the boys as confirmation of the genial good guy they liked so much.[1] Corzine could put anyone at ease. Now, as he took his new position in 1994, his friends would learn that Corzine had long wanted to be senior partner of Goldman Sachs. He had an agenda and was determined to put it through. Going public was Corzine's strategic imperative as Goldman Sachs's new senior partner. Having served as the firm's chief financial officer, he knew it could not succeed in the global financial markets that were developing rapidly without change, and as a successful bond dealer—who says, "Personally I never had an unprofitable year"—he understood how profitable a risk-controlled, diversified proprietary fixed-income operation could be *if* it had a strong capital base.

Without the substantial permanent capital that public ownership could provide, the firm he loved would be outgunned by competitors, particularly the giant commercial banks and foreign "universal" banks that were aggressively expanding into the underwriting and securities-trading businesses. In addition, the firm would

always be exposed to the unanticipated catastrophic risks that had been the final experience of so many once-famous firms. If it had substantial permanent capital, Corzine knew from experience in the markets that Goldman Sachs could create its own profits—and plenty of them—through the proprietary trading, for its own account, that it now knew how to do worldwide. Without permanent capital, reaching for those remarkable profit opportunities would increase the risks unacceptably. Thorough examination led to one inevitable conclusion: The firm's future—grim or great—depended on substantial permanent capital.

To prepare Goldman Sachs for an initial public offering, Corzine's first priority had to be to save the firm and rebuild profitability by cutting costs. Ominously, the fourth quarter of 1994 showed a major loss. But actual results were even worse: The active partners suffered a net loss for the whole year after their draws and the mandatory payouts to retired partners and to Sumitomo Bank and Bishop Estate.

Corzine understood his mission: Get Goldman Sachs back to financial health and full strength. With the comfortable confidence in him and his values held throughout the firm, his in-depth grasp of the financials, and his recognized prowess as a trader, Corzine had a lot going for him as the firm's crisis leader. Some of his great strengths were personal: a voracious appetite for work; a "patriot's" deep commitment to the success of Goldman Sachs; and an unrelenting, "don't bother me with any distractions" focus once he had decided on his main objective. His strengths were also his weaknesses.

To increase profits, Corzine's obvious first steps were working out of the accumulated losses in proprietary bond trading—losses totaling $2.5 billion—and getting the firm's regular operations and finances back under control; he set out to remove at least $1 billion of the $3.6 billion in operating costs that had accumulated like Topsy in the drive for geographic and product-line expansion and market share. During the prior two years, staffing had increased by more than one-third—from 7,200 to 9,400. Cutting costs meant cutting people and cutting compensation—hard work for anyone anywhere, but particularly hard at Goldman Sachs, which had a long tradition of protecting employees from layoffs and was already distressed by Steve Friedman's leaving, the departures of forty other partners, and the collapse in earnings. By early October 1994, commitments had been made to terminate 450 employees—5 percent—with particular emphasis on cuts at J. Aron and Fixed Income, where the 70 percent drop in

nine-month earnings had been concentrated. Terminations were soon increased to 10 percent of staff, or nearly one thousand people. Professional pay was cut in half, and year-end bonuses were cut from 30 percent of salary to just 8 percent—the lowest in twenty years.

But Corzine was far from being just a cost-cutter. He was a dedicated expansionist, determined to create the opportunities for personal growth that would attract and keep outstanding people. In October, fifty-eight people—by far the largest group ever and two-thirds more than in the biennial class of 1992—were added to the 151 partners who had stayed with the firm. The large number elevated to partnership helped offset the negative impact of the year's much lower cash payouts and helped keep stellar people from defecting to other firms. All new partners were paid bonuses of $500,000 without regard to the performance of their divisions.

Corzine advocated restructuring Goldman Sachs and expanding the organization substantially. As he explained, sustaining the firm's growth could take the profits to new highs before the decade was over. To dramatize his point at a firmwide planning session, he put up a slide that showed just one number: $10 billion. Many were, of course, skeptical at the time. But in a decade Goldman Sachs reported its profits: $10 billion.

In addition to cutting costs, Corzine had another challenge: establishing himself as senior partner with clients, partners, and the powerful management committee. The management committee traditionally had one representative from each major division. But even though membership had been expanded to a dozen, the committee no longer covered all the important business units and, some argued, was too slow in approving divisional initiatives. To increase efficiency, Corzine made two changes. To signal its decision-making power and move toward corporate nomenclature, the management committee was renamed the executive committee and cut from twelve members to six: Corzine, Hank Paulson, John Thain, Roy Zuckerberg, David Silfen, and Bob Hurst. (A year later, when Silfen went limited, Corzine appointed John Thornton.) This leaner group soon proved itself able to make faster decisions. Thornton and Thain had worked well together in London and tended to bond together, as did Silfen and Zuckerberg, who co-headed Equities so effectively.

To broaden participation in governance and leadership, Corzine simultane-

ously established two new and larger committees—each with eighteen partners, including a few from the new executive committee. Corzine would chair the more introspective of the two new groups, the partnership committee, to oversee partnership policies and partner-selection practices and to review and evaluate the firm's capital structure. Paulson would chair the other new group, the operating committee, which was to focus on facilitating communications among partners and between divisions to increase operational coordination, develop annual budgets, approve plans for new business initiatives, and ensure "strategic cohesion with an external focus." Corzine explained that he hoped the broader participation among partners would help spread the firm's culture and mission more widely. Members of all three committees were instructed to represent the interests of the whole firm, not just their own divisions. Skeptics expressed doubts about the real purpose and actual power of Corzine's two committees.

Since he was a bond trader, it might not be surprising that at first Corzine had little interest in developing relationships and rapport with unfamiliar corporate clients, but since he was always an astute politician, it is surprising that he gave so little thought or attention to the new executive committee or to its members, particularly president Hank Paulson. After a satisfactory first year, the strains between the two men were becoming increasingly obvious. "Corzine had to elevate Paulson to equal stature or one of them was inevitably going to have to leave," explains John Thornton. "The structure was inherently unstable, especially given their personalities. His decision to move him up but not as an equal just set the stage for an unhappy outcome."

No formal announcements were needed; everyone knew Corzine was moving the firm toward an IPO.* He was obviously making the moves that would make it easier to get there. Unlimited personal liability was eliminated by creating a limited liability corporation (LLC) as the sole general partner of Goldman Sachs. This meant that the liability of individuals, Sumitomo Bank, and Bishop Estate was limited to assets already committed to the organization. (Homes and personal investments would be safe, but since many Goldman Sachs people had over 85 percent of their total assets invested in the firm, it would not really matter

* Friedman had wanted to do an IPO in late 1993, but fortunately Corzine blocked it. To have had an IPO on peak profits, largely from trading, and then to have reported almost zero profits in the first year of public ownership would have been cataclysmic.

much for most partners.) The length of the capital-payout provision for partners going limited was extended, and in good years part of each partner's earnings would go into long-term capital accounts with an eight-year duration followed by a three-year payout. Corzine never took his eyes off his primary goal of taking Goldman Sachs public. He pressed the case for an IPO with partner after partner in a sustained campaign to accumulate votes for the action he *knew* was right—for Goldman Sachs and for Jon Corzine.

Corzine also made changes in titles. He started referring to himself, particularly externally and with reporters, as the firm's CEO. The most important change was to drop the term "partner" and convert all partners and many experienced vice presidents to managing directors (MDs)—the designation being used by competitors that had already gone public. The firm had long had complaints from the older investment banking vice presidents that in meetings with clients, the title "vice president" was less impressive than "managing director" and that they and the firm were losing business unnecessarily. With the MD title, selected vice presidents would get higher salaries and some perks: offices as large as partners', access to what had been the partners' dining rooms, and attendance at partners' meetings. In the annual report, managing directors would now be listed alphabetically, whether or not they were equity partners, and all would be offered participation shares in firmwide profits. Internally, the new title was mocked as "partner lite," but it was accepted as a pragmatic move because the firm was getting larger, going into more lines of business and more geographic markets, and so required more capital and more organizational formality. (Managing directors were divided internally into two categories: "participating" MDs were partners; "executive" MDs were not.) The MD title would also help with lateral recruiting: It was easier to offer a candidate an MD title than a partnership, and MDs at other firms wouldn't want to step down to a mere vice presidency.

By 1995, partners had become well informed on the issues involved in going public and, more important, had gotten used to the idea. Several competitors had gone public, and Morgan Stanley, Merrill Lynch, and Salomon Brothers all seemed to be gaining competitive strength. The strategic rationale for permanent capital was steadily gaining converts. Among the business reasons for going public—and during this era, they kept gaining in importance and persuasive power—were the size of the partnership and the increasing need for permanent

capital to finance proprietary trading, expensive computer systems, and large, long-term principal investments. Position sizes in dealing were getting so large that the risks were much higher than they had been in the past. The time horizon for payoffs on large principal investments was being pushed further and further out—so the time between risk-taking investment and distribution of rewards was getting further out of alignment with the steady turnover among partners. As profits rebounded in 1995 to $1.37 billion, morale was also rebounding. Partners and staff believed they had weathered the worst, knew they were making progress, and believed more confidently in their future opportunities. The main question increasingly was whether Goldman Sachs had enough capital to finance its expansive ambitions and opportunities.

As the partnership got larger and the business of Goldman Sachs became more diverse and geometrically more complex, partners saw or worked with each other less. The close personal ties of the old "family" partnership attenuated to less and less importance both personally and organizationally. "After large layoffs and then big hiring, a *lot* of people were new to the firm, new to each other, and new to our culture," recalls partner Robin Neustein, who, hoping to bridge the gap, made speech after speech about the firm's past and its values. A partner in Frankfurt wouldn't really know a partner in Singapore and couldn't know much at all about what he did or how well he was doing for the firm. The many newer partners understandably had less attachment to the mystic cords of partnership than the longer-serving partners who either had retired or were retiring. Other changes were powerful: the departures of so many partners, particularly the loss of John Weinberg, Bob Rubin, and Steve Friedman; the emerging politics at the top of the organization; the acquisition of J. Aron, which brought in a very different and unfamiliar business and several new and different partners; and the large capital infusions from Sumitomo in 1987 and Bishop Estate in 1989.[2] The nature of the business and of competition continued to change in major, consequential ways. The business was going global in customers, competitors, and markets, and big balance sheets were increasingly necessary. Restrictive regulations were disappearing, technology was linking once-separate markets, and the "right size" to be a viable competitor was increasing rapidly.

The reasons for going public included both providing the firm the capital required to act swiftly as principals and the increasing importance of capital for

defensive or protective strength: protective against groups of partners going limited in a hurry when times were tough, protective against the balance-sheet power of big competitors, and protective against the risk of a major accident such as a big loss in trading or a J. Aron–chartered tanker creating a disastrous oil spill. The large Maxwell settlement—and how it could have been much worse—was cited as instructive, as were the multibillion-dollar trading losses of 1994.

Corzine spent hours and hours week after week during 1995 trying to persuade individual partners of the importance of an IPO and lining up support. As a result, all partners knew where he stood. In January 1995, Corzine and Paulson met with the combined operating and partners committees to formally propose an IPO. Surprisingly, that meeting was a dud. Even though these senior partners would have the most to gain financially, they were still opposed. Without their support, an IPO would never be approved by the whole partnership. But in his drive to take the firm public, Corzine had already put an IPO on the agenda for the forthcoming meeting of all partners, which was now only two weeks away at Arrowwood in Rye, New York.

As Arrowwood approached, Corzine faced impressive opposition from within. His successor as chief financial officer, John Thain, highly respected within the partnership for his rational brilliance and his unemotional, objective judgment, was clearly opposed to an IPO. Paulson and Thornton supported Thain's position, so the executive committee was split three to three. This was not a good sign. In addition, Eric Dobkin, the firm's expert on pricing large global equity underwritings, said he believed that because so much of the firm's profits came from trading, an IPO would be priced at well under two times book value—a big discount from Morgan Stanley's market valuation at nearly three times book value. While others, including members of the executive committee, sharply disagreed, Dobkin held his ground. His low estimated valuation deflated the affirmative case at the individual partner level, leaving far too little pressure to help Corzine override the traditional "spiritual" concerns about protecting the soft values of the partnership that were important in recruiting exceptional people, ensuring clients' confidence, and governing operations.

Still, Corzine plowed ahead when the firm held its annual two-day meeting at Arrowwood in January 1996. On Friday he presented a detailed capital-structure analysis and the logical case for an IPO. He intended to put the decision through

at the Saturday session and was laying the groundwork for the "Let's go!" presentation he would be giving. Exceedingly political—an apt adumbration of his second career as senator and governor—Corzine pulled literally *every* partner aside for private, personal politicking for an IPO and made a continuous point of knowing the pulse of the partnership all the time. Through dinner and after dinner, he worked to connect with partners, particularly those from overseas offices that he didn't see so often.

As the partners' discussion of an IPO continued, it was increasingly clear that Corzine, while working hard to develop support all day Friday, would not have as much as he needed on Saturday. This was confirmed when the executive committee held a long meeting Friday night. After the committee meeting—at nearly 2 a.m.—Corzine, who enjoys relaxing with a drink, went to the bar, where a crowd of bankers were gathered. Having already had plenty to drink and being all fired up, they expressed a clear consensus on doing an IPO: *No way!*

Just a few hours later, at seven Saturday morning, Bob Hurst knocked on Robin Neustein's door, filled her in on the Friday night happenings, and asked her to go meet with Corzine. The Saturday agenda, already printed and distributed, had Corzine scheduled to speak that morning. But he knew he couldn't simply advocate going ahead with the IPO. That would not fly. So what could he say and do to strike the right tone? Corzine and Neustein quickly discussed what to say, how to say it, and what *not* to say. On a yellow legal pad Corzine wrote out an outline for his talk with a few key phrases, an introduction, and a closing line.

When he got to the meeting room, Corzine found that the young partners had organized their opposition. One after another, they spoke out against an IPO. After an hour, Corzine went to the podium and delivered the astonishing message he and Neustein had crafted, saying: "There will be no IPO. The IPO is off the table. It's over!"

He got it right. For the first time in the firm's history, the partners all rose and gave their managing partner a standing ovation. In the days that followed, congratulatory letters poured in: "We're so proud of you!" "I never felt more committed to the firm than I do now, thanks to you." "You were—and are—a great leader."

But those who knew Corzine best knew the IPO was not over. Although he couldn't force the issue, he wasn't about to give up. Corzine may have lost that particular round—even without a formal vote—but in his long-term campaign,

he had made important gains. And almost everybody came to sense it. "Everyone wanted to be certain to stay for the big bonanza, to protect their own position in the firm—and get rich," explained one of the older partners. "Everyone went on the defensive. The whole firm seemed to slow down while everyone rubbed everybody's back and held on to their positions. This was terribly frustrating to the lower-ranking people who wanted to get ahead."

While failing to win a commitment for an IPO, Corzine had successfully changed the topic of public ownership from "not discussable" to openly and fully discussable. This had an accumulating influence in favor of going ahead because more and more partners were recognizing the importance of permanent capital for the firm and because, on a personal level, the dual desires, once unleashed, for greater wealth and for the power that comes with greater wealth compounded at an accelerating pace. At the same time, the strength of the forces in opposition waned. The old camaraderie among partners, which had been so strong, steadily dissipated, and the power of tradition became less and less meaningful. The fact that a partnership structure had worked so well in the past with a smaller, closer-knit firm with far less capital at risk—and with strong memories of building Goldman Sachs from insignificance to global leadership as a private partnership—carried less and less weight as the firm grew and as more partners worked in London, Paris, Frankfurt, Tokyo, Hong Kong, Singapore, and many other local markets with important local clients that were largely unknown to most of the other partners.

Some older partners argued that what would be sold in an IPO was something special that didn't really belong to those who would get paid the most. A big part of the value was the *past*—and another big part was the *future*. Past partners had created the stature, reputation, and franchise of the firm and most of its business and most of its clients, building the strong foundation for the present profits. So it really wasn't fair or right that all that IPO reward should go to the current—and only temporary—seat holders who were, realistically, just passing through.

Others argued that the *future* earning power of the firm was what IPO buyers were really buying. Bestowing all that wealth on current incumbents meant taking something away from the partners of the future. It would weaken the incentives the firm would need to attract and keep the very best people in the large numbers Goldman Sachs would require to lead a worldwide organization driving

for leadership in all the many businesses that were now so important to its success. To those who felt this way, an IPO would inevitably rob the future. It might not show right away, but it would surely do irreparable harm.

John Whitehead and John Weinberg wrote a carefully crafted, several-page letter to the partners, making their case for not going public. Corzine read their letter aloud to the partners. It was obviously deeply felt and they were both highly regarded, but their era had passed. They were no longer the powerful leaders they had once been. Realistically, the center of gravity of their argument was already behind the firm—and every month, that reality was becoming clearer to more partners. Whitehead was asked years later why he and Weinberg, as experienced investment bankers who must have seen many other long-established business partnerships sell out, had not modified the partnership argument to ensure fairness in any possible future public offering when they had the power. Whitehead replied, "At the time of the IPO, there were 108 retired or limited partners. Back when I retired in 1984, there were eighty active partners and only twelve retired or limited partners, so the situation was very different. That's why we had never seriously considered predetermining the division of a hypothetical IPO."

With the prospect of an IPO deferred but still looming on the horizon, young people eager to become partners before the big payday realized they had an urgent need to find their mentor-sponsor-rabbi, develop their supporters, and make no mistakes and make no enemies. Those aspiring to become partners developed political skills, political alliances, and political capital. Politics takes time, energy, and attention—the same limited resources needed to build or maintain important client relationships and create new businesses. Throughout Goldman Sachs, time, energy, and attention went from being focused 100 percent on clients to being split fifty-fifty: half on clients, half on advancing everybody's own political position. "It was more important to focus inside the firm than outside with clients," said one knowing partner. With an IPO expected to produce a hundred, two hundred, or three hundred million dollars per senior partner, they all knew the stakes were enormous.

Tensions developed between partnership classes, or vintages, as issues clarified. Long-serving partners who had gone limited would get much smaller payouts than the successors they had trained up and to whom they had only recently turned over firm leadership. The forces behind the drive for going public were,

as they always are, partly business strategy and partly personal and financial. It's important to keep them separate. As J. P. Morgan famously observed, "A man always has two reasons for doing anything: a good reason and the real reason."

The sensible business arguments in favor of an IPO added dignity to the pervasive personal fascination of seeing how much each partner's net worth would leap forward. Another strong motivator was the crude but effective "reality" proposition: *If we don't do it, the next group of partners, facing exactly the same question,* will *do it. So be realistic; all you're deciding when you say no is to hand those guys the same fortune on the same silver platter that you and your family could have enjoyed. Nothing else changes. And ten—no, just five—years from now, nobody will give a damn except you, your family—and, maybe though very unlikely, the guys you'll be giving all that money to.*

Corzine would wait for another time to bring an IPO to the partnership, but he would not wait quietly. He persistently urged partners to support an IPO, typically in one-on-one meetings. "Corzine bought votes one by one," recalls a partner, "taking each guy into his office and showing each how much money he would make." Corzine made lots of calls, went to many meetings, and talked the IPO up in every way he could. He did a lot of arm twisting, and he said to many partners, "We'll both be around for a *long* time after the IPO, working together." Corzine's words more than implied the importance of cooperating in support of him as the senior partner—but he never made explicit quid pro quo deals or specific promises. Still, politics flourished. "I told Jon Corzine that it would take ten years to evaporate the internal politics he generated by his drive to go public," said John Weinberg. "We had lots of time-dated greed." Forces in favor of an IPO continued to increase. The magnitude of profitability, plus an increasing view that the strength of the firm's earnings would command a higher price-to-earnings valuation, suggested that individual partners would be getting more if the firm went public—or leaving more on the table by refusing.

During 1997, other investment banks enlarged, broadened, and combined their operations, seriously challenging Goldman Sachs. Morgan Stanley merged with Dean Witter, a major retail stockbroker with strong distribution. Salomon Brothers merged with Travelers—and a year later combined with Citibank to create Citigroup. For $5.2 billion, Merrill Lynch acquired London's Mercury Asset Management, the largest investment manager in the United Kingdom and one of

the largest and most prestigious in Europe with $175 billion in client assets, establishing a "high ground" base from which to build across Europe. Switzerland's UBS acquired S.G. Warburg. Deutsche Bank made a series of tactical acquisitions, recruited senior talent boldly, and expanded aggressively into investment banking and securities dealing; its powerful financial resources—which included over $25 billion of undisclosed reserves—could easily absorb large "investment spending" losses. Global banks were moving with their huge balance sheets into the investment banking and securities business, and regulatory restraints were coming down everywhere. Competition's center of gravity was moving inexorably toward permanent capital and big balance sheets.

"Heightened competition," Corzine observed, "will put a premium on cutting-edge technology, up-to-the-moment intelligence on global market opportunities, the development of innovative products and services, and a redoubled dedication to the customer. Competition will also require a renewed emphasis on risk management and financial soundness if firms are to survive the inevitable cyclical downturns, like the one from which the industry is even now emerging.[3] Striking the right balance between entrepreneurial initiative and financial prudence will be the fundamental test of success."[4]

The competitors were changing and the industry was changing—becoming more global, requiring major capital commitments for trading and information technology, increasing financial risk—and the business of the firm and its earnings were changing from agency-advisory investment banking to capital-at-risk proprietary trading and dealing. By many steps and stages, one partner after another moved from opposing to favoring an IPO. Fifty years before, the firm had had only one partner in the bond business; when an IPO came to a vote in 1998, there were fifty-three partners in Fixed Income and they voted 51 to 2 in favor of an IPO. Immersed in a trading culture, living in a mark-to-market world where everything was for sale, they had learned to be realists and were less enamored of traditions.

Good as 1996 had been in the firm's business, 1997 was even better. Goldman Sachs played key roles in Deutsche Telekom's gigantic $13 billion privatization, the privatization of China Telecom—that nation's first—and the largest industrial merger up to that time, and the $38 billion combination of Chrysler into Daimler-Benz. Profits exceeded $3 billion, taking return on equity capital up over 50 percent—well above the industry's 36 percent average.

As usual, Corzine was deeply and personally engaged in the global markets at any time of the day or night, checking the major markets every morning: a 6:15 call to Lloyd Blankfein in New York, a 6:30 call to Pat Ward in London, and at 6:45, a series of calls to offices in Asia. In addition, if needed for an important decision, Corzine gladly took calls at 2:30 a.m., again at 3:00 a.m., and again at 4:15 a.m. Naturally, more and more of the calls from those who needed a decision went to Corzine, increasing his operational expertise and his leadership strength within Goldman Sachs.

Not all the calls came from people trading in the markets. In 1996, Corzine got an angry message from Christopher Gent, the CEO of Vodaphone, a major client in the United Kingdom. Their business relationship could be terminated because the firm had underwritten a $1.2 billion IPO of Orange, a competitor, without first conferring with Vodaphone. Corzine quickly called Gent to apologize and, as Gent later recalled with characteristic understatement, "We came to an understanding early on of what was expected of them. I expected them to commit to us."[5]

While a partnership is a legal structure, the effectiveness of any partnership depends on informal bonds between partners. As partnerships get larger and larger, the person-to-person connectedness declines and the dynamic of the group changes. Intimacy fades into mere acquaintance; communication losses clarity, subtlety, and effectiveness; and personal warmth and affection decline. While the legal structure of partnership continues, the personal connections dissipate. Into all those spaces can slip tensions, misunderstandings, hurt feelings, and disagreements. Corzine believed he would outlast all the others; he compared himself to Sandy Weill of Citigroup and was determined to be the recognized king of Wall Street. "It's not that he always *thinks* he's right; it's that he *knows* he's right," said Bob Hurst. "That's dangerous."

As Corzine settled into his position as senior partner, the consensus jelled within the firm that he would be there for a long time. Partners agreed: *Jon Corzine will be picking his team for the next decade during the next few months*. Corzine would have good reason for thinking he was in a strong position. Profits had increased substantially; he had secured another major equity investment

from the Bishop Estate; and increasing numbers of partners were recognizing the strategic importance of having permanent capital plus stock to use as currency in acquisitions and to reward strong contributors without having to offer a full partnership. With higher earnings from the rising importance of GSAM and strong trading profits—and the higher price-earnings multiples accorded competitors, the compelling power of great personal wealth was pulling increasing numbers of partners to support an IPO. And the objective case for an IPO was gaining power.

Corzine was increasingly popular within the partnership. But within the executive committee, important changes were coalescing toward confrontation.

"Jon thinks *big*," recalls Bob Hurst. "He had decided that Goldman Sachs was not big enough."

Declaring "I'm an expansionist!" Corzine wanted to do a string of small "shock absorber" acquisitions in investment management and initiated talks with several firms, including Robeco, Wellington, and Grantham Mayo Van Otterloo. Anticipating the inevitable collapse of Glass-Steagall, which had separated commercial and investment banking since the Depression, Corzine initiated talks with the CEO of J.P. Morgan, the CEO of Chase Manhattan, the CEO of U.S. Trust, and the CEO of Mellon Bank.[6] Having initiated a conversation about getting together with a major bank, Corzine would sometimes "adjust reality" and tell his partners that the initiative had actually come from the other party. Seeing himself as CEO, Corzine considered these strategic initiatives appropriate to his position and the powers he wanted, but his partners—particularly those on the executive committee—strongly disagreed. As they saw it, *they* were the ultimate power in Goldman Sachs because they represented the partnership, and within the committee they were all "one man, one vote" equals.

Corzine was off the ranch, as others saw it, going around to firm after firm and bank after bank to "get acquainted" and raising questions with several about possible working relationships or even mergers. His independent strategic initiatives paired in the minds of others with his informal, ad hoc way of making operational decisions. Corzine was often intuitive and seemed to others improvisational and undisciplined, while Paulson was all about careful plans and always had everything worked out in advance. "Corzine kept making seat-of-the-pants

decisions and improvisations," recalls Bob Steel. "He was not buttoned up and had way too many things on his to-do list—way too many to get them all done."

Corzine's discussion with Mellon Bank provoked an especially negative reaction within the executive committee. When he came back from a weekend of unannounced talks with Mellon CEO Frank Cohuet, a partner said he was astonished that Corzine would do such a thing—partly because he didn't have the authority and partly because he was proving how naive he was about the dance of M&A. Thornton recalls saying, "As CEO, you should *never* initiate such a discussion. That's simply very bad tactics. Instead, you should carefully create a set of conditions so the other guy comes to *you*—and comes as a supplicant. The *last* thing a skillful CEO would ever do is go out courting a refusal all alone.[7] You are too inexperienced and you don't know how to play the role of a CEO in doing a merger deal. You have to be disciplined and self-aware. You don't know the rules. And, Jon, you're *not* a CEO; this is a partnership. You are our senior partner, Jon, but you're not our CEO. The management committee—all the way back to Gus Levy—is the responsible party in this firm's partnership. You can't go off on your own doing deals or raising possibilities of merger with others. Besides, you really don't have enough experience in M&A to know how to manager high-level exploratory talks about getting together."

John Weinberg warned Corzine to stay away from a merger with Chase. "Corzine was looking at merging with Chase Manhattan and I told him: 'If you join [CEO] Billy Harrison, he'll tell you he has to retire in a year because he has prostate cancer and will indicate that you can look to become CEO after he's gone in a year or so. But you'll be only one of five guys with the same come-on promise, and the other guys will all know all about commercial banking—about which you know *nothing*. Since that's the core business and since you don't know that business, they'll kill you. Besides, with a big outfit like that, they'll move lots of Goldman Sachs guys into various positions and milk the best of Goldman Sachs away, and then dilute the rest. You'll have no base of support. Commercial banking will be the combined organization's biggest business, so the next CEO will have to be chosen from those who know the main business—commercial banking—and it won't be you!' "

The balance between building the best firm and making the most money had changed a lot," explains a senior partner. "Twenty or thirty years ago, we all

knew that if we built a great firm, the profits were sure to follow. We *knew* that if we were the best firm with the best people, we couldn't miss making big profits. But with a public firm requiring quarterly earnings reports, the focus could shift."

Silfen leaned toward an IPO as a way of adding flexibility to compensation arrangements. "Reward the very best very well," he says, "but you need to find the balance that also holds the very good *and* motivates and rewards the very, very best, who are the decisive value-adders on crucial business transactions or the development of significant new ways of doing business. That's why I was one of those who favored going public—so we'd have the currency of a public stock and a way to tie everybody together with a common interest."

Much as he loved the firm, Silfen knew that being co-head of a major division and a member of the management committee was as far as he could go or wanted to go. He had made more money than he had ever dreamed of, and at fifty he still had ample time to do whatever he wanted in a second career. As a realist who understood markets, he felt comfortably objective about his career decision: It was time to go.

Silfen went to Corzine and laid it out quietly and clearly. The two men had never been particularly close. They had not worked closely together—one was in Equities and one in Fixed Income—and their personal styles were dissimilar. Silfen was careful, focused, and exact while Corzine was open, comfortable with ambivalence, and a risk-taker. Silfen may have had some hopes that Corzine would ask him to stay and perhaps even offer him a special incentive to do so, but Corzine didn't rise to the opportunity. He simply said he understood. "You've had a great run, David. It's your decision to make, of course. Not a problem." Silfen's parting would have little immediate significance to Corzine, but it would lead almost inevitably to Corzine's being forced out as managing partner of Goldman Sachs.

The initial public offering would position Goldman Sachs as an industry leader and make the partners rich, and the members of the executive committee very rich. The irony would be that the stresses generated by Corzine's unrelenting drive to complete the IPO were a significant factor in his approaching downfall. As Corzine said later, "It would've been a lot easier not to get into the fight about going public. I could've just stuck it out another fifteen years and accumulated a much bigger net worth."

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LONG-TERM CAPITAL MANAGEMENT

Excepting that annus horribilis of 1994, 1998 was as bad as it gets. Goldman Sachs lost hundreds of millions of dollars in proprietary trading and very nearly lost hundreds of millions more in a major hedge fund's collapse. It simultaneously missed—by minutes and a few key words—an opportunity to pull off a moneymaking coup that could have *made* hundreds of millions. As a result, as the stock market declined, Goldman Sachs had to postpone indefinitely its on-again, off-again plans for an IPO, on which Jon Corzine had expended much of his personal political capital. This would hurt his credibility as the firm's leader.

In a longer-term context, 1998 was a time of significant change in the partners' consensus view of Goldman Sachs. The year's events would be seen as forceful evidence of the importance of securing permanent capital by going public. It also showed the increasing importance within Goldman Sachs of proprietary trading, which was on its way to taking precedence over what had been the firm's long-standing, nearly sacrosanct strategic priority: earning trust and recognition among corporate clients as the premier service and relationship investment banker. With its accelerating drive into trading, Goldman Sachs was reinventing

itself as a major market-making, risk-taking financial intermediary—the revolutionary shift away from service-based *agent* to capital-based *principal* and toward becoming one of the most powerful financial forces in the world.

Goldman Sachs was becoming the quintessential capitalist organization, making aggressive capital investments and using highly sophisticated computer models to embrace and manage all sorts of risks—many previously unknown—to extract risk-controlled trading profits from capital markets around the world. The firm would profit from its creativity, its access to information, and its ability to organize transactions. Deference to clients and a strong commitment to nurturing relationships, valued as important strengths, would be balanced by and even outweighed by bold use of capital. They would be recognized as potential impediments and possible signs of weakness. One of the first major manifestations of the firm's emerging strategy was seen in its way of dealing with the threatened collapse of a giant, high-tech hedge fund called LTCM.

LTCM—Long-Term Capital Management—appeared to have discovered or invented a wonderful new way to manage a massive hedge fund with a low-risk, high-return portfolio. Only certified financial rocket scientists could really understand the details of how it worked, but everybody knew that LTCM—a mysterious, glorious, golden money spinner—produced spectacular results. The fund was launched in 1993 by John W. Meriwether, known to admirers as J.M., the quietly charismatic leader of Salomon Brothers' justly fabled and notoriously profitable proprietary trading unit. At LTCM, fewer than two hundred people, including two Nobel laureates and a host of brilliant Wall Streeters, managed a huge, private, and very secretive model-driven hedge fund for a partnership of fewer than one hundred large investors. In an era of financial creativity, it was truly outstanding. Four aspects of LTCM were large: the assets, the leverage, the egos of the principals, and the profits.

LTCM's portfolio appeared to be extraordinarily diversified because it was constructed of thousands of diverse, small, "perfect arbitrage" paired positions selected with the aid of advanced computer programs that identified thousands of anomalies, or market imperfections, in bond markets around the world. LTCM selected the most attractive opportunities for profit and constructed a portfolio designed to squeeze out or neutralize every identifiable specific risk and pile up the profits. While LTCM's individual positions were far larger than other

investors', relative to its enormous total size they seemed small, and the profit on each paired position seemed very small. The overall strategy was to vacuum up nickels, dimes, and quarters all around the world in such repetitive, wholesale volume and with such great leverage that cumulative portfolio profits would be huge and almost actuarially certain.

The LTCM strategy worked beautifully for a time. LTCM was demonstrating extraordinary success, compounding profits at over 40 percent a year. The fund's disciplined moneymaking machine relied on two interdependent systems. One was the brilliantly designed computer system for scouring the markets of the world to find an extraordinary number and variety of attractive component parts for its portfolio of thousands of paired positions. The other was a secretive and complex system of borrowing from banks and broker-dealers around the world. LTCM used such enormous leverage that while its investors' *equity* was $3 billion, its *portfolio* totaled a gargantuan $100 billion. Beyond that, it had derivatives contracts with virtually every Wall Street bank and dealer, for a total market exposure of more than $1 trillion! The secret to this extraordinary leverage was the lenders' confidence that LTCM's portfolio was shrewdly diversified against *all* risks.

But unknown to both LTCM and its lenders, there was one risk against which it was not diversified: the risk that somehow all the many different markets around the world would all react the same way to a specific, important, very unlikely, and very distressing event—such as a sudden devaluation of the Russian ruble.

At LTCM, instead of the usual hedge fund fee of 1 percent of assets plus 20 percent of profits, the fund's management got a 2 percent fee and 25 percent of the profits. LTCM investors didn't really care that the fees were so high because they too were doing very, very well. After a 28 percent gain in its first year, LTCM produced a spectacular 58 percent gain in 1994. (Actually, given the huge payments to the general partners for managing the fund so successfully, the net gain to limited-partner investors was "only" 20 percent in 1993 and "only" 43 percent in 1994.) By the end of 1995, with annual "2 and 25" payouts accumulating—which they kept investing in LTCM—the general partners running LTCM had amassed $1.4 billion in their personal accounts in the fund. The general partners' position was up nearly ten times from their initial investment of $150 million in just two years. And more good news was coming.

In 1996, LTCM gained an astonishing $1.6 *billion*—57 percent, or 41 percent net to investors after paying the general partners. If $1.6 billion sounds very big, there was an even more significant number that sounds very *small:* The real return on the total portfolio in LTCM's great year was actually only 2.45 percent. As we shall see, the crucial factor in the giant gains to investors—and to LTCM's general partners—was leverage, *lots* of leverage.*

In addition to those two divergent numbers—$1.6 billion and 2.45 percent—another annual number mattered greatly. LTCM's large-scale and hyperintensive portfolio turnover generated a huge volume of business for Wall Street. Paying fees, spreads, and commissions that totaled well in excess of $100 million annually made LTCM one of the world's largest customers for the securities industry. While investors wanted to get in on the LTCM gravy train, their enthusiasm seemed almost restrained compared to the intensity with which the world's major banks and dealers scrambled to be helpful to LTCM. They all wanted more of that rich annual flow of $100 million. Goldman Sachs was not only one of the major dealers, but Corzine's "prop" (proprietary) desk was making similar, even identical "arb" trades, so it was also a competitor.

Not only was LTCM designed brilliantly, but it was operating supremely well too. LTCM was a spectacular multiple success: success for investors, success for banks and brokers, and success for LTCM's managing partners. Incredibly, however, spectacular success was becoming a problem, a large problem: LTCM had too much money to manage. Compared to the market's liquidity and trading volume, the partners decided LTCM had become *too* big. By 1997, investors' equity capital in LTCM was $5 billion. And it kept rising. At $7 billion in 1998, LTCM had more equity capital than Merrill Lynch, Wall Street's largest firm. Size was a problem because LTCM's buying or selling was moving prices and shrinking the profit opportunity in each market imperfection.

So LTCM did something unusual for a hedge fund or any other type of investment manager: It obliged investors to take back $2.7 billion of their invested capital. And LTCM's general partners did something else that was unusual: While returning so much capital to outside investors, they deliberately did *not* reduce the size of LTCM's portfolio. Instead, the general partners chose to borrow more and

* Roger Lowenstein's wonderful study *When Genius Failed* (New York: Random House, 2000) provided much of the detail used in this chapter.

increase the leverage so they and their investors could make even more money on their equity capital. LTCM's general partners were already rich, but now, with the increased leverage, they would be on their way to being superrich, making *really* big money. And this they did . . . but only for a few months.

A further problem was that LTCM was clearly not alone—the fund had too many imitators. Astute traders at the prop desks at major investment banks and at the big hedge funds had studied together at the same business schools, trained together at the same Wall Street firms, and used the same sort of quantitative models and computer programs. They were out looking for the same trades, and talked with each other all the time, comparing notes and sharing insights and facts. Enjoying their rivalries in discovering new things, they were more than glad to steal or copy each other's ideas—including the best ideas of LTCM. LTCM was the biggest and arguably the best, but many, many other smart quant traders were putting together the same perfect arbitrage pairs for the same reasons. And more and more bond-arbitrage funds were being formed to exploit the small niche anomalies in which LTCM specialized. It could never be proved, but many on Wall Street believed that the dealer most actively engaged in trading against LTCM was Goldman Sachs.

The markets in which LTCM operated were about to change dramatically and prove once again that leverage cuts both ways—sometimes suddenly. In June 1998, LTCM had a bad month: It lost $500 million. But investors knew "things happen," and Meriwether was candid and specific about the loss and the reasons for it. Overall: not a problem—yet.

Then, in August, Russia abruptly defaulted on its debt, and that changed everything.

In a massive flight to quality and liquidity, frightened investors everywhere scrambled to sell out of unusual and illiquid securities—exactly the securities LTCM was holding—and buy into the higher-grade, more liquid securities that LTCM had sold short in its perfect arbitrage paired positions. Getting hit both ways—longs being sold *down* and shorts being bought *up*—was obviously bad for LTCM. Now Meriwether was not entirely forthcoming: Performance disclosure was selective—and performance was far worse than most LTCM investors

realized. Goldman Sachs realized it, though, because its own proprietary trading gave it unusual access to crucial market information.

Longer-term rational market behavior was being pushed aside, and the unexpected, unpredictable, and often irrational short-term market was being driven by anxious investors, dealers, and hedge funds fleeing to quality and liquidity. The spreads between LTCM's carefully matched long-short pairs were not closing as LTCM's models said they should; they were opening up wider and wider. Suddenly, LTCM was not making profits; instead, it was losing on thousands of pairs. And every time LTCM traders wanted to unwind a paired position, so too did many like-minded hedge funds and dealers.

Market liquidity depends on differences of opinion among many different buyers and many different sellers: the more differences, the better for liquidity. When investors agree, whether rationally or emotionally, on what is the "right" market direction, liquidity quickly evaporates. Strong agreement on market direction, particularly strong emotional agreement, can produce a stampede that quickly destroys liquidity. LTCM's computer models made no provisions for changes in market liquidity—particularly a sudden and unexpected evaporation of liquidity.

Volatility, or market risk, is roughly the opposite of what the most active investors and traders usually mean by "quality." Most investors dislike price volatility, so they would prefer to offload it. They can—for a price—and others will, for a price, accept or "buy" volatility. Volatility cannot be bought or sold directly. But volatility can be bought or sold *indirectly* by selling short or buying stock-index futures or, to get even greater leverage, buying or selling options on stock-index futures. Volatility is usually mispriced because, since most investors dislike market risk, they are quite willing to sell volatility at less than its mathematical fair value, because they are effectively buying insurance against market risk. Futures and options on futures will usually move away from their normal trading range when investors collectively either fear a market decline or hope for a rise. The more pervasive the hope or fear, the greater the distance from normal pricing for market volatility—which traders call "vol." LTCM could therefore effectively buy or sell vol by trading in stock-index futures, and this became a major part of its portfolio operations.

As investors, reacting to the surprising Russian default, scrambled out of

the unusual, illiquid securities that LTCM specialized in, they sold what LTCM owned long and bought what LTCM had sold short. That drove market prices further and further away from the normal price correlations that LTCM's computer models had used to identify the anomalies that LTCM had been so successfully exploiting in its highly leveraged portfolio. Suddenly, everything was different. Now the market was going strongly against LTCM, and while its portfolio was wonderfully diversified in many, many ways, it had *no* diversification against the one risk of a worldwide, simultaneous flight to quality, with investors shunning more speculative securities—and that flight to quality was becoming a stampede and trampling LTCM.

Corzine knew that the traders at Goldman Sachs had large exposures to the same kind of complex, derivatives-based portfolio positions that Meriwether and his crew at LTCM had been establishing in recent weeks. Corzine also knew—because Goldman Sachs was believed to watch LTCM closely and allegedly often matched LTCM's trades in the firm's own proprietary portfolio—that the "spread" trades LTCM always liked to do had been going very much in the wrong direction. Corzine knew too about LTCM's large leverage. Bold investors might borrow half the money they invest, so they would have 50 percent leverage and 50 percent equity. Hedge funds often borrow more, reaching as much as 80 percent or, very temporarily, even 90 percent leverage. But at LTCM, Meriwether and his group were borrowing much more: The equity wasn't 50 percent or even 10 percent; it was a mere 3 percent. LTCM was using leverage with a vengeance. With 3 percent equity, a loss of just 3 percent in its total portfolio would completely wipe out LTCM.

Phenomenally secretive, LTCM had irritated Wall Street in its first few years of operation by refusing to inform its investors or its lenders about *any* of its internal operations. In a world that increasingly insisted on transparency, LTCM arrogantly insisted on being opaque. So when Meriwether had a "serious markdown" and felt obliged to step outside his closely guarded realm of secrecy to call one of his major dealers and financial backers at home early in the morning, Corzine knew that the situation was serious, no matter what verbal assurances J.M. was giving.

If he'd known at the outset that Meriwether was calling from Beijing, where he had excused himself from a dinner party to make the call and had just booked

himself on the next flight home, Corzine would have known that the situation at LTCM was *very* serious.

As the worldwide flight to quality gained momentum and spread to more and more markets, arbitrage traders, who worked in the same market "space" as LTCM, got increasingly aggressive at cutting back their positions, particularly those positions that traders knew were similar to LTCM's and so wanted to get out of *first*. Some were acting on their senior managements' orders to cut back, and some had to reduce their positions because they were receiving margin calls from *their* banks. Suddenly, all the sophisticated traders wanted to sell. None wanted to buy. And they were selling their better-quality, more liquid positions, not because they wanted to—they didn't—but for one decisive reason: They *had* to sell the quality stuff to raise cash because nothing else *could* be sold into that suddenly anxious market.

In a normal, rational market, LTCM's highly diversified, carefully hedged positions *would* have been smart bets against a series of temporary pricing anomalies. In a normal, rational market, LTCM would have gone right on making millions by vacuuming up all those nickels and dimes. But LTCM's portfolio had two eventually critical problems. In every long-short pairing, LTCM always owned the lower-quality securities and was short the higher-quality securities. And most of its pairings involved complex trades in small, unusual markets where liquidity was always limited and could, as was now being proved, be *very* limited. Against the one specific risk of investors everywhere driving their portfolios toward higher quality and going against LTCM's clever positions, there was no hedge and no useful diversification. Instead of superb diversification in LTCM's portfolio, suddenly everything was strongly correlated.

Suddenly there was virtually no liquidity for the unusual, lower-grade securities LTCM owned most. Of course, given sufficient time, the market and its prices would eventually and inevitably become rational, but as John Maynard Keynes had warned long ago, "Markets can remain irrational longer than you can remain solvent." When they really *need* to sell, sellers don't choose the price, buyers do. A buyers' market was exactly what LTCM did not want.

When things go badly, the smart borrower doesn't wait for the lender to call. The smart borrower always makes the first call. So John Meriwether called his major banker: Jon Corzine at Goldman Sachs.

"We've had a serious markdown . . . but everything is fine with us." The words were reassuring. So was the tone of voice. But they always were when the very calm, understated, and self-contained and private caller was John Meriwether. J.M. was *always* calm and *always* understated, so his calmness this particular morning meant absolutely nothing. Corzine had enough experience and ample reason to know better than to feel reassured by Meriwether's call. First, the early morning call was not to his office; it was to his home. Second, it was starkly out of character for the secretive Meriwether to say *anything* about LTCM's portfolio, particularly anything as blatantly negative as "We've had a serious markdown."

As a long-experienced bond dealer who had made a career of buying billions of dollars of bonds that other people didn't want, Corzine was sensitive to signals, particularly any unusual or unexpected signal, and Meriwether was sending a soft, subtle, but very unusual, very unexpected—and therefore clearly significant—signal.

Corzine and Meriwether were contemporaries, knew each other well, had great respect for each other as major dealers, and understood markets and dealing in similar ways. They held similar beliefs about the changing nature of the world's capital markets and the increasingly attractive opportunities for highly profitable principal, proprietary investments, particularly in fixed-income arbitrage operations. Both men were unpretentious Midwesterners and comfortable within themselves—and both men were determined to win on a giant scale.

Corzine called Meriwether back because he wanted to know more—a lot more. He matched Meriwether's calmness with his own. Instead of saying, "J.M., you've been way too secretive. I know you're in a major jam. So you've got to come completely clean with us now or we'll cut your credit lines way back," Corzine simply cautioned: "We aren't getting adequate feedback. It could hurt your credit standing."

Corzine and Meriwether both knew the essential reality of the situation: LTCM was no longer in control. It would have to change its ways. Arrogant secrecy was over, a thing of the past. Now LTCM would have to share important information with its creditors, and that meant the creditors would learn things their traders could use to trade against LTCM, inevitably making the problem, however serious it proved to be, that much worse.

Given its extraordinarily high leverage, the adversities facing LTCM had developed rapidly. Calm as he seemed, Meriwether was quickly and quietly

exploring extraordinary moves, searching for the best way to go. Possibilities ranged from raising a huge capital infusion from investors to selling LTCM to a "white knight."

Early Monday morning, Warren Buffett of Berkshire Hathaway turned down an invitation to take over LTCM's entire portfolio. Later that same day, George Soros agreed to invest $500 million in LTCM at the end of August *if* Meriwether could raise another $500 million from other sources in those two weeks. Meriwether's negotiation with Soros was a dance of opposites. Meriwether was casual, Midwestern, and pragmatic while Soros, an Eastern European, was formal and conceptual. Meriwether's investing was rational and based on precise, predictive mathematical models, while Soros saw markets as organic, "reflexive," and unpredictable. Still, Soros and Meriwether had one thing in common: Soros's funds had just lost $2 billion in Russia.

J.P. Morgan & Company was ready to invest $200 million, and some bankers thought Merrill Lynch *might* come in with $300 million. But on Wednesday, Merrill Lynch called to say no. Because of the need for a swift decision, LTCM went back to Buffett, offering to cut its management fee in half if he would make a major investment in the fund. Again, Buffett said no.

The tension of the situation can best be appreciated if the reader assumes he or she was one of the LTCM general partners who had been experiencing this series of extraordinary moments:

- On the same Thursday that Buffett said no, LTCM lost $277 million. Only one prior day had ever been worse.
- Banks to which LTCM owed $167 million demanded repayment, saying the fund's poor results were a "default event." But the management company could not meet the demand; it had no ready money. And, as "insiders," the partners certainly couldn't make withdrawals—even to pay off their personal loans—when results were poor and they were asking others to increase their investments.
- Rumors flew through Wall Street that Goldman Sachs traders were selling what LTCM held in its highly leveraged positions. So were other dealers.
- During tough, sometimes confrontational negotiations with its crucial clearing broker, Bear Stearns, LTCM had refused, as a negotiating tactic,

to sign a formal clearing agreement. So LTCM had never gotten a signed guarantee from Bear Stearns to clear its trades. This meant Bear Stearns was free to stop clearing at any time—and if and when Bear Stearns quit, nobody would rush in to take over LTCM's complex clearing business.

LTCM partners were able—just barely—to persuade another commercial bank to take over a nearly $50 million bank loan that had just been called. Far more significantly, the partners, as individuals, had borrowed $38 million against their own investments in the fund so they could pay large year-end staff bonuses. Mechanically clever and technically legal, borrowing from already leveraged accounts was highly unusual and clearly whispered that the LTCM partners were skating into a very gray zone. Rumor on the Street was that the partners were feeling trapped. If the management company went into default, trading counterparties could claim immediate payment in cash. And if several counterparties tried to settle quickly, they would precipitate a ruinous run on LTCM.

Meriwether, twice cautious after having been burned a few years before for not informing the Federal Reserve Bank about Salomon Brothers' embarrassing involvement in a Treasury bond scandal, called New York Federal Reserve president William McDonough to advise him that LTCM would need more money.

Corzine got another call from Meriwether on Friday, the 11th—in Vienna, Austria, where Corzine was on vacation. LTCM's "assets in the box" had dropped below the $500 million minimum Bear Stearns required to continue clearing LTCM's transactions, so Bear Stearns had called LTCM: Its inspection team was coming to examine LTCM's books—on Sunday. Unless fully satisfied, Bear Stearns would immediately stop clearing LTCM's trades. Without a clearing broker, LTCM would be out of business. Period. To keep Bear Stearns, LTCM needed more equity capital. That's why Meriwether called Corzine: LTCM needed big money in a big hurry.

One billion dollars would be too little. LTCM needed $2 billion—and it needed it *now*. Corzine and Goldman Sachs were the best chance, and maybe the only chance, of finding a savior that would put up that kind of money that fast.

Goldman Sachs's overall business strategy had been shifting, in response to changing markets and business conditions, toward capital-intensive, risk-taking proprietary trading. That's why Corzine had been increasingly interested in

developing the kind of high-tech proprietary trading business that had been so profitable for LTCM. Now he recognized a major opportunity to move the firm decisively in the direction he believed best—a move that would also consolidate his position as the firm's undisputed leader.

Corzine knew his negotiating position vis-à-vis Meriwether had suddenly become very strong. Dealing from strength, he now offered Meriwether a proposition that was clearly tough, but just as clearly reasonable, given LTCM's grievously strained circumstances. For half ownership of LTCM, Goldman Sachs would provide $1 billion—partly from the firm's own capital and partly from its clients—and commit to raise another $1 billion from outsiders. With the money would come the intangible but obvious advantages of LTCM's having Goldman Sachs's strong, explicit, public support. In exchange, Goldman Sachs would not only own half of LTCM's management company but also set limits on LTCM's trading exposures (tantamount to taking full control of the fund's portfolio structure) and get complete knowledge of LTCM's investment strategies and analytic models, which Goldman Sachs could then use in its own proprietary trading operations.

The deal was conditional on Goldman Sachs's delivering the capital infusion and on an examination of LTCM's books, so both sides began working through LTCM's files immediately. Any deal involving a major commitment of the partners' capital would, of course, require approval of the newly formed successor to Goldman Sachs's management committee, the executive committee, but Corzine was increasingly thinking and acting not as a senior partner, but as the dominating CEO he envisioned himself to be.

As part of its insistence on maximum secrecy, LTCM had kept its long trades and its short trades at separate banks. Since the banks could not be sure the hedges were correctly paired, they had required somewhat more than the absolute minimum margin. If the hedges could each be paired up at the same bank, that extra margin could be released and the financial squeeze would be relaxed. Fine in concept, but as always, the devil would be in the details. LTCM did not run a simple business; it used extraordinary diversification to minimize the risk of any one position or specific group of positions going sour. As a result, LTCM had thirty-eight *thousand* different paired positions—with every pair carefully separated and each side housed at a different bank. Matching up all those pairs would take a lot of time. So LTCM was not only short of cash but also short of time.

The major irony was blatant: LTCM desperately needed *now* the $2.7 billion it had insisted that investors take back just months earlier. A Street-savvy guy at Bear Stearns gave a cold, blunt appraisal of LTCM: "It's all over. When you're down by half, people won't refinance your trades. They'll push the market against you. You're *finished*." LTCM's partners, sensing that LTCM might not make it, scrambled to protect their personal assets. One partner, recently worth half a billion dollars, was reduced to paying for work on his expensive new home out of his wife's checking account. Meriwether quietly put his own real estate in his wife's name.

Later some observers said Goldman Sachs's traders, working out of London and Tokyo, were selling short the positions they knew LTCM held and then, to cover those shorts, were offering to buy them from LTCM at depressed prices. Goldman Sachs was certainly trading actively, but if its traders were front-running LTCM, other dealers were surely doing much the same. In the global bond markets, the squeeze was on LTCM—particularly in volatility—and all the major dealers knew LTCM, with massive positions outstanding in futures and options, was massively short volatility. They knew LTCM would get increasingly desperate to cover its short positions, would have to come to them, and would have to pay up, greatly increasing their profits. Dealers all understood the rules of the market: if they knew enough about the way institutions were moving their portfolios, they could and would profit by using this market information in their proprietary portfolio operations. That profit opportunity was why Goldman Sachs had decided to get into proprietary trading in a major way and, as advocates told their partners, "learn to live with the conflicts of interest."

The month of August was cruel for hedge funds. Most lost serious money. But LTCM did far worse—its equity capital was cut down by 45 percent, or $1.9 billion, in that single month. August was the worst month ever for credit spreads. Irrational as it may have been in the long run, in the short run credit spreads expanded to record levels and moved strongly and "irrationally" against the historically "normal" assumptions so essential to LTCM's sophisticated market models. With the severe lack of liquidity in the market, LTCM couldn't sell portfolio positions to raise capital. It lost nearly $2 billion. LTCM also lost all hope of George Soros's delivering a major capital infusion.

Meriwether's regular monthly letter, containing some of the troubling news,

was faxed to LTCM's investors early in September. Leaked to the press, it caused traders at other hedge funds to sell out any positions they thought LTCM might hold and would now have to try to sell. During September, the spreads that LTCM had confidently expected would *shrink* instead kept *expanding* as other dealers and hedge funds made increasingly large bets against LTCM, knowing its positions were huge and that sooner or later LTCM would have to come to them.

LTCM's portfolio was still huge: $125 billion—and now fifty-five *times* its shrinking equity capital. In addition, it held a large package of high-octane derivatives. With another portfolio loss of less than 2 percent, the management company and the partners would be wiped out. In mathematical theory, the odds of such an event actually happening had been nearly impossible just a few months before. But in real markets, traders say bell-shaped curves have "fat tails"—events that are very unlikely but do happen and cause great damage, recently popularized as "black swans." The highly improbable was now threatening to become grim reality.

Corzine's concerns about how to deal with the accelerating problems at LTCM were magnified by large losses in Goldman Sachs's own proprietary trading portfolio. Because they used similar models and similar data, the firm's traders had been taking positions similar to LTCM's. Losses in the proprietary bond-trading portfolio were losses that came right out of Corzine's partners' pockets. And he knew that the last time Goldman Sachs had come close to an IPO, it had been stopped by, among other adverse events, losses in the firms' proprietary trading portfolios.

Goldman Sachs's long-planned IPO was due to come to market the very next month. For Corzine, the IPO was by far the most important trade in a lifetime of trading—the most important test of his professional career, particularly since he had become managing partner, and also the most important for him personally. While Corzine never seemed to care about wealth except as a convenience, if the IPO came off as hoped, his personal stake would be worth over $250 million. He would be a very rich man with massive liquid assets and, at fifty-two, the personal freedom to stay or to leave the firm.[1] But if the IPO was put off—perhaps for several years—Corzine's percentage stake in the firm would decline, perhaps significantly. And if the firm did not go public now, it could be years before another opportunity could be found to ensure permanent capital. During those years of deferral, partners' shares were sure to change, particularly for senior partners

who went limited and retired—a group that could include Corzine himself. Corzine was highly motivated to find a way to solve LTCM's problem, which was now the linchpin to launching the IPO.

Corzine understood that the major investors Goldman Sachs would be asking to join in a rescue had already been called—often several times—by LTCM itself. One specific possibility, already called several times, was obvious to everyone: Warren Buffett at Berkshire Hathaway. Buffett said he might be interested in buying LTCM's entire portfolio at its depressed market valuation, but he wanted no part of LTCM's management company or the LTCM partners.

Derivatives added a whole new dimension of pyramiding to the situation at LTCM. They had real potential for a disaster. LTCM had arranged seven thousand different derivative contracts with several dozen counterparties. Default on any *one* derivative contract could throw *all* those contracts into technical default. Their total notional value was spectacularly large—nearly $1.5 trillion, or $5,000 for every man, woman, and child in America—and they involved almost every major financial institution in the United States in the complex spiderweb that now had LTCM at its center.

Meanwhile, during the second week of September, trading losses kept hammering LTCM:

- On Thursday, $145 million was lost.
- On Friday, another $120 million was lost.

And during the third week of September, while initially less severe, LTCM's losses continued:

- On Monday, $5 million was lost.
- On Tuesday, $87 million was lost.
- On Wednesday, another $122 million was lost.

A tiny profit on Thursday was no help: Cumulatively, LTCM had lost over half a billion dollars in less than two weeks. In one month it had lost nearly 60 percent of its equity capital. And volatility spreads kept rising from one record level to another, driving still more LTCM losses.

Goldman Sachs was LTCM's only hope—and the capital gap it needed to cover had now jumped from $2 billion to $4 billion. John Thain, the firm's CFO and an increasingly central member of Goldman Sachs's senior management—a rational market technocrat with direct experience in the bond business—was moving into a key decision-making role. He didn't see a way to raise that much money for LTCM, but the firm would keep trying.

Another possibility was floated past Warren Buffett: a joint bid, perhaps with AIG, the giant and innovative insurer that had extensive experience with derivatives, for LTCM's whole portfolio *without* the management company. Buffett wasn't interested.

Corzine briefed president McDonough at the New York Fed, and McDonough called the other major banks. All agreed that an LTCM failure would seriously disrupt the nation's and the world's financial markets. Given the Fed's long-standing hands-off policy toward the capital markets, McDonough wanted to have a Wall Street leader take up the task of privately organizing a cooperative. But he and John Whitehead, Goldman Sachs's former managing partner and now chairman of the New York Fed, quickly agreed that no one person had the necessary stature or clout to do the job. McDonough accepted Corzine's offer to brief the Fed on LTCM's portfolio on Sunday, but fearing that any sign of urgency could upset the sensitive money markets, stayed with a previous plan to fly to London and sent his deputy instead. Before leaving, McDonough called Fed chairman Alan Greenspan and Treasury secretary Robert Rubin in Washington to warn them that LTCM probably couldn't raise the necessary capital.

Corzine was still hoping to find a solution, but he was hitting walls. Making contact with UBS's derivatives expert, who happened to be in New York that week, to ask if UBS would help, Corzine was surprised to learn that UBS was already LTCM's largest equity investor. Corzine was naturally angry about being underinformed or even misled—again—by LTCM. He would have to focus on Buffett.

As it happened, Buffett was with Bill Gates on a vacation float-trip in Alaska's fjords, where the sonic shadows of the steep mountains would break up cell-phone calls for more than an hour at a time. Buffett told Corzine it was okay for Goldman Sachs to work out the specifics of a Berkshire Hathaway takeover of LTCM so long as the management company and John Meriwether were specifically

excluded. Such a takeover would require $4 billion to $5 billion. Only Berkshire Hathaway had that kind of money on hand *and* a decision maker like Buffett. Even so, Buffett would probably insist on a co-investment by Goldman Sachs.

Realities were now slamming hard into LTCM from several directions. Reality one: Awareness was spreading that LTCM had not hedged its highly leveraged portfolio against the specific risk of market volatility and a flight to quality. Reality two: LTCM's major counterparties on derivatives trades were now about to lose $2.8 billion even if the market calmed. Reality three: The global markets were *not* calm, so derivatives counterparties' losses might *double* to $5 billion. Fed executives worried that the markets, which were sure to drop sharply if LTCM went into default, might not be able to trade at all. This could create a dreadful fourth reality: loss of order and even panic in the nation's and then the world's capital markets.

On Sunday, Corzine spoke again with Buffett in Alaska. Corzine was still unable to make a firm commitment of Goldman Sachs capital. His partners—particularly investment banking partners—were outraged by the losses already taken and the real danger that Goldman Sachs might be saddled with more risk, have its capital tied up for months or years, and might even lose it all. Corzine called the Treasury Department to caution against expecting a private-sector bailout. He encouraged the Treasury to arrange an emergency bank consortium.

In markets around the world, dealers complained that other dealers were trading against LTCM's positions. In those complaints, Goldman Sachs was cited for being particularly aggressive. On Monday, September 21, LTCM lost $553 million—over one-third of its remaining equity capital. With a $100 billion portfolio, this put LTCM's portfolio leverage up to an extreme level: Debt was one hundred times its equity capital. Even a tiny hiccup could now be fatal.

Bear Stearns insisted on $500 million in coverage capital, essentially a security deposit, and Chase accepted its obligation to provide that amount based on a previously negotiated loan agreement. LTCM actually got $470 million—not the full $500 million—from Chase and its syndicate of twenty-four banks because Crédit Agricole, the French bank, refused to honor its part of the commitment.

As a bond dealer, Corzine kept his options close to his vest while working to develop others. He had been working with Merrill Lynch's brainy president, Herb Allison, on the design of a collective approach involving Wall Street's lead-

ing banks, but was still hoping he would be able to preempt the collective bailout with a Goldman-Berkshire bid for the whole LTCM portfolio.

At 7:30 a.m. on Tuesday, September 22, the New York Fed hosted breakfast for Corzine and Thain of Goldman Sachs, Roberto Mendoza of J.P. Morgan, and David Komansky and Herb Allison of Merrill Lynch. Allison lacks a commanding physical presence, but his rational brilliance was clear to everyone. To survive, LTCM needed $4 billion. If allowed to fail, the losses to the group could total $20 billion. Allison summarized: "We're all in this together. This is a *very* complex problem and we all know that in order to work, a complex problem *must* have a simple answer. In addition, as the nation's leading financial institutions, don't we have an obligation to the public?"

The global context for LTCM's crisis was deeply concerning. Russia and South America were both moving toward recession. The Fed would not protect the banks that had lent to LTCM. Its proper position was that, as free-market participants, they should absorb the losses of roughly $300 million apiece. But the problem might not be confined to LTCM. Corzine, who got almost no sleep for four days, says today, "It scared the hell out of me." After two hours of discussion, the bankers agreed to explore a clever proposal developed by Mendoza of J.P. Morgan to divide LTCM's positions into two baskets—one of debt securities and one of equities—and then sell the securities back to the issuing corporations at discounts that would make the offering a proposition they could not refuse. That would leave the bank consortium to swallow a smaller, known, and limited loss. But the implementation details couldn't be worked out in the time available, so the group turned to their one remaining alternative: Allison's proposal for a consortium investment by all the major banks.[2]

Corzine was now engaged in a two-front strategic battle. On one front, LTCM was in extremely serious trouble and a solution, not yet in place, was urgently needed. On the other front, Goldman Sachs's own proprietary trading losses in just the past two months had totaled a stunning $1.5 billion. This huge loss, combined with falling equity prices, would oblige the firm to postpone the IPO on which Corzine had expended so much of his personal leadership capital. Moreover, the firm's losses were concentrated in Corzine's overseas bond positions, so he was losing personal stature within the firm. Those losses were now *partners'* personal losses. A few months ago, each partner "knew" what wealth he

might have with an IPO; now the partners faced real money losses. The double whammy concentrated their minds on Corzine and his adventurous trading. Understandably, they did not like what they were seeing.

That Tuesday, LTCM lost another $152 million. Now, with no alternative approaches, everyone focused on Allison of Merrill Lynch and his consortium strategy. The only way to achieve the necessary cooperation among so many banks and firms on such short notice would be for the Fed—even though it would not be proper for it to support any specific plan—to call a meeting of all the banks. This was agreed late in the afternoon, and a dozen major banks were informed that an emergency meeting would be held at the New York Federal Reserve Bank that very evening at eight. The four largest banks agreed to meet at the Fed an hour earlier. Merrill Lynch's plan would have sixteen banks each invest $250 million to reach the $4 billion capital infusion that John Thain had specified was necessary. If the group put up less than $4 billion, speculators would be too tempted to try to break the bank, as a decade before they had broken the Bank of England, forcing a devaluation of the British pound.

The four major banks were still arguing terms. Would the $4 billion be entirely a loan, or would some part have to be equity? Would LTCM's partners stay? Who would have control? On the last, Corzine was insistent: LTCM could *not* be in control. When the arguments went on past 8 p.m. without resolution, the other bankers, who had been cooling their heels, were brought in and told that while the Fed would maintain strict neutrality, it expected the private sector to find a workable solution to protect the integrity of the system.

Allison summarized Merrill's plan on one sheet of paper. Lehman Brothers objected to each firm's having to put up an equal share of the reserve fund; it proposed scaling contributions to match each firm's exposure. Others cut in saying that would be too complicated because each bank had its own risk model, so valuations—and "fair shares"—would differ way too much for resolution, given the shortness of time. Three hours later, at 11 p.m., the bankers' formal meeting was adjourned until 10 a.m. the next day. But informal work on specific terms continued until 1 a.m., when Corzine was briefed. Allison's plan could work—if everyone cooperated—and if it did work, it would be the first $4 billion fundraising ever done in a single day.

At ten the next morning, forty-five bankers assembled at the New York

Federal Reserve Bank. Bear Stearns's CEO, Jimmy Cayne, began with this blunt warning: "If you want this to work, don't go alphabetically"—don't start by asking Bear Stearns.

New York Fed president McDonough, who had just flown in from London, quickly postponed the meeting for three hours, saying only, "Not all avenues have been exhausted." He did not say that Corzine and Thain had just taken him aside to whisper that Warren Buffett was ready to bid for the whole portfolio. McDonough called Buffett and got his confirmation. Instead of feeling relieved, when the bankers learned of this, most were angry that Corzine was playing games with them behind their backs.[3] Such solo initiatives by Corzine had already angered the partners of Goldman Sachs.

Buffett's bid—joint with Goldman Sachs and AIG—came in at 11:40 on a single page: $250 million to buy LTCM, with $3.75 billion more to be invested in the fund immediately to ensure stability. (The $4 billion was just over 5 percent of the value of LTCM's portfolio only ten months before.) Of the total, $3 billion would come from Berkshire Hathaway. Buffett's bid was good until a 12:30 deadline—just fifty minutes away.

It didn't matter. The deal couldn't be made. There were too many different parties at interest with dozens of counterparties to derivative contracts, plus a series of hub-and-spokes partnerships. It would be impossible to reset all their different contracts. And unfortunately, the Goldman Sachs investment banker covering Berkshire Hathaway had misunderstood the complex structure of LTCM, so he had not given Buffett the specific guidance that would have been necessary to formulate a correct bid. Once again, the devil was in the details. Buffett's bid as written was for LTCM, the *management* company, not the LTCM *portfolio*. Even so, there was a chance: If the Goldman-Berkshire-AIG bid were converted into an investment in the fund, as opposed to the management company, it might work because Buffett's group could still fire the LTCM partners. But just then, Buffett's boat went behind an Alaskan mountain and he could not be reached by cell phone. Minutes ticked away. The time limit on Buffett's bid was fixed. The clock kept ticking, and in half an hour the time ran out—before contact could be made.

The only option still viable was the bankers' consortium bid developed by Merrill Lynch's Allison. Even though he was not sure they would all come, McDonough called in the banks. They did all return, but their mood had been soured by the

morning's events. Bear Stearns refused to participate, just as it had said it would. It already had more than enough exposure as LTCM's clearing agent. After a brief recess during which urgent pleas were made to it, Bear Stearns did agree to say to all the banks that it had no special knowledge causing it not to participate.

Tensions continued to rise as one after another banker got petulant and self-protective. Chase Manhattan's CEO, William Harrison, was furious: "Goldman Sachs is trading against the Street!" Morgan Stanley's Phil Purcell was in the consortium—and then out—until Allison said, "Call your capital-market traders and ask *them*." Purcell was told: "Herb's right. If you guys don't do this, and do it damn soon, it'll be a fucking catastrophe!" Then the French took a walk—followed by Bankers Trust's CEO, Frank Newman. During those tension-packed hours, it seemed that every bank was out of the deal at one point or another. As Allison recalls, "They were not seeing the big picture—how Wall Street would look to the whole world if the deal fell through and we failed."

Corzine insisted on signed contracts to lock in the LTCM partners, so they could be told exactly what to do or not do—a major change, of course, from his previous goal of partnering with Meriwether. Corzine called Meriwether to confirm that there would be full acceptance by LTCM of his tough terms. Nobody in the room at the Fed knew or suspected what lay ahead for Corzine, except Thain, who was taking calls in the conference room on his cell phone. Thain was speaking so quietly he couldn't be heard, but his facial expression signaled that he was struggling with grave concerns. He was *at* the meeting, but not *in* the meeting. He was providing updates on the negotiations to three other members of the Goldman Sachs executive committee. Those four would soon complete a coup d'état and oust Corzine.

The Merrill Lynch consortium plan assumed that sixteen banks would each commit $250 million, but when several banks refused to go that high, it was clear that the majors would each have to go up even higher—to $300 million apiece. Corzine, the only CEO who was also an experienced bond trader, had wanted to play the essential leadership role, but his partners were less caught up in the time urgency of endorsing the consortium strategy and were much more

concerned about the potential costs and risks to Goldman Sachs. They made this clear in messages via Thain's cell phone, which Thain then whispered to Corzine. Hank Paulson said it all: "Get the hell out of there!"

Corzine couldn't go above $250 million without the approval of his executive committee, which had only *very* reluctantly authorized $250 million. He certainly didn't have his partners' authorization for an additional $50 million.[4] Considering himself essentially the CEO of a major firm and an expert in bonds and bond trading, Corzine found it embarrassing to need his partners' permission. But he knew that preparations for the IPO, the large, recent bond losses, and the accumulating issues surrounding the firm's leadership made it doubtful that the partners could absorb yet another stress. Given the stupendous personal financial stakes involved, political alignments within the firm were still in play as individuals counted up "their" IPO wealth. Even Corzine, politically sensitive as he had always been, really didn't know now just what his partners would say and do. But he did know most would be enraged, and many disgusted, with a jumbo capital commitment to bail out LTCM.

With the table stakes now at $300 million, Allison was going around the huge table, calling out each bank in turn for its commitment. If Goldman Sachs and the other major organizations came in at $300 million each and a few smaller banks came in for less, the consortium would—just barely—have the necessary $4 billion, including what equity capital remained at LTCM. Lehman Brothers couldn't do a whole unit, only $100 million. Bear Stearns refused to participate at all. And everyone knew that Chase didn't want to participate.

As Allison continued around the table, collecting commitments from most of the banks represented—including Chase—Corzine turned to Sandy Warner, chairman of J.P. Morgan, who was sitting next to him. They had become friendly during recent talks about possibly putting their two organizations together, so the basis for man-to-man candor had been established. Corzine whispered: "My partners *really* don't want to do this. And if I do, I'll have a massive need to persuade—and I'll probably have to leave Goldman Sachs."

One bank after another committed to $300 million. Only two banks had not yet been called: J.P. Morgan and Goldman Sachs.

Suddenly it was Corzine's turn. "Goldman Sachs?"

Corzine, the cool trader, never blinked. As though it were the most ordinary item of an ordinary day, he said, "Goldman Sachs is in for three hundred."

Morgan too was in for $300 million—and the deal was done.* Herb Allison later estimated the potential losses throughout the financial system of a failure to solve the problem presented by LTCM at an astounding $50 billion.

Many details still had to be resolved. Goldman Sachs insisted that its lawyer, John Mead of Sullivan & Cromwell, had to participate in the follow-on negotiations, representing only Goldman Sachs, while the consortium would be represented by Skadden Arps. An oversight committee was established to supervise LTCM's portfolio. The consortium would get half the management company for $1. LTCM's partners were obliged to sign employment contracts, with compensation for the group fixed at $250 million, with no bonus or incentives—a drastic pay cut for that supercompensated group. Goldman Sachs's lawyer insisted that LTCM's partners give personal guarantees of the accuracy of LTCM's financial statements and that the new money invested by the consortium be guaranteed absolute protection from any future lawsuits stemming from past actions.

Sunday evening, September 27, Robert Katz, Goldman Sachs's chief counsel, startled the negotiators by stating that the firm would not stay in the consortium unless Chase agreed not to require payment on its $500 million loan to LTCM. Chase, which had already made several concessions, was not prepared to go that far. When Corzine confirmed Goldman Sachs's hard line, Chase's man exploded with expletives—and then, very reluctantly, agreed to leave Chase's $500 million with LTCM.

Goldman Sachs's executive committee would meet at 6:30 Monday morning for a final decision. But knowing that the consortium could not wait for such a critical decision, Corzine checked with some of his partners and got their okay to say Sunday evening that Goldman Sachs was definitely in the consortium for $300 million.

During the first two weeks of the new arrangement, LTCM lost another $750 million—and then it stabilized. Over the next two years, LTCM's positions were gradually liquidated—at a modest profit to the consortium—because, as markets

* This was almost certainly the largest-ever rescue effort by U.S. banks. The best-known previous bankers' pool, organized by Thomas W. Lamont of J.P. Morgan on October 24, 1929, during the Crash, began with $20 million (approximately $200 million in today's dollars) and was increased the next day to $40 million per bank. Over the next five weeks, the pool bought $129 million ($1.3 billion in today's dollars) of such major stocks as U.S. Steel, AT&T, General Electric, and American Can.

became rational again, the portfolio of perfect-arbitrage paired positions proved that Meriwether and his Nobel laureates were, as they always knew they were, very right. But Keynes was right too: "Markets can remain irrational longer than you can remain solvent." And bell curves do have fat tails.

Still, Corzine was not a corporate CEO, and he had clearly not gotten partners' approval in the only way major decisions, particularly decisions involving the partners' capital, had always been made since Sidney Weinberg set up the management committee as a governor on Gus Levy. Capital was the scarce resource at Goldman Sachs, and Corzine had committed a big chunk of the firm's capital at a time when his own area of the firm, fixed income, was incurring major trading losses. Capital would now be tied up in a deal that at the time seemed likely to have low returns, particularly in comparison to other choices available to the firm, and quite possibly the LTCM capital commitment would incur losses.

On Monday, September 28, after twelve years of preparation, Goldman Sachs canceled its public offering. Sure, an IPO could be brought forward at some time in the future, but fourth-quarter earnings were seriously disappointing. It could easily be several years before the market would again be right for a Goldman Sachs IPO. And for senior partners who wanted to go limited, deferring the IPO was tantamount to taking money right out of their pockets—money they'd so recently thought was as good as theirs. And they knew the man to blame.

33

COUP

In October 1998, Jon Corzine agreed to have breakfast with another partner at the Savoy Hotel, where he was staying in London. Two things made it unusual: It was seven in the morning—on a Sunday. And an article in the business section of London's *Sunday Times* carried a story that Corzine would be pushed out of Goldman Sachs by John Thornton and John Thain.*

"Have you seen the story in this morning's paper?" the colleague asked on the way to the dining room.

"Yeah, I saw it."

"What are you going to do about it?"

"I'm not sure."

"You should be sure, Jon. Since you're wearing a business suit, I assume you have another meeting scheduled this morning, so here's what you should do: Cancel any other meetings you've booked. Go directly to Heathrow and fly back to the States. Before you take off, call Roy Zuckerberg and Bob Hurst and tell them to meet you at your house in New Jersey today and make it absolutely clear

* Only the first edition carried the story, which apparently was quashed in all subsequent editions. But other newspapers carried references to the original article later that day.

to everyone that before the executive committee meets Monday morning, both Thain and Thornton are out—fired for playing politics and doing it in public so that it hurts the firm.

"If you do this immediately, everyone will understand and will back you. And if you don't, you'll be in real trouble, because in six months *they* will force *you* out."

"I couldn't do that," replied Corzine. "It would hurt the firm."

In ironic symbolism, Corzine and his guest could not have breakfast in the Savoy dining room. It was closed. It was never open at seven on Sunday morning.

In four months, Jon Corzine was forced out by four members of the firm's executive committee—John Thain, John Thornton, Hank Paulson, and Bob Hurst. Many small parts came together like the pieces of a jigsaw puzzle to complete the picture that Corzine had to go.

Corzine had offended the firm's investment bankers by unilaterally committing $300 million to bail out Long-Term Capital Management when he was authorized to commit no more than $250 million—and getting approval even for that had been a struggle. Bad enough to make huge capital commitments to proprietary trading activities they didn't fully understand, but bailing out another firm with such enormous amounts of their precious capital was going way too far. His various independent and secret sorties into merger discussions rankled, particularly his approaches to Chase Manhattan Bank, Morgan Bank, and, in early 1998, Mellon Bank. Corzine's informal, intuitive, undisciplined way of making senior-level executive decisions would not fit with the responsibility of a CEO of a publicly owned corporation. And his unilateral strategic thrusts were completely at odds with the "one man, one vote" tradition and structure of the management committee, as was his unbridled style of trading. Corzine was too unpredictable. Examples were numerous. The case against him had accumulated steadily over his four years as chairman. As one committee member explained, "Corzine made freestyle decisions on important questions again and again—literally hundreds of times." Another committee member recalled, "It was Jon's attitude and the way he did things—too solo, too sloppy, too unpredictable—and not appreciating or

even recognizing the importance of the executive committee." Another committee member concludes: "The code of conduct at Goldman Sachs was based on absolute candor and straight talk, but from day one Jon was not always straight or consistent, particularly with the people he worked with most closely."

The single most rigorously disciplined management process in the firm was the selection every two years of partners. It took a lot of everyone's time, and everything was done very carefully over several months. Still, there were always last-minute changes to the list, both additions and deletions. One year, as the executive committee was putting the final list of new partners together, Corzine exclaimed, "Oh, Jesus! I forgot so-and-so! Help me out, guys. I'm pretty committed and need your help on this one. I had a long dinner with him in Tokyo and pretty much promised him then that he would make partner this year. He's doing great work, and we've got to make him a partner. Please, guys, just one more!" Corzine may have been comfortable with improvising to circumstance—a necessary skill for traders—but to professionals experienced in the rigors of investment banking, improvisation was just being sloppy.

Paulson and Corzine were never good at working together. They didn't really like each other, didn't really respect each other's ways of leading or managing, and their businesses were completely different. At the weekly executive committee meetings, they didn't just disagree, they increasingly squabbled and bickered. "They were like teenage kids," recalls Zuckerberg, who had warned his friend Corzine during those UN Plaza meetings. To others on the executive committee, it seemed that Paulson and Corzine argued all the time, often quite bitterly. Partners went to Zuckerberg and said, "Can't you help? You know both guys and they both trust you." During one executive committee meeting, it got so bad—close to throwing punches—that Zuckerberg decided he had to do something, so he made Paulson and Corzine stay behind, closed the door, and said firmly, "You *must* work this out! It will hurt the firm if you keep it up." Paulson's accumulated frustrations were so wide and deep that he nearly left in late 1997 but was persuaded to stay. The committee spent one whole weekend trying to find ways to work it out.

In May 1998 Corzine offered that they should work as co-CEOs after all. Zuckerberg said tartly, "You two show you can really work together—for just six months—and *then* I'll support your idea." Looking back, Zuckerberg

laments, "Corzine as senior partner and Paulson as president—one a partnership title and the other a corporate title—made no sense. It was cockamamie. When Corzine said, 'Let's go co. It's fine with me. I don't give a damn,' he was wrong—wrong to think they could work together and wrong about Paulson." Still, the committee decided to accept Corzine and Paulson's commitment to try to work together.

That same spring, the firm decided to launch the initial public offering in the fall. But market turbulence originating with Russia's financial crisis compelled a postponement.

The conclusion that Corzine had to go was not based on any one thing. One part of the jigsaw puzzle was structural: Corzine's decision to maintain a six-member executive committee rather than a larger management committee and then, ignoring advice, to let Silfen and then Zuckerberg go limited without adding strong, loyal supporters of his own choosing onto the committee. Another was his treating the executive committee as not all that important and acting like an all-powerful, freewheeling CEO; the others on the executive committee believed the committee was the ultimate power in the partnership and that all decision making rested with that committee on behalf of the partners. A third piece of the puzzle: Corzine was so confident of strong support across the large partnership that he somehow didn't recognize that broad support could be trumped by the small executive committee. He had been losing support in the committee and should have known it had the power, if it wanted to, to take him out—not simply out of being senior partner and chairman of the management committee, but right out of the partnership itself.

Aborting the IPO in September after announcing it just three months before had been embarrassing, particularly to the firm's investment bankers. More pungently, postponing the IPO—after showing individuals exactly how much money they would make—was certainly disconcerting to the 200 owners, 345 additional managing directors, and 16,500 employees who would each have benefited. Moreover, Goldman Sachs, having lost nearly $1 billion in trading, often in positions similar to those that took down LTCM, was professionally humiliating to many at the firm. Tension between the firm's bankers and traders was

heightened when trading losses suddenly wiped away the distributable profits of a record surge in banking fees.

An important component of the case against Corzine came from the personal decisions of individual committee members. In 1996 David Silfen, having decided he wasn't going to be made managing partner and wasn't really interested in the job, felt he'd already done all he could do to build trading into a highly profitable power center. So other than loyalty to the firm and to individual partners, he saw no real reason to stay. As a trader, Silfen had an understanding of the business that was similar to Corzine's, so even though they had limited personal rapport, the two men usually had similar views on key decisions and Silfen almost always voted with Corzine.

Similarly, Zuckerberg enjoyed close rapport with Corzine and regularly supported him on decisions. As co-heads of Equities, Silfen and Zuckerberg shared a personal as well as professional understanding; they had worked together on an extensive and successful reorganization and a major strategic repositioning. Elevated to vice chairman in early 1997, Zuckerberg had built two strong businesses, had also gone as far as he could hope to go in stature and share ownership, was getting older, and was exasperated by the bickering at committee meetings between Paulson and Corzine. On November 27, 1998, Zuckerberg went limited—with an agreement that protected his ownership interest even though nobody thought an IPO could be relaunched in less than a year. He also offered some advice: "Jon, we've been friends for a long time. Please take some advice from a friend: You need to put some of your own people on the executive committee—people you can work well with and who will work well with you."

"Appreciate your thoughts, Roy, and really appreciate our friendship and how supportive you've always been, but I don't see a big need for change just now. We'll be okay."

"Jon, you really should think about it. They could bury you."

When Silfen retired, his seat on the committee was taken by John Thornton. Corzine's appointing Thornton indicated to some a good relationship, but the reality was more complex. Thornton opposed an IPO, which he saw as "only one hand clapping"; he felt that going public would inevitably lead to a megamerger with a major commercial bank and that the firm would be falling into the old trap of taking bold action before it had developed an overall strategy.

When Zuckerberg retired in 1998, his seat was left vacant and the executive committee was down to five members: Corzine Paulson, Hurst, Thain, and Thornton.

Other personal developments contributed to the growing opposition to Corzine. Thain had been posted to London for a year in 1995 before succeeding Corzine as chief financial officer. Corzine had known Thain well from their years as leaders in Fixed Income. They respected and appreciated each other and each other's skills, particularly in Risk Management. It was natural for Corzine to trust Thain and to send him as "one of my guys" to London. But Thain was not one of Corzine's deputies. Thain had always seen himself as independent and had always thought for himself.

In London, Thornton, a master of creating remarkable closeness in personal relationships with senior executives, bonded with Thain, an exceedingly numerate and rigorous analyst. Both men excelled at conceptual understanding and macro strategy. As a duo, Thain and Thornton were clearly stellar: an expansive "blue-water" conceptual strategist and creative top-level relationship banker paired with a computer-savvy CFO with highly successful leadership and managerial experience in Trading, Fixed Income, and Risk Management. Both had great experience and maturity, and both were young: Thornton was forty-one and Thain was thirty-nine. Neither was devoted to Corzine.

In 1994, Brian Griffiths, the firm's country adviser for the United Kingdom, had called Thornton to say, "John, have you heard the good news?"

"No, what have you heard, Brian?"

"Jon Corzine has been chosen as the firm's new senior partner. He's a real man of the people!"

"Damn! That's bad news, Brian. We don't need a man of the people. The firm needs a real leader."

Thornton had never met Corzine and had no opinion of him personally, but the firm was in crisis, and he felt the first priority in selecting a new senior partner should be strong leadership above all else.

Later, as a new member of the executive committee, Thornton quickly set the boundaries by telling Corzine: "Jon, you're in charge, so on ninety-nine percent of the issues that come to the executive committee, I'll give you my advice or volunteer my opinion but you'll make the ultimate decision. But one percent of the time—on the really big issues—I'll insist on the formal governance

mechanism in the partnership agreement and vote as one of six—as we all should. Okay?"

"Understood. Not a problem."

For a firm whose previous senior partners had been so dedicated for so many years to developing relationships with major corporations, Corzine's proprietary trading priorities were surprisingly different. His focus was on markets, not on client corporations. Walking along Park Avenue after a dinner, Gene Fife, who'd just spent several hours with IBM's CEO, Lou Gerstner, bumped into Corzine and asked, "Do you know Gerstner?"

"No."

"Would you like me to see if I can arrange a meeting for you?" Anticipating that the managing partner of Goldman Sachs—or any other investment bank—would jump at the chance to spend quality time with the accomplished CEO of one of America's great corporations, Fife was startled by the response.

"Why would I want to do that?" The obvious implication: Such a meeting would be a waste of valuable time. Corzine was still thinking like a proprietary bond trader. Later, as Corzine had more opportunities to meet one-on-one with corporate CEOs, he found he enjoyed it and—with his warm, avuncular, unpretentious style and open manner—was effective. He steadily increased his time commitment to corporate clients overseas.

Corzine repeatedly had "private" conversations with other partners—private from Paulson. "Don't say anything about this to Hank. We'll just keep it between ourselves—where it belongs for now."

As the pieces of the puzzle came together, a consensus developed among the members of the executive committee: Corzine was not the right man to lead Goldman Sachs—particularly as CEO of a publicly owned company—and he was not going to change. He would always be too sloppy and unreliable for the giant, fast-changing, complex business organization that Goldman Sachs had become. The organization needed discipline at the center.

With Silfen and Zuckerberg out, Paulson, supported by Thornton and Thain, needed only one more vote. Thornton and Thain understood Paulson to be planning to stay only two transitional years before passing the baton of leadership to them. Hurst now became the key man. He had been unhappy with Corzine for

a long time and had co-led banking with Paulson. Some thought it helped that Hurst, unlike the other three, was Jewish, which could be silently important at what had once been known as a "Jewish firm." While Corzine and his family were skiing in Telluride, Colorado, over Christmas break, Paulson, Thornton, Thain, and Hurst worked out an agreement: Corzine would have to go.

Timing matters. Within a few weeks the executive committee was sure to be expanded from its unusually small size when Zuckerberg was replaced. And once the firm went public, changes in CEO would be made by the board of directors, not by the executive committee. If they were going to move Corzine out, it had to be now. Decisions on who was brought into or taken out of the partnership had long been with the committee. According to the revised partnership agreement, to terminate Corzine as senior partner they needed an 80 percent majority of the five remaining active members of the committee—or four votes. With Hurst, they *had* four and 80 percent. Paulson, Hurst, Thain, and Thornton met and agreed to vote to remove Corzine as senior partner.

When speculating about the way the coup was organized, some partners point to early meetings held at Bob Hurst's apartment; others emphasize John Thornton's extraordinary skills at "blow your mind" strategizing; and others say, "Never underestimate Hank Paulson." Insiders see Thain's decision as a switch from supporting the man he knew and liked to a man he thought better qualified to head a public company.

Thain, who had known Corzine longest and was trustee-designate for the Corzine children's trusts, was chosen to tell him this cold-steel deal: Corzine would serve until the IPO was completed—to ensure at least the appearance of stability—and then would have to fall on his sword and leave the firm. He had to accept. They had the votes—and they had the power to reduce his shares *before* the IPO if he resisted.

Corzine had no accessible group to appeal to except the full partnership, and there was not enough time for that. As one partner explained, "If the decision had been put to the whole partnership, Corzine would never have lost his position; he was too popular and had too many loyal friends. But in the small group, when he wasn't looking, he could be—and was—blindsided. It was like living the history of imperial Rome."[1]

Corzine had tears in his eyes when told the surprise of a lifetime, but he

played it out like a man, calling key clients and the president of the New York Federal Reserve Bank, William McDonough, to say he had decided to relinquish being CEO but would still be co-chair.

While all the turbulence at the top was going on, the day-to-day work of the firm continued just as strongly and steadily as ever. Corzine insisted that renewing detailed plans for the IPO should be a decision of all two hundred voting managing directors, but Paulson and Thornton believed those decisions should be made by the executive committee.

Blithely calling the notion of a palace coup "inaccurate in every respect," Paulson went on to say to the press, with practiced air-brushing for public perception, "This is an evolutionary transition in management and governance, something that made long-term sense for the firm. The firm is doing very well and we thought it made sense to put these changes in place before the public offering. This was an evolutionary transition in management and governance."[2]

The IPO was completed on May 9, and on May 18 Jon Corzine's resignation was announced. Corzine was in a bizarre situation, and while he dealt with it straightforwardly, bizarre stores sprang up quickly. For example, Corzine's limo took him one day from his home in Summit, New Jersey, to Goldman Sachs headquarters in lower Manhattan. He did not get out. Being in the middle of an important call on his cell phone, he continued working from the limo's rear seat. While he continued his phone call, his driver called Corzine's secretary to bring some papers. A writer from *New York* magazine converted this brief happenstance into the core of a feature story saying that Corzine did this every day—working all day from his limo parked on the street next to Goldman Sachs's downtown headquarters.

While he focused on the IPO, Corzine also came close to organizing a group of investors to take over Long-Term Capital Management. But in early February 2000 New Jersey senator Frank Lautenberg announced he would not run for reelection. This gave Corzine the opening he needed—in a new field. As he explained, "I like to compete, and I like to win. Being in a campaign is the most competitive thing I've ever done." Corzine spent $60 million and won the election. He served part of a term in the Senate and then successfully ran for governor of New Jersey.

34

GETTING INVESTMENT MANAGEMENT RIGHT

One of the most profitable discussions in the history of Goldman Sachs took place over several weeks in 1995 between Hank Paulson and John McNulty. The essence of the strategy that they developed can be evoked by a simple analogy: The lovely eight-to-ten-foot trees we use to decorate our homes at Christmas would take twenty years to grow from seed, but the ones we buy are only six or seven years old; young sprigs are grafted into stumps with extensive, well-established root structures that provide so much nutrition that the sprouts develop and grow super-rapidly into full trees. McNulty—who had been consulting with Goldman Sachs Asset Management while on leave from the firm to recover from an early-age heart attack—convinced Paulson that grafting GSAM's investing onto Goldman Sachs's powerful distribution would produce rapid growth in assets managed and strong, almost riskless growth in profits.

Paulson assigned McNulty to work in GSAM with his friend David Ford. Things changed quickly at GSAM because Ford and McNulty were given important advantages compared to their predecessors. A decisive advantage was an agreement that their business success would be measured on the basis of the

market value of assets brought under management—that is, on GSAM's *capacity* to generate future earnings, not on current *reported* earnings.

"I had an epiphany," said McNulty, "that the correct way to measure the economic value of GSAM was *not* current profits, but accumulated assets under management—from which future profits and future growth in profits could be harvested." Traditionally at Goldman Sachs, each line of business, no matter how complex its inner workings, was always evaluated on a simple standard: Did you make money today for the partnership? That's the way it was and had always been with traditional Wall Street partnerships. But that's not the way it is in other businesses, such as oil and gas exploration, life insurance and annuities, and investment management. In each of these businesses, the first year of a major success appears to be a loser. The only way to understand these businesses is to use managerial accounting that recognizes the present value of the long-term increases in the economic value of drilling holes, creating customers, or building a franchise that will produce many years of *future* earnings.

Fortunately for GSAM and for Goldman Sachs, Paulson liked and trusted McNulty enough to listen carefully to his reasoning. Having watched M&A bankers sell asset-management firms to financial behemoths for surprisingly high valuations relative to earnings, Paulson was ready to recognize that McNulty and Ford had come to a crucial understanding about the best way to manage GSAM. GSAM's value was not current profits, but the accumulation of assets under management.

Changing the whole concept of how to measure success got strong confirmation from an unlikely source: the investment banking division. Goldman Sachs had been involved as adviser and banker in acquisitions of several asset-management firms and had learned how and why the market valued them so highly. This understanding was key to the transformation in measuring results and accountability that would enable McNulty and Ford to transform GSAM and its business. It meant that there would be no basis for complaints—and it might even be best for the firm in the long run—if the GSAM business was run at only breakeven for several years, provided it was adding substantial assets under management. With profits coming from a captive fee-based business, the stock market and debt-rating agencies would value those reliably recurring profits far more highly dollar for dollar than trading profits or banking fees.

When they took over from Steve Friedman in 1994, Jon Corzine and Hank Paulson were determined to decide once and for all what to do with GSAM—and how to do it. By agreement, Paulson would concentrate on improving internal operations while Corzine focused on making acquisitions. Paulson liked and trusted McNulty and listened carefully to what he had to say because he knew McNulty was a smart, conceptual, aggressive entrepreneurial realist. McNulty said of Corzine and Paulson, "They didn't really understand the investment business, but they asked all sorts of questions and their focus gave us energy for success." After starting out in Private Client Services, McNulty had moved from division to division, consistently in management and consistently successful. He spent hours and hours with Paulson, explaining the nature of GSAM's business and how it could be converted into a real success. The argument that the rating agencies were more interested in a million dollars of fee-based income than an equal million dollars of income from trading carried special weight with Corzine and Paulson since, as a private partnership without permanent capital, Goldman Sachs had a lower credit rating than its major investment banking competitors.

An expert observer of firm politics, McNulty viewed his career with engagingly sardonic good humor. "This is our last job at Goldman Sachs, David," McNulty warned Ford. "We are pioneers. And you know what they do: They fight the Indians, clear the land, and take all the big risks. Years later, folks build statues to celebrate the pioneers that nobody can remember by name—and the pigeons come and shit all over them. So, David, that's our destiny: pigeon shit."

Behind the banter were two successful partners with every intention of converting GSAM from perpetual widow-maker into another big Goldman Sachs success. As Ford and McNulty saw things, if the fee-based investment-management business could be built up substantially, GSAM could become important strategically to the firm and particularly to Corzine and Paulson, who were focused on launching the firm's IPO at the highest possible valuation. Paulson and Corzine had put Ford and McNulty in charge of GSAM with a clear mandate: "Build up the asset-management business so it at *least* moves the needle." McNulty told Paulson, "I'll stay until GSAM is profitable"—and he did stay until July 2001 and the first surge in profitability.

With Corzine and Paulson as sponsors providing air cover to protect GSAM from internal challenges from other divisions, individual partners, or even the

management committee, Ford, McNulty, and their team were off and running. Suzanne Donnahoe transferred in from Investment Banking, and David Blood moved over from the bond unit led by John Thain.[1]

McNulty and Ford were in a hurry to catch up with GSAM's opportunity. McNulty convinced Paulson that, to achieve success, the firm would have to hire top people from competing asset-management firms, which were also major customers of the other divisions, even if it hurt the firm in those other business lines. That's when Corzine and Paulson took the competitive gloves off by removing the constraints that had hindered predecessors. Not only could Ford and McNulty hire people from competitors, but they could now invest firm capital in building the GSAM business through acquisitions. In addition, GSAM was now free to compete aggressively for new business even though that business—new as it might be to GSAM—could be taken away from a firm that was an institutional client of Goldman Sachs's securities business. Paulson said he'd take the heat from other partners when their clients complained or punished the firm. He kept his promise to provide both air cover and capital.

Encouragingly, the firm soon learned that the institutions' bark was worse than their bite. While major stockbrokerage clients would threaten to cut off the firm if GSAM competed with them, with very few exceptions, the threats—no matter how loud or explicit—were just threats. The institutions needed Goldman Sachs and the liquidity the firm provided more than Goldman Sachs needed any one of them. And not only were the people making the threats a small minority among the institutional investors, but most of them did not and could not speak for their whole organizations. The institutional traders who cared most about doing block-trading business with the firm cared the least about competition at "bake-offs" for new pension accounts. With dozens of competitors vying for each account, they weren't about to stop or cut back on using their most important block-trading firm to reduce the competition by just one investment manager. And their senior executives, when push came to shove, would not ask or tell them to do so. So they bluffed and issued warnings, but the penalties rarely came through and never lasted.

The firm had always treated a dollar earned in asset management as no better and no worse than a dollar earned in trading, underwriting, arbitrage, or stockbrokerage. Yet even investment-management firms that earned only moderate

profits had market valuations twenty to twenty-five times their earnings, while trading businesses were worth only five or six times current earnings. In other words, the market value of a dollar of earnings in asset management was four or five times the market value of the same dollar earned in a trading business. The obvious imperative was to get control of assets, ideally by acquisition of capable investment units, and then apply the firm's power in marketing to gather in even more assets as rapidly as possible.

McNulty, who was never unnecessarily modest, acknowledged that he had great ability in recruiting strong people: "I believe in my nose for talent." In 1996–97, GSAM added two hundred new people, doubling its size and adding many needed skills, but taxing the infrastructure. Many new arrivals found there were no phones or desk space for them.

Ford, McNulty, Donnahoe, and Blood came up with a truly audacious plan, particularly for a business that seemed to be going nowhere. As McNulty put it, "We have to mirror Goldman Sachs's footprint. We have to be global *and* multi-product. If we are only a U.S. manager, we'll never be right for Goldman Sachs's strategic vision of the future. We *must* catch up and match the size of our ambition to size of our opportunity."

The proposition was so bold that it was either a bad joke or it was brilliant. Paulson decided that Ford, McNulty, Donnahoe, and Blood just might be right. For his part, Corzine was already out looking for asset-management acquisitions. As McNulty observed, "Jon Corzine couldn't wait to buy an asset-management business—or two or three—and the bigger, the better." He tried Robeco and then Mellon. Serious merger discussions were held over several weeks with Wellington Management in Boston, and discussions with T. Rowe Price were initiated but never got beyond the preliminary stage; T. Rowe Price wanted only an investor, not an owner. Corzine nearly acquired Grantham Mayo Van Otterloo (GMO), a successful quantitative manager in Boston, at a price that would have made GMO's Jeremy Grantham the largest Goldman Sachs IPO shareholder—but Grantham broke off the discussions. (Later, taking a strong position that the Internet boom *was* a bubble despite clients' optimism, GMO took a very conservative stance in investing; it missed the dot-com millennium market, and its assets fell from over $80 million to $20 million but then—after GMO was proved very right—zoomed rapidly to more than $150 million.) Partners Pat Ward and

John Thain contacted Stephen Zimmerman and Robin Jeffrey about buying their employer, Mercury Asset Management, the leading UK investment manager, for a suggested price of $5 billion. But they got little encouragement and probably would have encountered strong opposition within GSAM. While Corzine drove to acquire established management firms to get control of more assets, those closer to the business had a different focus; to them, the smarter buy would be a smaller firm with managers capable of handling much greater assets. "Buying on assets is buying the past," says Blood. "The smart buy is to lift out the top people and then help them build up the assets under management."

The strategy McNulty, Ford, Donnahoe, and Blood developed was almost as simple in summary as it was grand in scale of ambition and scope of imagination: "3 × 3 × 10"—three continental markets, three marketing channels, ten investment "products."[2] Their strategic summary was simple, but their ambition was no less than the total transformation of GSAM in just one decade of repetitive entrepreneurial innovations into a global asset-management powerhouse spewing profits like a lawn sprinkler.

In retrospect their multimarket, multiproduct strategy may be seen as a sure winner, but at the time the case for going ahead was not easy to make, particularly to that vortex of power, the management committee, where the dominant metric had always been current-year profits. When McNulty, Ford, Donnahoe, and Blood laid out their vision for the next ten or fifteen years, most partners scoffed that the ambitions they were discussing made no sense at all. *Those GSAM guys were actually advocating deliberately taking losses for years!*

The partners of Goldman Sachs had fought their way to the top of tough businesses, and the real power in the firm had always been the power of current profits. Instead of talking, as everyone on the management committee had always talked, about current profits booked and taken to the bank, McNulty & Co. were actually advocating accepting *losses* in GSAM for at *least* several years. To those on the management committee trained up in a cash-profits culture, it all sounded like smoke and mirrors. Losing money on purpose over a whole decade for something as abstract as "franchise building" in a business they really didn't know and understand made no sense at all—not any more than calling losses "investment spending." Losses are *losses*.

GSAM's business was still struggling with trivial profitability and had zero

stature within the firm or in the outside markets. Could it possibly be developed into a global powerhouse as one the world's largest, most profitable, and most rapidly growing asset-management businesses, delivering substantial, repetitive profits to Goldman Sachs? Brazen as they were—especially to those who had wondered "Why not close GSAM down as a totally lost cause?"—McNulty was able to persuade others his team's bold ambitions were realistic. As he explained to anyone who cared to listen, the 3 × 3 × 10 strategy boiled down to this: Three major markets would be addressed *simultaneously:* North America, Europe, and Asia. Three marketing channels would be developed *simultaneously* to reach three key customer groups: institutional investors, via direct selling and through investment consultants; other investment managers that had distribution and could offer third-party or subadvisory mandates to cover specialties like international investing, via direct selling and through consultants; and high-net-worth individuals, via Private Wealth Management. Ten investment products would be provided: money-market funds (through ILA), high-grade bonds, municipals, "quant" strategies, large-cap growth stocks, large-cap value stocks, small-cap stocks, international stocks, specialized funds subcontracted from other investment managers, and hedge funds through a fund of funds.

Stunning as it is that it took the firm's management long decades to "get it" about investment management, GSAM's history provides a crucial illustration of Goldman Sachs's unrelenting "try and try and try again" approach to building each of its many business enterprises: Select one or two very able, very ambitious and promising, but not yet proven young stars. Point to a far hill and say, "Congratulations! You are the Chosen One who can find a way to capture that hill. It will be hard—maybe very hard—but the firm expects great things of you. We *know* you can do it. Now, get going and . . . take . . . that . . . hill!" When success is achieved, congratulations are given to the successful young stars—and so is another, even more challenging hill. If success is not achieved, the firm selects another one or two very able, very ambitious and promising, but not yet proven young stars. If success is *again* not achieved, the firm simply selects yet another one or two very able, very ambitious and promising young stars to take the hill. Eventually, the hill gets taken.

McNulty was searching for acquisitions, ideally of small firms with strong investment products and track records but needing help in selling, where the

Goldman Sachs organization was so clearly powerful. The search was bolstered by the M&A specialty that partner Milton Berlinski developed. He ran a seller-rep business as an active intermediary between small and midsize investment-management firms—where Goldman Sachs's institutional sales force had long-established, close working relationships—and large banks, insurers, and other institutions that were buying investment managers as "strategic partners." Goldman Sachs was in an ideal position on both sides of a lively new market to earn good fees by putting combinations together.

In 1995, Herb Ehlers's Tampa-based Liberty Asset Management, which had been spun out of retail broker Raymond James & Company, was in discussions with Berlinski about his seller-rep services when McNulty took Berlinski to lunch and asked: "Do you know any good little managers with superior investment people who are weak in marketing that GSAM should consider buying?" Apart from the obvious conflict-of-interest question of how Goldman Sachs, recently retained as an agent, could quickly change to act as a principal, it was the right question at the right time. Negotiations for another large financial-services organization to acquire Liberty had just recently broken down, so Liberty was "in heat," and GSAM could initiate discussions sure that Liberty was for sale and knowing all the particulars Berlinski had been learning in his work as Liberty's seller rep.

Merger discussions moved ahead quickly, and McNulty and Ehlers developed good personal chemistry. Ehlers recognized the asset-gathering strengths of Goldman Sachs while McNulty was impressed with Liberty's dedication to investing. As McNulty described the situation, "Liberty had a solid growth product, and they had a team who were absolutely devoted to investing. If you call them at home on a weekend morning, they're doing what they love most—reading annual reports! It's a passion, a personal passion. They're so dedicated to investing, you could call them addicted."

Adds Ford: "We brought good things to the party too. First, we had strong distribution and could raise a lot of money for Liberty, enabling their people to realize their personal dreams. Second, we had some pretty sophisticated expertise in risk analysis and risk management, and showed them how they could cut back any unnecessary risk in their portfolios.[3] Third, we would give them the security and confidence of having a major organization behind them, which enabled them

to focus on their true passion: investing. Indirectly, we would also help them stay organizationally disciplined because we had a big stick in our hands. GSAM had the option, written right into the contract, to bring everybody at Liberty from Tampa to New York if things at Liberty didn't run smoothly."

But getting the final agreement signed was not easy. Herb Ehlers threatened to abort the deal after he saw draft legal documents. The lawyer working for Goldman Sachs may have known contracts and acquisition law very well, but he overplayed his hand in writing the terms because he didn't understand the key to successful mergers and acquisitions in a service business: trust between the key principals. Goldman Sachs's banker on the deal had let the lawyer take control of the contract, and the lawyer wrote every part of the merger agreement to GSAM's advantage. Item for item, the results were different from what Ehlers thought were accepted understandings. Thinking GSAM was trying to pull a fast one on him, Ehlers got angry and—at least as much in sadness as in anger—declared, "The deal is off."

After weeks of negotiations, McNulty had gotten to know Ehlers well and sensed there was something not yet settled. Somewhere, somehow, he just *knew* there was a way to save the deal. But what could it be? "Of course!" said McNulty to himself. "It's Yom Kippur." In drawing his line in the sand, Ehlers knew that Berlinski, the partner from the investment banking division who was supervising the deal, would be unavailable because he would be at temple, so GSAM wouldn't have its expert working in between the two principals. McNulty and Ehlers would be on their own. To McNulty, that showed how savvy Ehlers must be: "Since he's that smart, we *had* to win this deal because a guy that smart could be a control player for the future of GSAM." McNulty went to Corzine and explained the whole picture, but Corzine didn't get it. He tried to calm McNulty down, saying, "You win some and you lose some. We'll be okay." But McNulty couldn't calm down.

He quickly went to Paulson next and said, "Let's catch the seven a.m. flight out of Newark." Paulson agreed, and when they got to Tampa, they swung into action, making the strongest pitch they could. "Herb had the contract in front of him and we could see he had lots of marks on it—page after page. Our only hope was to go through it item by item." As Ehlers identified items he didn't like, McNulty would ask, "What *would* you like, Herb?" Item by item, Ehlers said

what he wanted and thought had been agreed. Item by item, Paulson said one word: "Done!" Paulson said that one word a dozen different times. "Done!" "Done!" "Done!" After all the marked items were resolved, Ehlers said, "We'll go into another room and discuss among ourselves all you've said, and then we'll vote." After half an hour's discussion, Ehlers's colleagues came out smiling. They had voted yes.

The next priority was to make it clear to everyone at Liberty that while they all could remain in Florida, GSAM was in charge. McNulty recalled how he did this: "I told the guys at Liberty they could stay in Florida, but that I had a big inventory of warm winter coats in a big closet, and if performance ever went south and stayed there, I was going to send those coats to Tampa because they were *all* coming north—to stay. Naturally, this made it very clear to everyone that they better produce consistently good performance numbers. And the results of this enforced discipline were great for them—and great for us."

When the acquisition's final closing was only one week away, Ford called Ehlers to say, "It's important that we all agree on one thing. There's only one franchise or brand and only one vision for our future together. On the day after the closing, I'll call your office and there are only two possible ways for your folks to answer: 'Goldman Sachs' or 'Goldman Sachs Asset Management.' And you'll want to print some business cards—not many, but some—with 'Liberty' in big letters and 'Goldman Sachs' in smaller type right under it, and then we'll switch to some cards with 'Goldman Sachs' in the larger type and 'Liberty' under that in smaller type, and *then* we'll switch to new cards—and you'll want lots of these—with only 'Goldman Sachs Asset Management.' Always remember, Herb, *we* are the brand."

A few days later, when Ehlers was at Goldman Sachs's office in New York City, Ford walked him over to the large picture window with a great view of lower Manhattan looking south toward the outer harbor and said, "Look out this window and tell me what you see."

"The river, the ferry, the Statue of Liberty . . . and Brooklyn. Why?"

"Keep your eye on Brooklyn. *That's* the objective. I'll find a way to get you over there—ferry, tunnel, helicopter. You keep your focus entirely on Brooklyn, and don't even look at the river." The message was clear: Liberty should focus on investing while GSAM accumulated assets through selling.

A few years later, another round of negotiations developed over Liberty's five-year payouts. Ehlers called McNulty: "I've been looking again at the earnout, and I realize it's not fair. We've done great work in recent years, but if our part of the market—growth stocks—suddenly goes against us, we'll come up short on performance, and our investors will disappear. We could be hurt badly by some fluke in the stock market."

"Sounds bad to me too. Tell you what, Herb. You're a proprietor. You've sold Liberty once before and then bought it back, so you study the whole situation and if you can come up with a fair rearrangement, we'll do it." In the end, Ehlers worked out a better buyback deal than McNulty ever could have proposed. McNulty returned the favor: "I did suggest that they take 50 percent in Goldman Sachs stock. They agreed and that worked *very* well." Goldman Sachs stock doubled and then doubled again by 2007.

The original deal for Goldman Sachs to buy Liberty was done in 1995, when Liberty had $4.5 billion in assets under management. Ten years later, assets under management were at $23 billion and rising, because GSAM had such strong distribution. GSAM had paid $80 million for Liberty. After a decade of strong asset buildup, the buyback by Ehlers's group valued it at over $2 billion.

GSAM was looking for more of the same and found a likely target in Rosenberg Capital Management (RCM), one of the finer investment firms on the West Coast. Claude Rosenberg was surprised when Berlinski, the Goldman Sachs banker managing the intended sale of his investment-management firm, suddenly went from being his agent to being a principal, saying, "We might be interested in buying your firm for Goldman Sachs." This again raised all the classic questions about conflicts of interest, but Rosenberg decided to go ahead with discussions with GSAM.

For GSAM, it soon developed, the underlying problem with acquiring RCM was business fit. RCM had a small international investment product that it really wanted to continue. But Goldman Sachs was already a well-established international investment bank with offices in every major country and significant research being done on all the major economies and most of the major corporations from its regional headquarters in London, New York, and Hong Kong. It

would be hard for the firm to justify to clients or prospects having another international investment product headquartered in San Francisco. "A great city for living it may well be," says Ford, "but it's not considered a center of international investing compared to London or Hong Kong or New York." So keeping RCM's product separate would be a problem. "We'd be buying business we *knew* we were going to lose—and should lose. Not a smart move."

A larger problem was in bond management. GSAM had bond management and RCM had bond management, and the two bond operations were similar in investment style. The obvious answer was to bring RCM's bond assets and some of its key people to New York and combine them with GSAM's team into one major operation. But the RCM people, as settled San Franciscans, were not about to agree to that. And GSAM couldn't agree to pay a full price for a duplicate bond business when having two similar units would be confusing for clients, prospects, and the consultants who advise institutional investors on selecting managers. "We'd have had 'channel conflict' all over the place," says Ford. "And there were other problems. San Francisco is too far from New York, where GSAM had its headquarters. Claude Rosenberg had great stature in the pension market, but he had retired and nobody had filled his shoes. In addition, they had some interesting internal politics, and they had no new-business pipeline." So, after giving serious consideration to acquiring RCM, Ford and McNulty decided to take a pass—and kept looking for other firms to acquire.[4] It didn't take long.

"Did you guys see what I saw in today's *FT*?" It was still the spring of 1995, and George Walker had just come over to GSAM from Investment Banking. Highly regarded as a strategic thinker, Walker would effect three significant acquisitions in 1995–96—each valued not for the assets that were currently under management, but for its distinctive investment capabilities that could, with Goldman Sachs's prowess in sales and business development, lead to major increases in assets under management in five or ten years.

Walker was waving the *Financial Times* over his head and smiling. He saw an opportunity in the British government's decision to privatize the management of the British Coal Board's pension fund. "The auction for the right to manage the British Coal pension scheme has been declared a 'failed auction,' so there was no sale. But that doesn't necessarily mean that it's game over. I know I may sound crazy, but I'll bet we could negotiate to acquire the British Coal mandate if we

act very quickly and make a decent offer." Would-be managers were expected to pay up front for the right to receive management fees for a fixed number of years, guaranteed by the British government.

"But, George, what in the world would we be buying? It's just a contract to manage two big pension funds—and for only seven or eight years. Not exactly hard assets, George."

"You're right—but you're wrong too. You're not looking at this for what it really is. Here's the way to see the value here: The UK pension business has long been closed to outsiders like us. Four big *British* investment firms—with four *British* consulting actuaries guarding the gates on new manager selections—control almost all the UK pension business. As things stand today, we'll never get in. But, if we can win the Coal, we'll suddenly be on the inside. We'll be able to show the consulting firms what we can really do—and they'll have to pay attention because we'll be out of the holding pen where they keep all the non-UK investment managers like GSAM. We'll have at least a toehold that we can then build on. If we produce decent investment performance and show we know how to build and manage a major investment organization, we can launch a total-immersion sales campaign to win over the consulting actuaries so they'll bring us more and more business. At the very least, they'll give us a decent chance to win business by including us in more of the beauty parades they now arrange when their clients are picking new managers."

The Coal Board had gone through two failed auctions. The senior investment managers were dead set against a UK acquirer because they knew they would all get made redundant and terminated because the acquiring manager would already have people in all the key positions. With five hundred thousand coal workers' pensions depending on it, the British government clearly wanted a strong buyer because the government had a contractual obligation to cover any shortfall due to poor investment performance by appropriating new money. This meant that good risk controls—a major strength of Goldman Sachs—would be particularly important.

Walker argued that if Goldman Sachs could get the mandate and be the Coal Board's manager, that would be the firm's ticket of admission—the key to open all those closed doors. "With £25 billion in assets, it brings us up to scale. We won't be really big, but we will clearly be a presence. With all the stockbrokerage

commissions that the Coal generates, we can buy all the best investment research in the City of London. And we know from our brokerage work with them that the guys at the Coal [pension fund] have a pretty good portfolio team and pretty good research. But they don't do *any* marketing, so we'll do all the marketing and business development. And we can base our pitch on the truth; we bought this team because we believe in them—and that's why prospects should buy in too!"

GSAM had only twenty-five people in Europe, but decided it would bid for the multiyear contract, knowing that the Coal Board had problems with staff, problems with information technology, problems with operating procedures, and surely problems GSAM didn't yet know about. GSAM figured it had three two-year blocks of time to work within: two years to fix the problems, two more years to run the Coal Board funds and establish a good performance record, and two years after that to build assets through selling services to others.

"The Coal Board's senior people assured me in our first meeting that we would be getting a great team," recalls Ford, "so I said to them, 'Great! If they're as good as you say they are, this is the best deal in the world for them because with our marketing organization, we're really going to grow this business.' "

GSAM had an interesting proposition to sell to the investment consultants. They knew Goldman Sachs had staying power and would see this acquisition as a solid commitment to the UK market. The consultants were worried that the investment business was consolidating so much that it was virtually imploding. Only four important UK investment managers were still standing—down from six two years before and way down from twenty important managers fifteen years earlier. With only four investment firms left, the consultants were afraid of losing any more. As Blood said, "The whole market was really ready for strong, new managers like us." Ford quickly saw the opportunity and gave his strong support: "It was like a free option. If we have an up stock market, and we perform at least decently, we'll have had a big win. If there's a down market, we'll get our purchase price back through management fees and we've lost nothing." GSAM paid $75 million for the contract and, over the next six years, received $95 million in fees.

"We made lots of mistakes with that acquisition," remembers Blood. "But one after another they were corrected during the integration process. We made major investments in IT and in people, and it took us five years to reach break-

even, but when we did, we had a big, strong business base in the UK and a platform for all of Europe." Some in the firm judged that while McNulty cleared the land, laid the foundations, and built the ground floor, all the upper floors of GSAM were built by David Blood.

British Coal was an acquisition that became a real marriage because it gave GSAM market visibility and showed GSAM the best practices in client services. The Coal Board acquisition obliged GSAM to produce written definitions of several different portfolio-management capabilities. Over the next several years, this formalization developed into a major competitive advantage because large accounts increasingly wanted one or two managers with broad investment capabilities who could take responsibility for as much as half of their total fund—and then have a few smaller managers as outriggers to keep the major managers on their toes. GSAM focused its marketing efforts on the consulting actuaries as powerful gatekeepers. The best new-business opportunity was as a specialist manager, rather than a generalist managing all kinds of investments, as had been the British tradition—and GSAM was all about multiple specialties. McNulty's team set out to build the major business they now envisioned for GSAM.

Over the next decade, the business growing out of the Coal Board acquisition grew fortyfold—from $2.5 billion to $100 billion of assets under management—because GSAM's distribution was so powerful. Two major external changes played directly to GSAM's advantage: The United Kingdom's leading fund managers—Mercury Asset Management, Gartmore, Schroders, and Phillips & Drew—all suffered either poor investment performance or major internal organizational problems while GSAM's Coal Board acquisition did well. And the UK pension funds and manager-selection consultants, or consulting actuaries, shifted their focus from "balanced" managers to specialist managers—which was what GSAM had become as it demonstrated its capabilities to perform. The selection consultants—which most UK money managers disdained professionally—were the center of GSAM's attention. After two years of observation and intensive courtship, the consulting actuaries became convinced. Given their influence at most major funds, GSAM's focus paid off handsomely.

Internal changes were made too. GSAM compensation was separated from firm results and based much more than before on each individual's contribution. Each investment unit got incentive compensation based on its own investment

performance. Blood and Donnahoe hired in a team of strong sales executives, set up an incentive compensation plan, and made it clear to all that bringing in the business was *the* priority. By 1998, GSAM's assets under management had grown enough for it to add effective salespeople to cover the Continent—where the same manager-selection consulting firms were powerful, specialist managers were becoming important, and the local competition was caught napping. After that, expansion in Asia was almost simple: replication of a strong sales and service organization to gather assets to be managed by the proven investment teams in London and New York.

The implementation of the 3 × 3 × 10 strategy was described with obvious satisfaction by McNulty: "Each product is a separate focus of energy. Centralized 'manufacturing' (managing investments) and local distribution make for the best business. We want to have the best team in each product. And in marketing, GSAM is like a Roach Motel: more assets come in than go out every day. We have balance without conflicts, and the operating units are small enough for each team to have real ownership commitment."

As Paulson and Corzine were quickly learning, the underlying economics of investment management as a business are marvelous: Assets grow almost automatically at an average annual rate of nearly 7 or 8 percent compounded because the stock market averages that kind of growth; since new assets can be added onto that base, annual growth averaging around 15 percent seems surely sustainable—which doubles assets in less than five years. Even 20 percent annual growth is not unusual, and *that* doubles assets every three and a half years.

GSAM continued to get better and bigger at gathering assets, which, from the owners' perspective, is the surest way to maximize profits and wealth. When investment management flourishes as a business, commitments to client service, investment professionalism, and quality control often fade. What's right for an owner is not necessarily what's right for a client, particularly when business incentives trump professional disciplines and conflicts of interest develop. For example, GSAM had explosive early success in Japan, raising $10 billion in mutual funds whose performance was enhanced with a winning dollar-yen play. But a little later, that extra foreign-exchange lift got reversed and assets melted away as Japanese brokers urged disappointed retail customers to sell and move on to their next "opportunity." Fees were high. In a global bond fund, it cost 5 per-

cent to buy in plus 1 percent annually for management *plus* 0.5 percent for custody and 3 percent to terminate. There was no way investors could profit: Fees were too high, even relative to an optimistic estimate of value added.

Financially the Japanese failure had a silver lining, at least for GSAM. Profits in Japan on that first fund's introduction paid for the worldwide buildup of infrastructure for GSAM. "We knew that if we didn't globalize GSAM," explained McNulty, "other divisions or the firm's local offices would set up asset-management business units in any decent market we left uncovered. So we had to move quickly and preempt internal competition from our own colleagues. Every business should stick to its real strengths; Goldman Sachs's strength is selling. And we wanted to sell captive GSAM investment capabilities because raising capital for other investment-management organizations is a lose-lose proposition for GSAM. If the manager does well, they'll drop GSAM and use their performance record to raise future funds on their own, so GSAM loses. If their performance is poor, GSAM loses, period. The much better business model is to organize a fund-of-funds business with GSAM in control of the client relationships."

McNulty became convinced that "alternatives"—including private equity and hedge funds of all sorts—would be important, but he says, "You can't mix long-only investing and hedge funds in the same organization because the fee structures and profitability are so different; they are almost contradictory, and the requisite people skills and disciplines all differ. The economics and profitability are too different, the management styles are too different, and the internal glory is too different. How can you help but know that the hedge-fund business is so lucrative that it *has* to be your first priority? Besides, with hedge funds in a large organization, the incentives for hot managers to go out on their own are way too big."

The answer was to acquire an "alternatives" manager—ideally in a different city—and run that business separately in "production" but as part of a coordinated combination in marketing. Goldman Sachs did that in 1997 by acquiring Commodities Corporation, a $3 billion manager of managers or, to use the current term, a fund of funds.[5] During the 1970s, Commodities Corporation's returns had been superb, but the company "knew" that performance was everything, didn't believe in marketing, and culturally couldn't accept salespeople. As a result, it couldn't raise the money it could have managed, so revenues from fees covered costs only if and when investment returns were over 20 percent per

annum and large incentive fees were earned. In 1998–99, investment performance was dreadful, and the company had to find a white knight quickly to take it over. The fit with GSAM was obvious. Anne McNulty, with consulting experience at McKinsey, was working as a consultant on information technology and human resources for Commodities Corporation. Her husband turned to Ford and grinned, "David, you always wanted to hire Anne. So now you'll have your cake and eat it too."

Operationally, Commodities Corporation broke up its total portfolio into many different subportfolios, and each manager ran his own piece. The returns were additive, but owing to the structured diversification, the risks were *not* additive: They offset each other, so total risk was significantly lower—the investor's holy grail. In a fund-of-funds business, returns are worth much more from the business owner's perspective because the risks are diversified down to a very low overall risk level. McNulty had known Commodity Corporation's CEO, Rick Hillenbrand, for years, and the two men liked and trusted each other.

Late in 1998, Commodities Corporation organized a series of "boutique" specialist investment units—across ten different asset classes—pursuing four common objectives: Know the risks in the portfolio and in the markets and then take only "on-purpose" risks—and reward investment managers explicitly for success. Diversify the portfolio widely to get a hundred different risk-reward decisions rather than having a portfolio driven by just one or two dominating decisions. In research, avoid stale old models and invest in developing the best models for the future. Take a global perspective. Since the world has many, many markets, understand and use their differences to capture true diversification.

"Commodities Corp gave us a big platform for entry into hedge funds and private equity," recalled McNulty with a smile, "and it had zero marketing capability, which was *our* great strength. One other thing: It was losing money when we bought it, so we bought them for just the value of their office building and the land around it—$11 million." Ten years later, Commodity Corporation's fund of funds had assets under management of many billions.

Organizationally, having co-heads of structural units like GSAM is strongly supported by the Goldman Sachs culture. It certainly costs more to have

two leaders, but it's worth the money because the value is increased even more than the costs. While one unit head is at the firm developing alpha (superior investment results not directly correlated with beta, or market risk), the other head is out meeting with clients and prospects. As Ford says, "Teamwork can work *very* well if you truly believe in it."[6]

In 1999 and 2000, GSAM lost money. In 2001, it made $25 million, a laughably tiny amount within Goldman Sachs. But then in 2002 profits jumped to $120 million, and in 2003 they surged to $250 million. And in 2004 everybody noticed as profits kept soaring to nearly $1 billion, making GSAM a major contributor of repetitive rising earnings.

As McNulty had mused, "The pioneers get all the arrows." Even as his strategy was proving itself, McNulty got more than his share. GSAM's profit progress before he retired in 2001was simply not fast enough for the traders, who were increasingly impatient and increasingly powerful within the firm. Nor was McNulty moving forward fast enough with his missionary educational campaign to teach everyone how to understand what it had and what it was getting. And while most senior people made articulate declarations about the importance of international experience and urged their best young people to develop experience in several different areas of the firm, most of the members of the management committee spent most of their careers in New York City and concentrated all their careers in one part of the firm's business. It was a classic case of "Don't do as I do, do as I say."

The earning power of GSAM is now quite formidable. The burgeoning profitability was invisible until it was already too late to change basic strategies and came after all the most important concepts had been proven by superb execution. Results were excellent in 2006. Its long-short quantitatively disciplined funds were up over 20 percent net of fees while many hedge funds faltered; most competitor funds were down somewhat or were up by only single digits. Given client demand, the firm estimated it could add another $2 billion in assets under management over eighteen months. In terms of absorbing a manager's capacity to add value, however, adding $2 billion to a hedge fund, because of its intense trading, could be like adding $30 billion to a long-only portfolio. To be sure of getting paid for the scarcity of capacity in its hedge funds, GSAM raised its fees from 1 percent base plus 20 percent of returns above a low hurdle to 1.5 percent plus

20 percent. GSAM had $100 billion in quantitatively disciplined portfolios—$50 billion in global tactical asset allocation, in which a manager makes frequent price-sensitive adjustments in a worldwide investment portfolio, and $50 billion in "enhanced index" funds—and believed it had capacity for another $100 billion. As partner Bob Litterman explained, "The firm tracks the trading cost, which now runs about 10 percent of our alpha, or value added. As this creeps up, we'll have to decide where and when to close this unit to new business."

A hot seller in the market is a product with a guaranteed return of principal, usually with a seven- or eight-year life to maturity. As with a zero-coupon bond, the investor can be guaranteed the $100 "par value" principal with $70 invested in available securities, and can then invest the other $30 opportunistically. People in other parts of the firm wanted to sell this product but insisted they needed to see GSAM's actual positions to price the product properly. But GSAM leaders didn't want to show them everything, knowing their own colleagues would trade against GSAM, particularly if there was a market crisis. That's why Goldman Sachs's leadership will be challenged again and again to manage an aggressive dealer organization and an asset-management business in the same firm. Asset management is a profession full of fiduciary responsibilities, not a caveat emptor business.

With the surge in business during the first half-dozen years of this century, the firm had to be careful not to maximize reported profits rather than reinvesting to build an even larger, stronger business. "To build a great asset-management business, the key decision makers have to love the business," says Blood. "That secret ingredient is crucial." With scale come challenges. The importance of person-to-person bonds of friendship that have been so important to the strength of GSAM are hard to sustain in a truly global business with ten categories of investment products and thousands of customers with many different needs in hundreds of cities.

While building a large global business, GSAM had a surprisingly personal touch in its nature, particularly among those who joined the firm under the Two Johns. When John McNulty's father died of a sudden heart attack at seventy-two in the late 1990s, McNulty turned to David Ford: "We never had much money when I was growing up. My dad was orphaned at thirteen and got little education. He worked hard for what little he got paid. He never once saw Easy Street. So I

want to go all out for my father and give him a truly special burial. He was from Philadelphia, and I'd like to arrange it at what has to be the finest country club in the area. You're a member at the Merion golf club. Could you arrange it for me—for my dad?"

"Great idea! I'd be very glad to arrange it."

"David, that would be wonderful."

"And it *was* wonderful," recalls Ford. "Merion is really such a special place. And it was a beautiful day. John hired Ronan Tynan, the great Irish tenor, to sing Irish songs. Flowers were *everywhere*. Nice food. Lots of people came and they all had a *very* good time."

Only later, after it was all over, did McNulty tell Ford something he'd never told anyone at the firm because it had never mattered. His dad had worked for many years as a groundskeeper—at the Merion golf club.

35

PAULSON'S DISCIPLINES

Some of the most difficult and important decisions for individuals and for leaders of organizations are "not" decisions. Decisions not to marry Alice or Sam, decisions not to take a job offer or, in a business, decisions not to acquire or merge. So it was for Hank Paulson and his decision not to combine with J.P. Morgan. At the time of decision, Paulson was classically alone at the top.

One strategy advanced by some at Goldman Sachs had been to achieve public ownership without going through the stress, uncertainty, and distraction of an IPO by combining the firm into a publicly owned bank. Chase Manhattan was mentioned most frequently. But after some initial exploration by Jon Corzine, that idea had not been pursued. At the Arrowwood meeting, John Thornton had protested that doing an IPO without a clear strategic vision of the organization's future and of how going public would advance that vision was like only one hand clapping. He went on to say that the firm's going public would almost inevitably lead to a merger . . . with a big bank. Then, to illustrate his point and give it specificity, he had said . . . with J.P. Morgan.

Later, after Goldman Sachs went public in 1999, the firm gave serious consideration to combining with J.P. Morgan. The prevailing view was that all

the leading investment banking firms would have to have big balance sheets to succeed—or even to survive. Advocates of the merger pointed to how commercial banks had bought control of securities firms in London after Big Bang and how Citibank, having recently combined with Travelers, had acquired Smith Barney and Salomon Brothers. In most countries, commercial banks owned or were buying into investment banking firms and using their big balance sheets and price cutting to force their way into the business. The trends, many believed, were irreversible, and the mistake would be to stay romantically attached to the old separation of investment and commercial banking and try to compete without the strategic imperative of the future: a big balance sheet.

Corzine and J.P. Morgan's chairman and CEO, Douglas "Sandy" Warner, had had preliminary conversations and one meeting to explore a possible merger and had developed an easy rapport. After the IPO, Paulson followed up on Corzine's conversations by accepting an invitation to a private luncheon hosted by Warner at J.P. Morgan, where they talked about reviving those conversations. The two men were cordial to each other, but the luncheon led nowhere. After several months passed, Paulson invited Warner to breakfast at Goldman Sachs, after which they went to Paulson's office. As usual, Paulson went directly to the point: "We've done a lot of thinking about the future of finance and would like to talk very seriously about the merits of a combination. If, after serious consideration, it looks desirable, we would make a very specific offer."

Discussions were conducted during July and August by two teams of three: Paulson, Thain, and Thornton for Goldman Sachs and Warner, Walter Gubert, and Roberto Mendoza for Morgan. Others from both organizations joined in some of the division-by-division discussions. No numbers and no papers were exchanged. At Warner's insistence, it was agreed that poaching each other's employees was strictly forbidden. He worried that Goldman Sachs might pick off some of Morgan's best people and was particularly anxious to protect the bank's derivatives specialists.

Both groups had learned a lot about each other and their organizations' strategic fit. As Warner recalls, "The joint examination found—for both organizations—an even greater combined strength than had been expected or even imagined. Thain and Thornton seemed most keen, saying the combination was in their judgments a home run." To Warner, Goldman Sachs seemed

particularly interested in his bank's derivatives capabilities, its international stature with both corporations and governments, its great strength in Latin America, and its large, prestigious investment-management business. While Warner's team was hearing clearly the expressions of interest from Paulson's team, they should have been better tuned in to their reservations.

Looking back, the consensus at Goldman Sachs was that Warner was wrong to be his own expert adviser and to put all his cards on the table at the start of the negotiations. More specifically, Paulson's team was surprised to learn that J.P. Morgan was spending as much as Goldman Sachs in M&A and in securities dealing—both in bonds and in equities—but could not generate half as much in revenues. They were also concerned to learn how much of J.P. Morgan's business depended on derivatives and proprietary trading, and they were particularly concerned about having to go through large layoffs after a combination.

Both organizations had regular board of directors meetings scheduled for the same week, and that week was fast approaching, so if a deal was to be done, the time for decision was coming up soon. "It's time now to be specific," said Warner. Given what he felt was the strong business case for Goldman Sachs's acquiring J.P. Morgan, it was time to set a price. To represent full fair value for J.P. Morgan's shareholders, that price would have to be a premium over the current market price for Morgan shares.

While the two organizations were exploring each other as businesses, Paulson and Warner and the others were learning more about each other as people and as business leaders. Warner was particularly anxious to settle on the management roles. He called Paulson and asked if he could come over to Goldman Sachs's offices. There he proposed that he and Paulson become co-chairmen of the new company. Paulson wasn't ready to get specific about titles until a decision had been made on a combination, but he wanted to avoid any misunderstanding about the senior management structure. Acknowledging the possibility of becoming co-chairmen with Thain and Thornton as co-presidents, he was clear on one specific: "I'll be CEO." Warner replied, "I do know the difference between a merger and an acquisition." Paulson recalls, "Sandy understood that as CEO I would select the leadership team and said, 'Hopefully, you will pick some of our guys for your top team.' "

Then Warner asked, "Why not be co-nonexecutive chairmen? We do the deal and then appoint Thain and Thornton co-CEOs, to address all the tough

implementation issues and do all the reorganization work—work that will involve large redundancies in both organizations over three or four years of difficult integration." To make the acquisition work, there was sure to be lots of redundancy and many layoffs. For example, Goldman Sachs had 1,500 people in Tokyo and J.P. Morgan had 1,500 people in Tokyo.

Paulson brushed the proposal aside: "I'm not ready for that and our firm is not ready for that."

On Monday of the week when both organizations had board meetings, where presumably the combination would be ratified, Paulson told Warner, "I'm going to my apartment now—by myself—to give this whole proposition a deep think. Let me sleep on it and I'll call you in the morning."

Looking back years later, Paulson recalls, "I kept asking myself: In what business are they better than we are? In five years, where will they be stronger than we will be? At the very end—with board meetings coming up for both of us, I met early in the morning with Thain and Thornton and told them I had decided we were not going to do this deal—and hoped I wasn't disappointing them too much. Legally, we would be acquiring Morgan, but J.P. Morgan was so much bigger than Goldman Sachs that in reality *they* would be taking *us* over, and they would bury us. I also knew that somehow we'd figure out how to do everything they could do." Early that morning, Paulson called the members of Goldman Sachs's management committee and then all his directors. "There was no great push from our board. I had kept them close enough to my thinking all along so they would stick with me if I went either way on the decision."

At nine o'clock, Paulson called Warner. They had been planning to meet and discuss specific numbers so Warner was startled to hear, "Sandy, I've decided not to proceed. All I can tell you is that I went home to consider all our options and asked myself: Is this best for Goldman Sachs and what I really want to do? And the answer to that core question is no. And that's final." Paulson never called again.

Warner, in Paulson's view, could not have been more gracious as he thanked Paulson for calling. But after hanging up, Warner, who had been under increasing pressure from his board to do a deal, was understandably upset. He felt Paulson had never been serious and had just been asking all sorts of questions—"getting into bed for some sex with no intention of ever getting married." In frustration,

Warner protested, "At each stage along the way, their guys said the combination looked better and better and used terms like 'home run.' What has changed, for Christ's sake?"

The frustration Warner felt is still evident in his summation: "It's really something when one man takes something that important that far—with over a hundred people involved on each side—and then, overnight, decides 'No.'" The gulf between the two men spilled over into the press. A story appeared in the *Wall Street Journal* that Goldman Sachs had agreed to a merger and then reneged. Warner explains how that story originated: "Paulson had really spun it when he told the press that we went to them offering ourselves. This forced us to say something ourselves to set the record straight." Paulson denied this account: "Any leak came from J.P. Morgan and we responded."

Paulson was virtually alone when he made his decision, and he was profoundly alone when he told Thain and Thornton, "I hope I haven't disappointed you guys too much." Thain and Thornton, who had both favored doing the deal, each called their opposite numbers at J.P. Morgan to say they were surprised and that they would try to turn it around. But they couldn't change Paulson's decision.

Looking back, Paulson says, "Only a few people on the management committee were *not* bulls on J.P. Morgan." But as the years passed and J.P. Morgan merged into Chase Manhattan Bank, each observer, including Warner, came around to the conclusion that Paulson's decision had probably been right for Goldman Sachs. Balance-sheet assets, which would have been huge in a Goldman Sachs–Morgan merger, are a powerful store of value; they show the strength of past achievements and can be used to create new revenues and absorb risks and losses. But the real strength of a modern-day financial intermediary is not balance-sheet capital nearly so much as it is reliable, ready, large-volume access to the capital markets. And that depends on the creativity and connectedness of people with superior talent, drive, and strategic dynamism. These assets were far greater at Goldman Sachs and were increasing.

With the discipline and focus that Paulson had always lived by as a leader and talent finder, Goldman Sachs was almost certain to continue accumulating and compounding its competitive advantage. The firm's access to the open capital markets of the world meant that it could obtain assets and lay off risks at times

of its own choosing. It did not need to own huge balance-sheet assets because it could always find institutions that would rent them to the firm. Meanwhile, the firm's own comparative advantages—unusually talented, motivated individuals interconnected through shared values, teamwork, Whitehead's Principles, and the high financial rewards of effectiveness—would lift Goldman Sachs to higher and higher levels of power and profit. Even though many able people believed that merger was the right way to go at the time Paulson was making his crucial decision, these competitive strengths could have been overwhelmed and dissipated by a combination with a bank—even with the best big bank.

Pragmatic, hard working, disciplined, and determined, Hank "Hammer" Paulson had been formidable as a guard at Dartmouth, where he was ranked as one of the college's twenty-four all-time best football players *and* made Phi Beta Kappa. He was formidable in government service, working at the Pentagon under David Packard and in the Nixon White House as liaison to Treasury and Commerce; formidable as a business developer in Investment Banking Services at Goldman Sachs's important Chicago regional office, where he went after earning his MBA (with distinction) at Harvard Business School; and formidable in his pursuit of business in China and Japan and with every corporation on his domestic call list.

Investment bankers had traditionally been expected to focus their relationship calls on corporate treasurers and financial VPs, not chief executive officers or presidents, because Wall Street's principal function was raising capital, a specialized finance function. But when Paulson was getting started in the late seventies, the takeover boom was changing all that. Investment bankers were no longer just talking about money; they were now taking about a company's very survival—and the CEO's own career—with new services like tender defense. Suddenly, the established relationships based on standard financings were eclipsed by new, more strategic relationships with CEOs. As a new man with no prior relationships that he had to spend most of his time maintaining, Paulson could focus all his energy on developing long-term client relationships and on the best opportunities for significant new business. And so he did. Government service had given him confidence in dealing with very senior people like cabinet officers, and his

access to insider stories about the top people in government gave him a special advantage in his drive to link up with corporate CEOs. He made the most of his advantage, positioning himself as a confidant—not just another young investment banker—to CEOs at companies like Caterpillar, Kellogg, and Sears.

"Hank Paulson *is* tenacity," observes Lee Cooperman. Persistently forceful in expressing his ideas, Paulson was competitively aggressive without being abrasive. He regularly called client executives late at home and would go to the mat if he thought they were taking the wrong action in any deal. Similarly, says partner Peter Fahey, "He would not hesitate to block other firms if he thought something was 'not fair or not right for me and Goldman Sachs.' He's intensely competitive. Hank was a lot more than a bull in the china shop; he was a force of nature, very smart, and a huge producer."

Paulson's self-discipline served him well as a high-volume, high-value relationship banker. Still, it must have been surprising for client CEOs to be forced into a corner by Paulson's sincere, unrelenting logic as he worked to advocate a corporate action he knew was for the client company's own good. Over time, Paulson's persistence in doing what was right won him the respect and admiration of the Chicago business leadership, a group that prizes trustworthy directness and feels uncomfortable with the too-smooth ways it often associates with people from the coasts.

One of Paulson's great advantages in life is that he is always learning—partly through continuous observation of others, partly because he takes criticism easily with no defenses and no resistance, and never personally. A weakness is that he is almost oblivious to office politics and for years had to fight the urge to speak his mind immediately, without caution or consideration.

In developing relationships with client-company CEOs, Paulson was unconventional. He worked on nonbanking matters like the composition of boards of directors or investor relations—always looking for ways to demonstrate Goldman Sachs's value and win more business. Years later, Brian Griffiths, the Goldman Sachs international adviser who had been in Margaret Thatcher's cabinet and later became a lord, introduced Paulson to China's vice premier, Zhu Rhongji, and Paulson escorted Zhu to a rating-agency meeting after briefing him on how to respond to questions. After the meeting, the vice premier asked, "How did I do?" As always, Paulson was direct: "You did okay on the first and third questions but did not do well on three others." Chinese securities did not get the desired rating. Point made.

The Q&A was carefully rehearsed before they went back again—and got the rating they had hoped for. An important relationship was soon developing. In the firm's vernacular, Paulson was both highly professional and very commercial.

He made partner in 1982, and Steve Friedman appointed him and John Thain to co-head strategic planning for the banking division. As young, ambitious guys, their job was to think "new"—new markets, new services, and new ways of doing things on the simple theory that Goldman Sachs had "the attacker's advantage" versus Morgan Stanley and its traditional "white shoe" ways and established corporate clientele.

Paulson was a serious student of leaders, seeking to understand why some were so much more effective than others: "The more I observed the most effective leaders, the more I became convinced that the key is to have the right people in your own organization working for you and with you." Within Goldman Sachs, he soon earned a reputation for having the best people working with him to serve his clients, and for identifying outstanding talent early.

In 1990, Paulson chaired a firmwide strategic planning committee as John Weinberg was preparing to step down. Asked if he would become co-head of investment banking and go on the management committee, Paulson had serious doubts, because he didn't want to live in New York City. Steve Friedman quickly cut through that ambivalence: "Bob Hurst and Mike Overlock will be asked to be co-heads. We're offering you the opportunity to be the first co-head. Would you like to be working *for* them or *with* them?" Paulson quickly accepted and went on the management committee.

Starting with a suite in New York's Pierre Hotel that he used each week from Sunday to Thursday, Paulson began commuting and teleconferencing regularly from Chicago. (He eventually bought an apartment in Manhattan when he became COO and moved to New York.) Since Chicago was closer to Asia, he took Asia while Hurst took the Americas and Overlock took Europe. Paulson was soon making the first of what would accumulate to seventy-five trips to China. Goldman Sachs had only five people in Hong Kong when he started; five years later it had 1,500.

Day after day, Paulson took, as his first priority, completing whatever loomed

as the one most difficult or unpleasant task on his to-do list. And year after year his initiatives and discipline added strength and momentum to his career. "He has a bias for action," says Bob Steel. "You start by looking at what people want to accomplish, look for areas of agreement and then work toward achieving that." Armed with a few long-term principles—unrelenting client service and always asking for business, powerful work ethic, and a consistent commitment to identifying and developing future leaders—Paulson was free of prejudice or precommitments and open to finding the best way forward, which made it feasible for him to work effectively with many different people. Obviously sincere, he was seldom thought of as a pal, a charmer, or particularly charismatic. He was unconventional and unpolished. His clothes didn't fit well and his shirt tail was often hanging out, but he was connected with clients and built strong relationships. He gave unvarnished advice and was aggressive in getting the business.

Paulson found an ideal mentor in Jim Gorter, one of the firm's great relationship bankers and talent developers. When assigned to Chicago, Paulson was told, "Normally we don't assign men as young as you are to important client relationships, but you're bald enough to look older than you are so you'll be okay." Gorter took Paulson under his wing and counseled: "It's not how quickly you start completing transactions, but how well you do your work. Do everything the right way—always. Don't chase near-term transactions. Go long-term. Do it right and you'll get the really big business. Relationship banking is not a sprint; it's a marathon." Gorter taught Paulson a great lesson: "Secure people give all the credit they can to the other people on the team." The strength of this advice was amplified for Paulson by comparison to partners who took credit—sometimes more than they deserved—and seriously hurt their careers over the longer term.

Gorter would continue to counsel Paulson even when Paulson was CEO and Gorter had retired. Gorter would modestly say, "Of course, I'm no longer directly involved and can't be sure, but my instinct would be . . ." and then go on to give his wise advice. He gave Paulson the benefit of the best detailed thinking of a shrewd "firm patriot" who spoke in private and with candor.

Paulson also got advice from Steve Friedman on organizational and strategic decisions, particularly the buildup of principal investing. Eventually, despite the strong feelings Weinberg and others still held, Paulson would bring Friedman onto the board of directors.

. . .

Paulson and the mergers group believed the firm's "no hostiles" policy tradition was holding Goldman Sachs back from lucrative business it could easily have had by advising large, ambitious, serial-aggressor corporations on takeovers. They believed the traditional policy did not reflect developments in global capital markets and that it had been designed for a clientele of smaller companies that were likely targets. In another of their personal policy clashes, Corzine had opposed any change that conflicted with the firm's "good guy" image as corporate management's most reliable friend. Paulson was determined to move ahead and said that what he called the "PR factor" was being way overblown. As a compromise, it was agreed to conduct an experiment. The firm *would* advise on a hostile takeover on two conditions: the experiment would be conducted outside the United States and would not involve any U.S. corporations; and, to be certain the payoff would be worth the reputation risk, the deal *and* the fee must be really big. As always, the quality of the client company, the probability of success, and the competition would also be criteria.

The chosen deal was Krupp's 1997 hostile acquisition of Thyssen—a multibillion-dollar deal in terms of market capitalization that would produce nearly $10 million in fees to Goldman Sachs. While some clients "wondered," the overall reaction was neutral in the European corporate community; there was little or no surprise because "everybody did it." In the long run, Krupp's move was truly brilliant. It originated with Ulrich Middelmann, who was then in charge of corporate strategy at Krupp and is now vice chairman. Middelmann recognized that Krupp's prospects were declining and would continue to decline unless a major change was made—and that merger with Thyssen would bring the combination up to a scale of operation that would create a durable giant.

Paulson and others at Goldman Sachs saw this as an unusual and compelling opportunity. Germany was both a strategic priority for the firm and a difficult market to break into. This takeover would give Goldman Sachs an opportunity to outflank the dominant national competitor in Germany: Deutsche Bank.

With detailed advice from Goldman Sachs, Krupp's execution of the surprise attack was timed perfectly. In Germany, Easter weekend is a four-day tradition that includes both Good Friday and Easter Monday as holidays. Most senior

executives make this weekend a special event for their families by leaving instructions not to bother them with calls, and many travel considerable distances to one or another of Germany's numerous resorts—usually departing early Thursday afternoon. Their assistants "disappear" with their families too. So by announcing the tender offer late that Thursday afternoon, Krupp caught Thyssen completely unprepared. And for four straight days, Thyssen executives, widely dispersed to "unknown" locations and with no assistants on duty at headquarters, were unable to contact or communicate effectively with one another.

Blitzkrieg! No defense was possible to organize until well after all the newspapers, magazines, broadcasters, and financial news services had reported the story just the way Krupp wanted it defined. For a firm so long identified with being on the defensive, Goldman Sachs's performance on the attack was remarkable—and Paulson's point proven.

After Paulson took over as sole CEO, the process of completing Goldman Sachs's IPO was, after all the angst and anticipation that had built up, almost routine. Corzine performed his role as chairman with dignity and discipline. The roadshows were well organized and the reception constructive. Analysts did have various concerns. They worried about the disruption of changing from partnership compensation to corporate salaries and stock options. They worried about a diaspora of "IPO partners" once partners had completed three more years' service to achieve full vesting; analysts noted that the *average* partner would be worth $66 million—or, assuming an early run-up in share price, even more—and they doubted many would stay and continue to shoulder the burdens of working long, intense hours. Given the larger role of trading in its profit mix, the main and most persistent rap on Goldman Sachs was that it was really a giant hedge fund with a sideline in investment banking. The firm resisted this summary at first. But the comparisons to other investment banks were incontrovertible, and it wisely changed from rebuttal to a much more credible proposition: if you're looking for smooth earnings growth, you'll want other firms; our earnings will be more lumpy and less predictable because our focus will always be on long-term earnings growth. This more realistic positioning was well received.

The IPO succeeded brilliantly, raising $3.6 billion, making it the second-

largest ever and creating more centimillionaires than any other.[1] On the first day, Goldman Sachs's newly public shares zoomed from $53 to $76 a share before closing the day at 70 ⅜. Best of all from the standpoint of Paulson and his colleagues, it left the partners and the management committee still in charge: 87.4 percent of the stock stayed in the hands of partners, retired partners, other Goldman Sachs employees, Sumitomo, and the Bishop Estate organization.[2] In spirit, the partnership persisted.

The concept of leadership at Goldman Sachs has changed completely over the past fifty years. Sidney Weinberg was a leader, but in many ways his firm was a proprietorship. While Gus Levy insistently expected many people to do all they could to build the business, there was no question that he was *the* leader—in overall pace and direction and on dozens of transactions every day. Whitehead and Weinberg pushed decision responsibility and accountability out to the unit heads. Rubin and Friedman matched even more widely distributed authority and responsibility with centralized accountability to the management committee. Paulson continued the multiplication of decision-making leaders and increased the coordination of operating units through centralized disciplines: risk controls, business planning, and performance measurement at increasing numbers of smaller and smaller, more agile units that were closer to particular markets.

"When I joined Goldman Sachs's senior management team," says Paulson, "John Whitehead told me that the most important thing we did as senior management was recruiting. If we had high-quality people, then all that senior management needed to do was figure out the firm's strategy and put dollars behind resources appropriately."

The number of leaders needed rose by a factor of ten in the years between Sidney Weinberg and the Two Johns; then by another factor of ten under Rubin and Friedman; and on upward by yet another factor of ten under Corzine and Paulson as the firm and its business became increasingly competitive and specialized. The firm had grown from 300 to 30,000, and the need for leadership had grown even more rapidly with the distribution of authority that comes with rapidly advancing technology, multiplying geographic and customer market segmentation, increasing competition, and the firm's own intensifying determination to prevail.

Paulson emphasizes the lessons learned from his observations of successful leaders. "The things that make a good leader are being open-minded, having a willingness to really ask for and accept advice, showing a sense of humility—and putting the right people in the right seats." He developed considerable confidence in his ability to evaluate people and match them with the responsibilities best suited to their development. "Business failures are always linked to people failures. I work hard to find outstanding people and try to match them with a job where they can succeed. Often, I'll say to them—and they always appreciate the candor—'I'm not sure you're in the right job for you. Let's repot you and see how you do.' "

Paulson stressed the importance of leadership. Everyone, no matter how junior, was expected to lead. As Paulson put it, "We're global and multicultural like other professional service firms, but we also have huge capital commitments and risks to manage. It takes many, many leaders. Goldman Sachs is leaders working with leaders." The firm had become too large and diverse, markets were changing too much and too fast, and consistently skillful leadership at all levels was too important to depend on the firm's traditional apprentice process to learning and development. In 1999, urged on by John Thornton and John Thain, Paulson appointed a development advisory committee to assess the firm's needs for a more systematic approach to developing the leadership effectiveness of its more than 1,000 managing directors.

Over six months, the committee gathered data in different ways. Internet surveys and interviews sought opinions within the firm on management and leadership development: how much was going on, how effective was it, and were the firm's changing needs being met? "Best practitioners" were visited around the world to study what they did and how well it worked. Finally, experts and consultants were interviewed to learn about the latest concepts in management development. During its study, the committee grew increasingly concerned about the need for many more well-developed leader-managers as a result of the firm's increasing complexity and global size. Each division was as large as the whole firm had been just ten years before.

Pine Street, as the program would be called, expanded its focus to include what was identified as "leadership acceleration" for a group of nearly 100 fast-rising VPs. The message was the same message the Two Johns had given new partners thirty years ago: Congratulations on your well-deserved promotion. We expect even more of you now, so take the pace up even higher and be a real leader.

Formal training was a foreign concept for Goldman Sachs. The firm had traditionally relied on one-on-one coaching. The committee recognized a major problem: the firm's culture, work ethic, and reward system were notoriously commercial, so something as soft and abstract as a program of management development would be consistently overshadowed by real transactions, particularly when the program was new and unproven. Leadership for the new leadership program would be crucial. Who better than Steven Kerr, the head of GE's fabled Crotonville leadership-development center? Thain and Thornton courted him for nearly a year, and he joined in March 2001. Even before officially arriving and even though somewhat mystified by the time and effort being invested in developing the program, he was soon joining in 6 a.m. planning sessions.

Bob Steel offered an explanation: "We talk about Goldman Sachs being a culture, but let's face it, it's also an economic relationship that we have. If Goldman Sachs doesn't earn any money, we're not going to end the day singing songs around the campfire and come back the next day with a warm glow. In the end, people need to believe that this training will help them do better at the firm and with their career or as individuals. They have to believe that. It's got to be about doing better at your job and being recognized as being better." To ensure the program would be embedded and accepted as an integral part of Goldman Sachs, a separate campus was rejected in favor of conducting all Pine Street activities in the firm's regular facilities and engaging firm leaders with strong internal credibility and strong connections to the firm's business success.

In 2005, the firm introduced small-unit workshops for two to twenty people at a time. Topics included how to jump-start your leadership in a new business, pragmatic guidelines on vision and strategy development to make a business unit more effective, how to convert vision and strategy into action steps, individual roles and specific task responsibilities, and how to resolve process or people problems that might limit business performance.

Paulson always was serious: serious about discipline, serious about getting business, serious about serving clients unusually well and developing people and making decisions—so consistently serious that it must have been a bit much for others. His partners did not resist teasing him or giving him a hard

time—particularly if they thought he was encroaching on their territory and responsibilities, which they were not about to concede. In his early years as COO, Paulson wanted to examine the profitability of the firm's stockbrokerage business in London, so he called for a meeting with the co-heads of that business, partners Wiet Pot and Pat Ward. Paulson, who had a reputation as a commanding leader who liked to take charge of a meeting, had signaled ahead that he was dissatisfied with London's profitability. Pot and Ward had zero interest in being raked over the coals, so they agreed in advance to seize the initiative and ask Paulson all the questions—partly for fun and partly to control the session. Pot, a tough Dutch Catholic who is never intimidated, began asking questions right away to put Paulson on the defensive: "Why did you call this meeting?"

"I wanted to know how you are managing this particular business."

"I see, you had some sort of concern, perhaps a real worry. Okay, what exactly concerns you?" Paulson, who had expected to be asking the questions, was caught off guard. His first response was a bit uncertain. Pot quickly poured it on: "Which business is larger in London, Hank, equities or Private Client Services?"

"I'm not sure."

"You're not sure. Okay, how big are we taken together as a business?"

"I don't have an exact revenue number."

"So you don't know the revenues. Okay, how many analysts, traders, or salesmen do we have?"

The barrage of questions kept coming and coming at Paulson until Pot paused to say. "So, let me summarize. As the firm's COO, you've called a meeting—apparently because someone whispered to you that we may have a problem—but you don't know the size and mix of our business, our revenues versus competitors' revenues, the number of our people, or any other particular about our competitive situation or even why we run our business the way we do. So in brief you've called a meeting for which you are not prepared." Paulson retreated. He took it as a lesson learned and never again had a similar challenge in a meeting.

Goldman Sachs was looking for acquisitions that could give it strategic balance by adding strength among retail investors to its traditional strengths in the wholesale or institutional markets. Morgan Stanley had merged with

Dean Witter, and Merrill Lynch, the firm's other major competitor for corporate and institutional business, had, of course, built its strength in retail and then expanded into the corporate and institutional markets. Lehman Brothers, having acquired Shearson's retail system, was gaining strength and momentum. Acquiring Charles Schwab, advocated by John Thain and John Thornton as one way to gain access to the retail market, was seriously considered.

Aiming to increase its access to order flow and to get closer to the center of "price discovery" (finding the price that clears the market by balancing supply and demand), the firm in 2000 paid $6.5 billion—$4.4 billion in stock and $2.1 billion in cash—to acquire Spear Leeds & Kellogg, a large NYSE specialist firm, and agreed to set aside another $900 million to help retain Spear Leeds employees. Paulson was clearly the driving force in executing the decision and made several persuasive calls to key people in support of the equities division's strategy. That division had been struggling with weak profits and feared not having retail business would put it at a serious strategic disadvantage versus competition. He thought Spear Leeds was a close cultural fit with Goldman Sachs. Others worried that it had a history of securities violations, including a 1998 NASD fine of $950,000 for intentionally delaying reports of trades to get a profitable competitive advantage. Spear Leeds had responded that it was "not surprising that we have fallen short of perfection" given its trading volume. Paulson insisted at the time of the acquisition, "We feel very comfortable with their people and their standards."[3]

Within Goldman Sachs, views on the acquisition differed strongly. Skeptics argued that at $6.5 billion, it was far too expensive, that the specialist business was yesterday's business and sure to be headed for disruptive change, and that the two cultures were not complementary. Advocates saw the acquisition as a way to get closer to retail order flow, which was important to underwriting in the new dot-com era. Today the consensus would confirm that acquiring Spear Leeds was strategically wrong and not a good deal.

Spear Leeds & Kellogg had three different businesses. It was the largest specialist on the New York and American Stock Exchanges; it did a major clearing business, processing transactions for local brokers around the country; and it made markets in over 3,000 stocks on NASDAQ—which compared to just 380 stocks for Goldman Sachs. Spear Leeds served 20,000 accounts[4] so there were

possibilities of cross-selling Goldman Sachs's services to those accounts. There were clear pluses and minuses to the transaction.

As Paulson said, "We were concerned that we didn't have access to retail business and retail distribution. This transaction was important to our people in the equities business. In a time of fast change, we wanted to expand our strategic options." The problem was that Goldman Sachs bought Spear Leeds before it had a clear understanding of the direction the market was moving in. The structure of the equity markets was in a state of flux and uncertainty. Spreads were under pressure.

Looking back, Paulson takes a rather optimistic view even while recognizing that the acquisition tarnished the firm's reputation: "While the specialist business deteriorated more quickly than we anticipated and the NASDAQ or over-the-counter business was very disappointing, we got a great technological trading platform in the clearing business that has worked out well and is today the backbone of one of the largest electronic trading networks in the world. So while that acquisition didn't enhance our reputation, net-net, it was probably okay." Others would be less sanguine. Some have groused about "vaporizing several billion." Whatever its merits in the clearing business, Spear Leeds executives were surprised to learn how badly inferior their technology for risk control was to what Goldman Sachs already had. Some called the acquisition the revenge of the dummies.

A sharper blow to the firm's reputation came from the IPO market. In 1999 and the first half of 2000, as the dot-com bubble market was peaking, Goldman Sachs had been the leading underwriter, with fifty-six new issues. However, this was no triumph in quality: 40 percent of those issues fell from their offering price, including Flowers .com, which came out at $21 and fell below $5, and PlanetRX.com, which fell from its $16 offering price to less than $4. Even excluding "e-tailers," 42 percent of the firm's Internet IPOs were down from their IPO prices, versus only 11 percent for rival Morgan Stanley.[5] Goldman Sachs and other firms were subsequently found guilty in federal court of breaking the industry's accepted rules of conduct and the securities laws in the notorious "analysts case." In what became known as the "global settlement," Goldman Sachs paid out $150 million.

Paulson led a major repositioning of Goldman Sachs's strategy and its franchise in the world's financial markets. The conceptual frame for this change

traced back to the problems—and what was hidden by the problems—of Goldman Sachs's Water Street "vulture" fund. By the time the Water Street Recovery Fund was shut down, Paulson, Friedman, and Peter Sacerdote had become convinced that private-equity investing could have major attractions for Goldman Sachs. If properly designed and managed, it could fit strategically with the firm's commitment to agency corporate relationships.

Paulson was determined to establish a major business for Goldman Sachs in private equity and real estate—not as an agent, but as a principal investor. While Morgan Stanley separated its principal business geographically as its way of solving the problem of conflicts of interest, Paulson rejected that sort of action: "You could locate principal investing at the South Pole, but if you do something wrong or if an action is perceived as a conflict, that will hurt you with the same clients just as much."

During an era in which other banking firms were dropping out of private-equity investing and saying, "We don't want to compete with our clients," Paulson went the other way. Typical of his direct style and thoroughness, he visited with every significant private-equity firm and made his case: "We'll be smarter, better bankers and more effective in our work with you if we do this and gain the experience. We are going to do both principal investing for our own account—often, we hope co-investing with you as partners—and, as advisers, helping you accomplish your objectives. We believe we know how to manage the differences and avoid direct conflicts of interest. We want you to understand and certainly hope you will understand that from time to time, we are going to be investing for our own account, regularly and in size." There was no need to say that Goldman Sachs would not be asking for permission.

Paulson's drive met resistance within Goldman Sachs as well as outside. Senior Goldman Sachs people—particularly partners who had gone limited—would go to Paulson and say, "Hank, you're destroying the culture of Goldman Sachs," and follow on with an explanation like, "We cannot compete with our clients!" Paulson wasn't buying it. "What they really mean is that they don't know how or are unwilling to adapt to change. The facts are that our clients' expectations for capital commitments and sharing the risks are forcing us to be principals. The business is changing because our clients want us to change. If you don't or won't change, you *will* wind up with less than the best strategies, practices, and

plans. The market—the world—does change, and as intermediaries, we must change."

Paulson—with help from John McNulty, Peter Sacerdote, and other partners—moved the firm to a new strategic proposition: it was committed to being both explicitly principal *and* agent. No longer could or should clients expect the firm to be just an agent or expect it to subordinate its interests in the principal investments it might make on its own account with its own capital, expertise, and access to information. If the firm had a client relationship, the people working for that client or that assignment would, of course, strive mightily to do all they could properly do to excel in completing that mission, including committing capital as a principal. But Goldman Sachs would also be working just as hard and just as cleverly and imaginatively for its own account.

"I saw that if we, as always, managed business selection and conflicts effectively and avoided direct conflicts, we could do both investment banking and principal investing," says Paulson. "If you deal openly with clients, this should serve all interests well and make us a stronger, more experienced firm able to do even better for clients in the future." Goldman Sachs leadership would be responsible for managing the differences so they would not be—and would not be seen to be—in conflict. Of course, a major challenge with such a position is that Goldman Sachs was holding itself responsible for deciding what was right and how others should perceive the firm's decisions, policies, and practices.

The change in strategic positioning would involve educating clients about the meaning of being a client. After Goldman Sachs invested—entirely for its own account—in Sumitomo Bank via a 4 percent convertible preferred bond with twenty years to maturity at a large conversion discount, the firm offered Singapore's Government Investment Corporation, one of the world's largest and most sophisticated investors, an opportunity to invest in a very different preferred issue: a 2 percent convertible with only two years of convertibility offered at a slight premium. The senior investment officer, Ng Kok Song, called John Thain to protest: "Is this the way you want to treat an important client?"

"You were offered what the firm is offering. If you don't wish to participate in this deal, that will, of course, be entirely your decision. Our responsibility is to offer you the same terms we offer all other major clients. What the firm does

for its own account is separate." Goldman Sachs was redefining its role in a client relationship and redefining the role of a major client.

"Full disclosure of your strategy and your objectives—in advance—so clients know what they can or should expect is vitally important," says Paulson. "No surprises: full disclosure and full discussability. The firm's strategy must include not putting client X in harm's way. This is a lot easier to describe in general terms than to execute in specific situations. Co-heads and tri-heads [of business units] really help with decision complexities by providing a different perspective or opinion."

Paulson had been a believer in technology and its impact on the securities business since the seventies, when he first saw continuously updated bond prices displayed on a computer screen at a client's office. Goldman Sachs was certainly no technology leader in the early years. Senior management got its first briefing on the impact of the Internet in 1996, including answers to the basic question: What is the Internet?

That changed a lot. Paulson believed the firm was in a race to exploit the revolution in digital technology. "For people who can embrace change, there's great opportunity to grow. Others soon just won't be here." After the firm spent $5 billion in five years, by the middle of this decade proprietary trading algorithms handled twenty thousand derivative trades a day and 70 percent of the firm's Treasury bond trades—updating prices two hundred times a second and executing all trades up to $100 million automatically.

"The best protection is to continually reinvent ourselves so someone else doesn't do it to us," Paulson said. "What keeps me up at night isn't what our traditional competitors are doing, but that someone we didn't foresee will use technology to emerge as a significant rival." Paulson's strategy was to cover all the bases, enabling the firm to keep in close touch with changing technology and able to move quickly in any direction as developments clarified. "We have two dozen electronic trading ventures going on, and they're a sideshow compared to what we're doing in-house." Hull Group, for example, which traded derivatives through complex quantitative pricing models and algorithms, was acquired for $550 million and promptly expanded into equity-options trading. The greater the market volatility, the more Hull's trading speed and precise pricing increased

profitability and market share. In Tokyo, Hull's know-how resulted in its controlling nearly half of all options trading.

Paulson pursued the same general goals through difficult times as a director of the New York Stock Exchange. In 2003, he was told by the exchange's CEO, Richard Grasso, "My compensation package is not on the agenda," so Paulson felt no need to change his plan to go birding in Argentina and missed the crucial meeting on Grasso's outsize compensation package. "He lied to you, Hank," advised an experienced senior colleague, "so you can and should resign with a clear conscience." But others insisted he should stay: It was his public responsibility. So Paulson, at considerable cost to himself, stayed on and worked through the problems. It was good for the exchange that he did stay. Over the next few years, the old, obsolete business model of the NYSE was revolutionized with the central limit order book, which consolidated limit orders received from all sources, and the merger with the Archipelago electronic stock exchange, which transformed operations and produced major gains in valuation for both sides.

Paulson's decision not to combine with a major bank left him with a major unanswered question: How would Goldman Sachs compete with the world's leading "universal" banks? All the universal banks were pushing their way into investment banking by lending capital. They were substantially increasing their lending capacity by syndicating term loans, but their main competitive weapons were speed to commitment, flexibility on terms that they could custom-tailor to the specific borrower, and price. If those who had advocated Goldman Sachs's combining with a big bank had foreseen these developments, they would have insisted on a merger.

In 2002, Paulson found an opportunity to obtain comparable capacity to provide capital without having to absorb a large commercial bank. The opportunity came from the firm's big friend in Japan: Sumitomo. Sumitomo had merged with Mitsui and was once again determined to expand, particularly in America. Paulson worked out an agreement in which Goldman Sachs made a substantial investment in the bank, and Sumitomo-Mitsui would provide a backup guarantee behind commercial paper issued by Goldman Sachs. With this innovation, the firm could deliver low-cost credit quickly and in large amounts—up to $1 billion—through an entity called William Street. Now Paulson had an enormous balance sheet that

Goldman Sachs could call on at any time. This arrangement also offered a major opportunity to develop investment banking business in Japan.

Around this time, Paulson gave one of his most important speeches as CEO. At the National Press Club, he discussed the state of corporate America and the lessons learned from the breakdown in financial reporting and corporate ethics and the resulting scandals involving Enron, WorldCom, and others. In a highly charged environment and against the counsel of some in the firm, Paulson laid out a comprehensive examination of accounting, corporate governance, and ethical issues that had coalesced to cause a crisis of confidence. "In my lifetime, American business has never been under such scrutiny. To be blunt, much of it is deserved." He went on to say, "I see this as an opportunity to reassess our practices, renew our principles, and rebuild the trust that is so fundamental to our markets and their vitality."

Initial reactions from some corporate executives caused Paulson to worry that he may have made a mistake to speak out so forcefully, but he was soon getting a broad and strong positive response. Senator Paul Sarbanes credited Paulson's statements with playing a key role in getting support for the Sarbanes-Oxley reform legislation.

As Enron, WorldCom, and the Wall Street research settlement began to fade in the public's eye, Paulson still wrestled with his disappointment that he and the firm hadn't done enough to positively differentiate Goldman Sachs during the bubble. What ensued was a year-long program called the chairman's forum, embodying Paulson's determination to get all the managing directors to show strong leadership and be personally accountable for good business judgment and advancing the firm's reputation. Paulson's personal engagement was typical of his discipline and commitment: During the first six months of 2005, he spoke at twenty-six chairman's-forum sessions around the world. Paulson maintained that the firm had not been truly distinguished in its own behavior, as it should have been, and led each group in discussion of what should be done.

Ego management has been a continuing priority at Goldman Sachs since the days of Sidney Weinberg's saying to those he thought prideful, "You're so

smart . . .” and proffering another Phi Beta Kappa pin from his collection. Later John Weinberg admonished colleagues: “Clients are simply in your custody. Somebody before you established the relationships, and somebody after you will carry them on.”

If someone new to the firm says “I just did so and so,” a partner will say, “Excuse me*?*”

“I just did a big trade,” the newcomer repeats.

“Stop. Wrong pronoun. *We* just did a big trade. Try again.”

As Bob Steel explains, “First-person singular is only used to describe a mistake, not an accomplishment. It may sound silly but little things like that are quite significant. I’ve never heard a boss at Goldman Sachs say, ‘I just did this.’ If I ever did, I’d be embarrassed.”

Paulson remembers getting his first Goldman Sachs memo back from Jim Gorter. “Good memo!” was written at the top—and every “I” was crossed out in favor of “we.”

The most visible test of Paulson’s capability in matching people and positions—a capability that was certain to be watched closely by his board of directors—was in establishing his senior leadership team and his successors. He had become CEO with the explicit objective of stabilizing the firm’s senior management.

Paulson had come to the top job with the support of his chosen co-COOs, Thain and Thornton, and an understanding among them that he would serve only two years. They had worked well together in the early years. But now he was having second thoughts on how long he should stay—and on his successors, which added to the question of his own appropriate tenure. Some partners did not react well to Thornton and Thain as co-COOs, feeling that they projected a sense of entitlement. John McNulty captured the problem that Thain and Thornton were developing for themselves: “They act like the owner’s sons!” At the same time, Paulson came to the conclusion that he should stay: “I was naïve to think I could do my part in only two years. And I couldn’t leave once we decided on the IPO.”

Doubts were spreading about Thornton’s becoming CEO. He was recog-

nized as one of the most creative strategists and relationship builders the firm had ever had. As one partner summarizes, however, "Great charm and amazing macro-vision, he was superb on the big picture, but he had no long-lived or deep friendships with other partners. When he was co-COO, he didn't do the work. After he and Thain carved up the world and divided up the business units of the firm, Thornton seemed to lose interest and just didn't go to some of the areas he was responsible for. Just didn't go. Period." While some felt he might have been a great nonexecutive chairman, he didn't show the necessary interest in the nuts and bolts of implementation, control of costs, or organizational discipline.

Thornton would have picked up signals of a change in Paulson's feelings toward him as a co-successor and knew he had generated resentments within the firm. His ability to conceptualize remarkable strategies for the firm or for clients could be applied, of course, to his own career. Recognizing that Paulson was increasingly thinking of staying on, he asked only, "Stay if that's what you'd like to do, Hank, but please tell us so we can make our own plans." As Paulson gradually extended his estimated term and then stopped talking about leaving, Thornton did not wait. He had "conversations" with a few major U.S. companies about becoming CEO and continued to build up his personal franchise in China, where he had been rapidly expanding the firm's investment banking business.

For Paulson, as CEO, it would have been troublesome to have chosen a successor who did not give priority attention to careful implementation. He may also have been concerned that Thornton's brilliant conceptualizing and articulating could someday surprise him with the sort of surprise that had stunned Corzine in the management committee. Whatever the reason, Paulson told Thornton he would be staying. This began the conversation that led to the announcement that Thornton would be leaving. Paulson called directors one at a time to inform them and be sure they were comfortable with his thinking. John Browne of BP saw right away that Thornton was going down and couldn't be saved, so he stood back and let him go—but a year later, got him a seat on the board of directors at Intel.

Thornton would see the process of separation quite differently. Academic institutions are considered more central and prestigious in China than in America, so close observers may not have been surprised, at least in retrospect, to learn that Thornton accepted an appointment as a professor at Tsinghua University's business school, where he would teach an advanced course on leadership. What

few would have known or appreciated was the importance attached to such an appointment by the Chinese government. Full professors must be endorsed by the State Council, a process closer to the way federal judges are confirmed in America. It takes time: at least six months. And Thornton would be the first non-Chinese elevated to such stature. The result was that while Paulson came to the conclusion that he would stay and lose Thornton in January—announcing it in March, with an effective date in July 2003—that separation process had already been quietly initiated by Thornton the previous October.

After leaving, Thornton had dinner with Thain and advised him to give fresh consideration to the situation, particularly if Lloyd Blankfein were advanced to equal status. While Thain had been working almost exclusively on internal operations and organization, Blankfein had been accumulating the power of profits. Starting with J. Aron, which had expanded boldly in oil trading and foreign exchange, he had then taken over and integrated fixed income and then added equities. His units now accounted for 80 percent of the profits of Goldman Sachs, and historically he who controlled the profits controlled the firm. Blankfein was increasingly popular—and he was smart. He and Thornton were not close.

Paulson had a plan. With Thornton out, he would appoint Blankfein, already a member of the board of directors, to be co-COO. Paulson recalls that when they worked together in 1994 on the operations committee, "I saw that Lloyd had great ability." Late on a December morning of 2003, Paulson completed the changes that he had planned so carefully and, as always on organizational matters, had talked over with his board of directors.

Paulson had discussed the co-presidency with Thain for several weeks, but Thain had been vigorously resisting that approach. That may be why Paulson decided to ask Thain to co-sign the memo to the firm announcing that Blankfein would be elevated to co-president. Paulson may have thought he had evidence that Thain would see that his best decision would be to stay, accept reality, and adapt—and continue earning large rewards in his already remarkable career. Realistically, he would have no comparably appealing alternatives.

But Thain did have an alternative. He knew John Reed from their service together on the MIT Corporation, equivalent to its board of trustees. Thain had been approached by Reed to be the new "reform" head of the New York Stock Exchange. Major changes at the NYSE were certain and they played to Thain's strengths. The

public-service integrity of the exchange had been severely questioned when Richard Grasso's prodigious compensation package became public, and the NYSE was falling behind in two major areas—automation and globalization—that were areas of strength for Thain. In addition, Thain felt more than ready to be a CEO and had always had a Boy Scout's instinct for public service. Thain and Reed had been having serious and advanced discussions, and Reed was ready to make a formal offer. So shortly after his heads-up, Thain closed his door, picked up his phone, and called Reed to say: "The mission at the exchange is right for me and the timing is good. If you can make a definitive offer now, we have an agreement."

Reed could and within hours did. Thain went to tell Paulson. Paulson knew Thain well enough to know he had no chance of getting him to change his mind—so he didn't try. Quickly recovering from the surprise, he took the line he would continue with: great pride that another leader from Goldman Sachs was responding to a major public need.

With all the changes, a casual observer could have seen the realities this way: Paulson picked Thornton and he's gone. He picked Thain and he's gone. Paulson won't want to lose any more carefully considered and carefully selected key lieutenants. He won't want to lose Blankfein. But Blankfein understood that only so long as he kept Paulson's confidence did he have leeway to continue making changes. Despite some initial disagreements, senior positions at the firm were soon filled by people both men wanted. Operationally, Goldman Sachs was becoming Lloyd Blankfein's firm, but Blankfein knew he would have to measure up. Paulson had already proved he was ready to make tough decisions—including decisions on management succession.

With Blankfein on the board and installed as COO, Paulson had his succession in place. He and his board had rigorously reviewed each of the firm's twenty-five top leaders and agreed on how and why each senior seat would be filled. He was confident that Blankfein would prove that he could handle being CEO of a very complicated but now publicly owned, globalized, and stabilized Goldman Sachs. And as the environment changed, he believed Blankfein would be able to adapt well. As Paulson expressed it, "People knock Lloyd, saying he's a chameleon—always changing his color. But they might instead consider giving him credit for learning and growing. Lloyd is a unique talent. For a dozen years, I've watched him develop as a leader."

. . .

In May 2006, Henry M. Paulson got a call, not the first, from the White House to discuss his becoming Secretary of the Treasury. He told partners he wasn't going to take the job, and John Whitehead advised against considering it: "This is a failed administration. You'll have a hard time getting anything accomplished."

On Saturday, May 20, Paulson met more than once with White House chief of staff Josh Bolten—who had worked at Goldman Sachs—to discuss the basis upon which Paulson would agree to serve.[6] Bolten had begun the conversation: "Let's discuss for a few minutes what you would want to know this job was going to be—on the hypothetical assumption that you had accepted because those understandings were the way you wanted to work." The two men worked out an e-mail memorandum of understandings that would include "regular, direct access to the president; equal stature with Defense and State; principal spokesman on all economic and fiscal policies—even those not normally reporting to Treasury; chair the economic policy luncheons in the White House, and ability to choose his own staff." With that understanding, Paulson went into a meeting with the president.

Their conversation centered on family—Paulson's family and Bush's family—and on other personal matters before turning to what Paulson calls "philosophies and objectives" and agreement on having regular, direct access, chairing the weekly policy luncheon, and being spokesman for the administration on all fiscal matters. As the conversation continued into its next hour, the president invited Paulson to join the cabinet. Knowing that "no agreement means anything unless real trust is earned," Paulson would sleep on it. Next morning, he called to accept.

Paulson's priorities when he became CEO eight years before had been to effect a smooth transition from private to public ownership with the completion of the long-anticipated IPO, to operate Goldman Sachs as a disciplined public company with an effective board of directors, to build the international business, particularly in China, to expand GSAM and private-equity investing substantially, to develop capable leadership succession, and to position the firm's overall strategy so its evolving policies and objectives would be understood and well accepted. When he left, Goldman Sachs was recognized as the premier "solutions provider." It had the best working relationships with the largest number of major

corporations, governments, institutional investors, banks and private-equity investors; the best knowledge and understanding of companies, industries, economies, and markets; the largest appetite and capacity for taking risks of all sorts, with the ability to commit substantial capital; the strongest recruiting program; the highest compensation—and a well-accepted overall strategy for the future. Paulson had led the transformation of Goldman Sachs, and the experience in leadership had equally transformed him.

"The ultimate test of a CEO," Paulson says, "is that he worries about being sure no bad things happen, that he leaves the outfit in better shape and with a smooth leadership succession. I believe I left Goldman Sachs in materially better shape than it was in when I became CEO, both internally and externally." Even better, his colleagues at Goldman Sachs and his customers and competitors would agree.

While it would not have changed his decision to serve his nation and risk his reputation by joining the Bush administration, the irony, as some saw it, was that the financial benefit to Paulson of accepting the call of duty is surely greater than that enjoyed by any other public servant in U.S. history. Goldman Sachs has long had a policy that all deferred compensation becomes payable promptly to any partner who accepts a senior position in the federal government. Congress passed a law a quarter-century ago that people taking senior appointed federal positions who convert their investments into either an index fund or a blind trust can do so upon assuming office with zero taxable capital gain until such investments are later sold. If Paulson took advantage of these provisions, they enabled him to sell his shares in Goldman Sachs without raising any public questions and without tax and to diversify his large personal investments in a single stroke. For just over two years' service, the savings in Paulson's personal income taxes could have been as large as $200 million. Paulson had no interest in diversifying his investments and had never sold a share of Goldman Sachs stock. So these "benefits" were purely hypothetical.

There's another large irony. Paulson, who had encouraged others to diversify and stay at the firm, had never previously sold a share of Goldman Sachs stock. He sold his shares at $150, a price he believed deeply—and accurately—was low because 2006 was a very strong year, and he estimates that the timing of the sale cost him $200 million. He also had to liquidate his large private-equity

holdings—including a substantial position in the Industrial and Commercial Bank of China, which has since multiplied fourfold. The tax break was no great boon to Paulson: He plans to give most of his wealth to his charitable foundation.

Philanthropy and public service are more important to Goldman Sachs people—particularly its alumni—than to any comparable group. This makes sense because they earn substantial wealth and have been beneficiaries of cultural, educational, and medical institutions. Still, it is impressive to recognize that no other organization spawns so many trustees of colleges and universities, art museums, foundations, libraries, and hospitals. At Goldman Sachs, service and serious giving are expected, and leaders are expected to set the pace.

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LLOYD BLANKFEIN, RISK MANAGER

While some of his partners still saw balancing Goldman Sachs's agency business with its principal investing as a worrisome choice, Lloyd Blankfein was sure it was instead a momentous strategic opportunity. At an internal meeting in London in 2005 he laid out his argument. It was a powerful extension of the strategic thinking that had originated with Friedman and Rubin and gathered force under Paulson—and could be traced all the way back to Gus Levy's business in arbitrage and block trading. For many years, Goldman Sachs had been able to do both—act on behalf of clients and invest aggressively for its own account—and keep them in acceptable balance. It accomplished that by emphasizing, particularly to clients and in public, the still-dominant agency business, particularly investment banking for corporations, research-based stockbrokerage, and investment management. The coexistence of agency and proprietary businesses had been feasible because proprietary activities were relatively small and incidental, and not in conflict most of the time with agency work for clients. So the choice between proprietary and agency had been deferrable, and deferring a choice had been profit-maximizing.

But both kinds of business were changing. No agency business had rising

profit margins, and most were requiring more capital and more risk-taking just to maintain market share. Brokerage commissions were being squeezed harder and harder by institutional investors, particularly mutual funds and pension funds, where managers argued that both fiduciary duties and competitive necessity compelled them to negotiate lower rates. Commercial banks were increasingly competing with loans they then securitized and sold to investors, and cutting prices to get more business in M&A advice and underwritings, particularly debt underwritings. The adverse trends had been developing for some years and could no longer be offset by increasing volume.

Meanwhile, principal businesses were growing, and profit margins were high and holding up because only a relatively few firms could seriously compete—and all the major competitors were smart enough not to ruin the party by competing on price. Real estate, a huge market, had moved away from a business of negotiated private deals into a business of transactions on both private and public markets. That played to Goldman Sachs's dual strengths in both private transactions and public-market transactions. Private transactions could be either principal deals employing the firm's own capital or controlled deals for the big funds the firm managed with capital raised from individual and institutional clients. Either way, the profit margins were much wider, competition was much less keen, and the scale of operation was now much larger thanks to Goldman Sachs's going public.

Goldman Sachs's competitors, notably the giant "universal" banks like Citigroup, JPMorgan Chase, Deutsche Bank, and UBS, increasingly used their balance sheets not only to extend credit but also to underwrite stock and bond offerings, and they used their credit relationships as leverage to get M&A mandates. Blankfein felt Goldman Sachs would either make a definite choice to go its own chosen way in this new world or it would lose the freedom to make its own choice and sooner or later—probably sooner—would have a clearly inferior choice imposed upon it. "How can Goldman Sachs survive in a world of the big balance-sheet firms of Citigroup and JPMorgan Chase?" was the question analysts asked year after year. Few believed Goldman Sachs could succeed as a stand-alone investment bank basing its business strategy on the agency business of giving advice.

Not only did the firm need to make a serious choice, it needed to make that

choice soon.[1] Given the pace of change in the world of finance, if Goldman Sachs was going to make that choice from a position of strength, it was probably now or never.

Blankfein made his case: Goldman Sachs's strategic opportunity—and, as he saw it, the firm's strategic imperative—was to integrate the roles of adviser, financier, and investor: giving astute advice and committing capital. The investment banking industry was reconverging after the repeal of Glass-Steagall: The merchant banking model of J. Pierpont Morgan, based on integrating lending with advice, was coming back. Goldman Sachs had the best advisory franchise in the world, but giving advice was not enough. Clients increasingly expected investment banks to help finance the transactions they recommended. The firm now had to be more willing to use its own capital on behalf of client transactions and for its own account.

As Blankfein asserted that day in London, Goldman Sachs had come of age and was no longer dependent on anyone or anything. With its worldwide operations *plus* its diversity of businesses *plus* its knowledge of economics, industries, companies, and markets *plus* its client relationships *plus* its capacity to embrace risks, the firm had developed for itself a unique strategic position. Each of those strengths was unequaled, and in aggregate they were unbeatable and unmatchable. Goldman Sachs was now free to capitalize on all the years of hard work and steady business development done by predecessors.

But it could all be lost.

Of course, it *would* be lost if the firm squandered its reputation or failed to anticipate, understand, and manage the many potential conflicts or failed to excel in its important agency businesses. It could be lost if the firm made the easy, obvious, familiar strategic blunder of designing its future strategy to replay old movies of its past success and staying too committed to the old agency business like stockbrokerege. Even Goldman Sachs could stabilize, stiffen, and lose bit by bit its vitality and its most valuable asset, the freedom to choose its own course. Shrinking profit margins would translate into inability to continue being Wall Street's most rewarding employer. And over time that would mean losing the unmatched ability to attract and keep the very best people. Already, the firm was losing a few star performers to hedge funds and private-equity firms. Everyone knew that Goldman Sachs did great recruiting and excellent training, so it was every

recruiter's favorite fishing ground—and not every great employee would love forever the long hours and the intensity of working at Goldman Sachs. Take away the remarkable rewards and then have two or three so-so years—or worse—and the war for talent would be in full force against Goldman Sachs.

But that bleak future needn't come to pass, Blankfein told his colleagues. There was an alternative—a better, more profitable alternative. "We have the capital and investment prowess; we have one of the fastest growing asset-management operations in the world; we have the risk-management skills; we have the proprietary research; we have the originating deal-flow through our thousands of corporate relationships and our dozens of major relationships with private-equity firms; we have the knowledge of all the major financial markets around the world; we have the creative, driven people; and so we have every opportunity to reorient our business around both the needs of our clients and the traditional strengths of our firm." The proposition had one *if*—and really only one: *If* the firm had the wit to recognize that the strategic choice was not agency *or* principal. The best choice was and would be agency and principal combined together in an unbeatable whole.

As Blankfein explained, "We definitely need to continue nurturing major relationships with corporations, central banks, funds, and investors because they provide us with more and better deal-flow than anyone else, and we always need to preserve and build that great strength as much as possible. It is vital to our ability to be profitable and attract outstanding people to Goldman Sachs. Agency relationships are crucial to the firm. But never forget: When combined with being a principal, this strategy of being an adviser, financier, and co-investor allows us to recruit and keep the best people and keep building our reputation as the preeminent investment bank in the world. But if we insist on anchoring our firm only to the pure agency service strategy of the past, we will surely, gradually at first but inevitably with acceleration, cease to be leaders and even lose our relevance."

The crucial differentiating advantage of Goldman Sachs would be one that outsiders might find surprising: Its complex variety of many businesses was sure to have lots of conflicts. Goldman Sachs, Blankfein said, should embrace the challenge of those conflicts. Like market risk, the risk of conflicts would keep most competitors away—but by engaging actively with clients, Goldman Sachs

would understand these conflicts better and could manage them better. Blankfein (who spends a significant part of his time managing real or perceived conflicts) said, "If major clients—governments, institutional investors, corporations, and wealthy families—believe they can trust our judgment, we can invite them to partner with us and share in their success."

By the time he gave this speech, Blankfein was well on his way to the top of Goldman Sachs. It had been a long, circuitous journey. Coming out of Harvard Law School in 1978 after Harvard College—both on scholarship, since his father was a Brooklyn postal clerk—he had tried for a job at Goldman Sachs but was turned down. He worked for a while at Donovan & Leisure but left that law firm (where his supervising partner said he was the only departing associate he truly missed) when a headhunter called him up and suggested he might be a fit with J. Aron. Blankfein wanted great success and was already perceiving that even with two Harvard degrees, his career in corporate law would be constrained and he would probably never create a fortune.

He wanted to manage a business and was intrigued with markets. He signed on at J. Aron when Herb Coyne was hiring people with law school training to solve complex problems and explain the solutions to clients. Where Donovan & Leisure was formal and uptight, J. Aron was informal—almost Wild West. With his delightful sense of humor and understanding of people, Blankfein soon became an unusually successful customer's man. He matched his obvious brainpower with unusual emotional intelligence and quickly developed acute numeracy to go with his verbal fluency. Unusually for anyone as bright as he was, Blankfein showed none of the frequently associated arrogance. Instead, he was accessible to others, so they too benefited from his perceptions, analysis, and judgment. And he was funny.

When J. Aron was acquired, Blankfein got into Goldman Sachs by the back door—and just barely. Fortunately, Mark Winkelman decided not to include him in the major layoffs and, against Bob Rubin's advice, encouraged Blankfein to switch from sales to trading. J. Aron expanded into risk-embracing trading in currencies as well as in oil and other commodities, and Blankfein flourished and rode the expansion to increasing authority.

Recognizing earlier than most that the major institutional investors were sure to continue squeezing the commission-based agency business, he concentrated on

doing business with hedge funds. Their focus was on making money, not on saving costs; they acted quickly and paid full fare, so they were more profitable and, while much smaller in assets than the major institutions, their high turnover made them more profitable accounts for Goldman Sachs. Far better than most securities firms, Goldman Sachs knew how to meet their needs in a win-win working relationship.

Principal, risk-embracing trading in currencies was extended into derivatives and on into fixed income where embedded options increasingly mattered. Simultaneously, competition—particularly from large commercial banks—drove the profits from investment banking lower and the need to deploy large capital commitments higher. As a result, the traditional strategic priority of Goldman Sachs and its core profitability declined persistently and substantially. Risk-embracing trading grew more and more important in scale and profitability while the old pure agency service businesses faded. Blankfein was gaining strength within the businesses that were getting steadily stronger.

As one after another rival got outmaneuvered, his power compounded, and he had the political prowess, the ruthless objectivity, the capacity to learn and adapt quickly, and the driving ambition to go all the way to the top. His standing, particularly with Hank Paulson, continued to rise as their articulated visions for the future Goldman Sachs came into closer alignment. Blankfein was always looking ahead at least several moves and understood what was really important to the organization and to his seniors. He was skillful at managing upward. "His seniors *all* thought he was just terrific," says a colleague from his early years. When unit heads at J. Aron were all asked to produce quarterly reviews of their units' operations, Blankfein somehow knew this was a major request. While other unit heads treated it lightly, he did a superb job and broke out of the pack.

"We all knew that in our crowd of bright, committed fast-track young professionals, Lloyd was the exception," says the former colleague. "So very smart. So very quick. What a wonderful, nice sense of humor. And so original in his perceptions and analysis. He had great perspective: time and again he was seeing things very differently, way outside the box. Mark Winkelman picked it up right away too. Mark never laughed, never smiled, and always seemed *so* serious, while Lloyd was always seeing the comic side. But the minds of those two had an amazing understanding and bonding right from the start."

Blankfein's detached rationality generated fear and respect—and cut out costs that were not producing profits. When he visited one of the international offices, he asked, "What are all these guys doing?" First the flowers and the big bowls of fresh fruit were gone. Then the free soda. Then 20 percent of the staff was gone. Then another 20 percent was gone. Costs were coming down and people were cut out—almost as easily as the fruit and soda. They were costs too.

Blankfein surrounds himself with unusually bright people he has learned to trust over years of working together. His past as a lawyer comes out as he questions and questions until satisfied. Those who know him well say he wants to be challenged—not to be proven right, but to get to the right answer. Others are not so sure. "Lloyd is really smart—and he knows it," said a former partner. "He wants really smart people who will anticipate market trends and client needs and anticipate what he'll want even before he decides. Lloyd is usually right, but his centralized way of making decisions means Goldman Sachs is not *my* firm anymore."

Seemingly always in a state of anxiety, Blankfein says, "If I weren't afraid to assert anything with any kind of confidence, I would tell you that I'm the most insecure person in the world."[2] He is certainly not alone. Even with the powers and successes of today's Goldman Sachs, those old-time anxieties and insecurities that characterized the firm when it was striving for acceptance decades ago—or entering the established markets of Europe or Asia as outsiders or launching new businesses that nobody had yet mastered—continue to lurk at the core of the firm. Blankfein muses that Goldman Sachs's culture is "an interesting blend of confidence and commitment to excellence, and an inbred insecurity that drives people to keep working and producing long after they need to. We cringe at the prospect of not being liked by a client. People who go on to other commercial pursuits frequently self-identify as a former Goldman Sachs employee long after they have left the firm. Alumni take a lot of pride in having worked here."[3]

His rationality enables Blankfein to see opportunities for useful "soft" moves away from habitual "tribal" mistakes like the long history of treating retiring partners as almost instant outsiders—with abruptly downgraded ratings of their formerly admired capabilities. While this may have been an understandable reflection of both ambitions and insecurities, it was also an enormous waste of opportunity. With most partners going limited in their late forties—with twenty high-productivity years still ahead of them and with experience, expertise, and

vibrant network relationships that would and did enable them to do great things elsewhere—it was a head-shaking wonder to see them feeling jettisoned by the firm they had served so well and were so committed to for so many years.

Blankfein is taking Hank Paulson's first steps—annual dinners for former partners with candid briefings on progress and a Web site—to a whole new level. A former partner has been meeting with all interested prior partners to learn firsthand what they would like the firm to do for them and what they would be interested in doing for the firm. The response has been positive, and the prospects for significant, profitable business are encouraging. Blankfein continues to increase the firm's commitment, and his own, to the Pine Street leadership development program. Notorious for asking questions, he seems to thrive on being interrogated by well-informed institutional investors. Where other organizations' leaders offer a set-piece presentation and give stock answers to a few questions, Blankfein likes to go directly to Q&A and often responds best to the toughest challenges.

Risk is complex and deceptive. There are known risks and unknown risks. And risk is not entirely quantitative. At the margin, managing risk is closer to an art than to a science and depends on experience and judgment. That's why the original J. P. Morgan so wisely emphasized character as the basis for extending credit.

Modern finance is based on one great simplifying assumption—that markets are efficient and that market prices reflect almost all that is known or knowable. So, if diversified to absorb imperfections, the aggregate portfolio will be "market efficient." Of course, for every rule there will be exceptions—exceptions that prove the rule—so when dealing with new or unusual securities, investors should diversify even more widely, adding a margin of safety so their portfolios will be protected against risks—except for the unusual and unexpected anomalies called black swans.

Too much faith in the rationality of the efficient market is *not* rational. In the vernacular, stuff happens. As chair of Goldman Sachs's audit committee, John Browne, the celebrated leader of BP, focused on risk management. Browne was pleased to see that discussions of risk—always complex and arcane in the securities business—were open, candid, and comprehensive at Goldman Sachs. Browne's

challenge after the IPO was to transform risk management from the "family style" of a partnership to the procedural formality appropriate to a corporation—without losing the advantages of individuals taking personal responsibility for vigilance and accountability. One risk in auditing or in risk management is for a leader to stay too long in the responsible position, getting to know and like people as people, and developing perhaps too much trust or tolerance. There is a risk of going from not knowing enough to knowing enough and then on to thinking you know more than you do. Those with substantial experience knew that analytical models like value at risk (VaR), however widely celebrated as the latest thing in risk controls, would catch all the normal risks, but not the "killer" risks—the toxic black swans that reside in the six-sigma "fat tails" of a normal bell-curve distribution of probable events.

Almost every element of risk—toxic or rewarding—was on display in the mortgage crisis that rocked the United States and the world in 2007. At Goldman Sachs, the structured-products group of sixteen traders is responsible for making a market for clients trading a variety of securities based on residential mortgages. Simultaneously but quite separately, members of this group trade or invest the firm's own capital or take the other side of a client's transaction, either because they see a good opportunity or to fulfill their role as a market maker. Because those businesses are separate, it's well understood by all parties that Goldman Sachs has no obligation to tell trading clients what it is doing in its proprietary activities—even when it is handling buy orders for clients' accounts and selling for its own account, as was the situation in 2007.

A year earlier, in yet another line of business, Goldman Sachs had been a major underwriter of securities backed by subprime mortgages. Because subprime mortgage-backed bonds traded only occasionally and only privately, a new family of indexes, called ABX, was created to reflect these bonds' values based on instruments called credit-default swaps. These are derivatives that pay the buyer if borrowers default on their mortgages and the mortgage-backed securities fall in price. The derivatives actually trade more often than the bonds themselves, with their prices rising or falling as investors' views of the risk of subprime defaults rise and fall. As expected within the firm's mortgage department, the introduction of the ABX was great for traders: The firm made $1 million on the first day, but volume was thin and the firm had to use its own capital on most trades.

In December 2006, David Viniar, the firm's highly respected, long-serving, and unflappable CFO, pressed for a more negative posture on subprime mortgages.[4] He wanted the firm to offset its long position in collateralized debt obligations (CDOs) and other arcane securities that it had underwritten and was holding in inventory to trade for customers, and to do so by shorting parts of the ABX or buying credit-default swaps. When traders complained they did not know how to price their portfolios, Blankfein ordered them to sell 10 percent of every position: "*That's* the market price. Mark to that." Since the market was so thin, it took months to complete hedging the firm's exposure. By February 2007, the firm had a large short position, focused on the riskiest part of the ABX.[5] That index would drop rapidly from about 90 to nearly 60.

In late April, Dan Sparks, head of mortgages, and two traders, Josh Birnbaum and Michael Swenson, met with a small group of senior executives and warned of a major problem with the firm's inventory of $10 billion in CDOs: It was heading south. Sparks wanted the firm to cancel underwriting any pending CDO issues, sell all the inventory it could, and make major bets against the ABX index. Sparks's recommendation was accepted and implemented. By midsummer, with its change in position, Goldman Sachs was making large profits for its own account—while two Bear Stearns hedge funds vaporized and rumors were rife of major CDO losses at other firms. During the third quarter, this one unit reportedly made $1 billion.[6]

The separation between business units—and, dramatically, between their results—was made starkly explicit by the firm's response to stunning losses in the Global Opportunities Fund and Global Alpha. The first was a pure "quantitative equity strategies" fund; the second was a "macro strategies" fund. Global Alpha was considered the flagship of Goldman Sachs Asset Management, and both were quantitative funds—committed to following computer-generated trading signals. They combined the firm's vaunted expertise in risk management with its leadership in the world's markets for stocks, bonds, currencies, and commodities. Regularly described as rigorously risk-averse and asset-protective, Global Alpha was designed to have volatility or risk similar to the S&P 500 with returns that were advantageously uncorrelated with the S&P. The fund had produced a series of strong results and, being highly salable, was gathering assets at such a rapid

clip that its managers spoke solemnly about limiting cash inflows to protect its ability to generate superior returns. Suddenly, in a single week in the third quarter of 2007, Global Alpha lost 30 percent of its value and Global Opportunities lost even more. The total loss in Global Alpha for the year was 37 percent.

During the same quarter, Goldman Sachs's reported profits increased 79 percent. While certainly not identical, the causes of the sharp loss and the strong gain were both connected to market reactions to the crisis in subprime mortgage-backed securities, whose roots traced back to years of sloppiness by credit providers and regulators.[7]

Global Alpha was highly liquid and could sell investments to reduce debt as assets fell. Global Opportunities was not liquid, so to prevent a highly visible failure, large amounts of new money were needed immediately, and there was too little time to raise the necessary capital from investors in the fund. Goldman Sachs injected $2 billion and raised another $1 billion from wealthy individuals like Eli Broad, in part to have an arm's-length validation of the terms for its own investment. CFO Viniar explained, "This is not a rescue. We believe this is a good investment." And so it would prove to be—from the depressed level at which it was made—for Goldman Sachs. The profit on the capital infusion was reported as $370 million in the first month.

As a partner reflects, "Only looking back could we see the real risk—the risk of arrogance. We didn't see it then, but it was there and it was growing because the outsiders of Goldman Sachs were no longer the outsiders. The firm was at the top. We had always been the best—always the top students and the best athletes and the class leaders. And now we were at the best firm—in our own self-appraisal. But that was the first step toward arrogance." Blankfein drew a similar lesson: "We're not that much smarter than the guys who got hurt so badly this time around, so we certainly can't be complacent."

While Global Alpha and its investors suffered major losses, and investors in securities underwritten by the firm experienced seriously disappointing performance, the firm and its own investors enjoyed the substantial profits Goldman Sachs produced by taking an astute and almost unique short position

in the subprime mortgage market. While some would question whether the firm did not have an overarching fiduciary responsibility to all clients and customers to share its expertise across all three areas, senior management was and is clear: Each business unit is responsible and accountable for doing its best to complete the mission of that particular business—period. No business is its brother's keeper. Each tub on its own bottom.

The firm presents itself as a problem-solving provider of solutions. As an organization of skillful, smart, experienced people connected to corporations, governments, institutions, and expertise all over the world—an organization with its own capital, access to all the major markets, and a formidable appetite for risk—it has the ability to draw reliably, repetitively, and rapidly on all these strengths to create solutions of its own design that address customers' problems in ways no other firm in the world can match. The firm's strategic objective is to be recognized widely as the world's best solutions provider so that it will get the first call and will always have the freshest information, the most traffic, and the best opportunity to innovate—at the highest profits.

As an intermediary's service becomes a commodity or gets automated, the importance of being capable and committed to acting as a risk-assuming, capital-based, multimarket solutions provider goes up a lot—and so do the profits. If General Electric had a complex problem ten years ago, Goldman Sachs might have earned a $10 million fee for working out the best available agency solution. Today, with more precise knowledge of the various demands in specific markets, the firm may divide the problem into a variety of new, specialized components and work out a series of actions component by component—some pure agency, some principal, some a blend of both—with a variety of risk characteristics and a range of counterparties that would have been unheard of ten years ago and may still be unknown to most competitors.

Goldman Sachs has again reinvented itself into a new kind of financial organization that is profoundly independent—no longer dependent on one or two lines or business, no longer dependent on any particular market, no longer dependent on the goodwill of any corporation or institution, and no longer dependent on any single technology.

As a past partner explains, "In the blend of agency and principal-with-risk business, it's the principal business that really rings the cash register. I loved old

Goldman Sachs and respect new Goldman Sachs. Respect is more important than a favorable regard to Goldman Sachs today." But another partner says, "Today Goldman Sachs is number one with clients and has arguably the best reputation and the dominant market share, and is best positioned to attract the brightest recruits. The firm has never been more focused on clients."

Yet Blankfein's self-professed insecurity, and even the traditional touch of paranoia, still very much has a place. The partnership, more than any private company, perhaps in the world, is free to choose its own future—unless, perhaps in a period of poorly performing global markets or because of catastrophic losses, the ultimate imperative of making larger and larger profits becomes too difficult. That would erode the edge that has enabled Goldman Sachs to attract, develop, motivate, and keep most of the financial industry's best people, always its strategic constraint.

The partnership is creating more successes than ever before, in more ways and places for more people, but it must always do better and better. That's why so many remarkable, capable, and ambitious people join the firm. And that's why Blankfein may have the toughest job ever as the leader of Goldman Sachs. And his successor's job will be harder still.

AFTERWORD

Friendship has been a vital factor in enlisting more than one hundred partners of Goldman Sachs to share with me their own recollections and stories about the firm. Our meetings, interviews, and critique-review sessions have renewed and enriched the many associations I so enjoyed developing while serving over three decades as a strategy consultant to the leaders of various parts of the firm in Asia, Europe, and North America. Readers should know that most of the conversations reported here are best-effort re-creations. In many cases I was not there, and those who were there are subject to all the familiar difficulties of precise recollection. That's why each conversation has been reviewed with those who know best what was said and how it was said. Not surprisingly, these reviews have reduced the amount of slang and the frequency of conventional expletives while increasing the substance.

Accuracy about names, dates, and facts is a strong habit—even a compulsion—for investment bankers generally and particularly for the partners of Goldman Sachs. Whenever possible, facts and perceptions have been verified by those partners of the firm who lived the experience. An example is telling: To check for accuracy and objectivity, I sent a draft of one chapter to one former

partner. Several errors of fact and one misunderstanding—or misrepresentation, depending on your own perspective—were identified. Within a week, to be certain the story was factually accurate, four senior partners who had been out of the firm for fifteen years, all still very busy people, had offered to meet with me. Three current partners also agreed to help get the story told as accurately as possible. Six other former partners were helpful via telephone.

The same kind of generosity—born out of caring for the Goldman Sachs they knew or know—was shown by Treasury secretary Hank Paulson's spending nearly two hours with me the day after he returned from an important negotiating trip to China; former Treasury secretary Robert Rubin's spending three hours in two meetings; former undersecretary of state John Whitehead's meeting six times (most recently between calls to UN secretary general Kofi Annan and New York mayor Michael Bloomberg) and, while on vacation in Africa, correcting names and dates in an early draft; John Weinberg's inviting me to his home several times for three-hour sessions; or Geoff Boisi, Frank Brosens, John Browne, Lee Cooperman, Eric Dobkin, George Doty, Gene Fife, Bob Freeman, Steve Friedman, Jim Gorter, Steve Hendel, Bob Hurst, Steve Kay, Fred Krimendahl, Bill Landreth, John McNulty, Bob Menschel, Richard Menschel, Robin Neustein, John Rogers, Peter Sachs, David Silfen, Frank Smeal, Roy Smith, Bob Steel, L. Jay Tenenbaum, Barry Volpert, Pat Ward, Peter Weinberg, Mark Winkelman, Richard Worley, Ray Young, and Roy Zuckerberg each meeting with me numerous times.

Spacious as this book has become, the story of Goldman Sachs is more spacious still. A few of the firm's landmark adventures have been squeezed out of these pages by compassion for the reader. Primary among them is the long series of wildly complex deals in which Goldman Sachs was involved in selling and buying New York's Rockefeller Center, and then selling it again, more than doubling the firm's investment in five years to $1.85 billion. For similar reasons, dozens of lesser fascinating or amazing stories have been relegated to the end notes that follow these pages.

As my interest in researching and writing a study of America's great professional firms increased, that interest had to remain an abstraction. I was totally immersed in a thirty-year all-out drive to lead Greenwich Associates in developing a worldwide franchise of research-based strategy consulting with senior management at professional financial services organizations. Our dream was to serve the leaders in all of the world's 135 financial markets. Developing colle-

gial relationships with each of these complex client organizations absorbed all the time and energy my partners and I had. All of us put aside other interests to focus on our own firm's immediate challenges.

By the mid-1990s, the demands on time had crested and other activities were permissible. Appointed to the Overseers' Visiting Committee at the Harvard Business School, I was delighted to note that John Whitehead would chair our group. I admired him as the finest strategist and organization leader-builder on Wall Street and as my most rigorous, through, and effective client. On a personal level, I liked him and found his high expectations inspiring. Besides, I had an idea for a book and would need John's cooperation.

Working with the clients of Greenwich Associates, I'd gotten acquainted with many of Wall Street's most interesting people and had heard stories of many others. My plan was to write insightful profiles of the most interesting contemporaries and collect the best available profiles of prior heroes—and villains—into an enjoyable weekend reader. I couldn't imagine such a collection without Whitehead. So, much as I intended to serve Harvard Business School in our two-day meeting, I also hoped to persuade John to let me write a profile of him. It wouldn't be easy: As a firm, Goldman Sachs has a near fetish about no publicity, particularly for individuals—which is why there had never been a profile on John Whitehead or John Weinberg—and Whitehead had already deflected me when I had first raised the subject. "That's not really our way here." But he had not said no.

Lucky me. During the social hour at the end of the first day of meetings at HBS, I noticed a slim, stylish woman I'd never met but everyone knew: the first woman to became a star television reporter—the young, assertive woman who reported on the Kennedy administration, Nancy Dickerson—Nancy Dickerson Whitehead.

Knowing she would understand the merits of visibility and recognition as a leader, I introduced myself: "I need your help. I'm writing a book about the great leaders in the world of finance, and your husband should be one of the people featured most prominently. Several others have already agreed to participate, and John Wiley & Sons will publish the book next year. Can you help me persuade your reluctant husband?"

"Sounds interesting, but I'll have to talk with John. He would have to decide."

Lucky again. After our meetings, I caught the early Sunday morning shuttle from Boston to LaGuardia. The plane was nearly empty—but John and Nancy Whitehead were already on it. With a quiet smile Nancy said, "Call John on Monday."

When I called and made an appointment for an interview, I knew that the "weekend reader" book of profiles would make it.* More important, that interview with John Whitehead would be the first step taken toward the present book. The second was when John Weinberg decided that if his friend and partner was participating, he probably should too. We met several times on Sundays at the Weinberg home. I became sure that an objective study of Goldman Sachs could and should be done. I was determined to do it.

Over the next few years, I met with and interviewed the partners and former partners I had known best. The more I learned, the more I was sure that a serious book about Goldman Sachs would be interesting to do and very interesting to read, and that to be accurate it had to be an up-close and personal study. However, at Goldman Sachs—perhaps because the firm was going public, perhaps because firm leadership had changed, perhaps due to a resurgence of the firm's traditional reluctance to have any outsiders write anything that the firm does not control—willingness to see a candid study done as a book slowed way down. This came to me in the person of the firm's longtime public relations specialist, Ed Novotny, who called to say he understood I was interviewing various Goldman Sachs alumni for a possible book and that he would like to meet me. We met for lunch at the Yale Club across from Grand Central Terminal, and Ed explained that senior management had asked him or one of his people to accompany me on all my interviews; if that condition was not accepted, the firm would pass the word to everyone not to cooperate with me in any way. He hoped I would understand.

Having no alternative, I agreed to give it a try, but it soon proved hopeless. A "chaperone" from Public Relations would come to each interview. While everyone was polite, the character of the interviews changed from candid and interesting to cautious and dull. The difference was decisive—and depressing. I was getting pablum. I would have to give up on something for which I had had such high hopes.

* It was published by Wiley in two volumes as *Wall Street People* in 1996.

Coincidentally, I happened to have lunch at Michael's Restaurant on Fifty-fifth Street in Manhattan with two old friends. After a while, one of them, Gershon Kekst, the preeminent public relations consultant to corporations, asked me, "So, Charley, what's important in your life these days?"

"You're a week too late with that question, Gershon. Last week I could have told you, but not this week."

"What happened?"

"Last week I was all excited about writing a serious book about Goldman Sachs and how it became the leading securities firm in the world, but that's now over. They've started sending chaperones to sit in on my interviews, so I'm not getting the spontaneous candor or insights you really need to tell the story accurately, and I'm only going to do such a book if I can do it right—and that means 100 percent objectivity, warts and all, which is never going to happen with those chaperones."

Kekst reflected on this lament briefly and, looking straight at me, said quietly, "Call my office—after four." He then explained that he was a public relations consultant to the firm and would be glad to speak on behalf of the project.

At 4:01 that afternoon, I called Gershon, who mentioned a name at Goldman Sachs and added, "He's expecting your call. He'll work it out with you." While I'll never know for sure, Gershon must have said something like "A book on Goldman Sachs is inevitable, so why not cooperate with someone the firm knows who will produce a serious book?" The simplicity of the arrangement was all I could ask for: I would have access to the firm's archives and could interview all the alumni I wanted, come back with a draft of several chapters, and work from there together. Word would be passed that anyone interested should participate; that Goldman Sachs would help with factual accuracy; that one executive would read drafts for warts-and-all objectivity; and that final decisions on content, style, and evaluations would be entirely mine to make.

The previous time this book nearly never got written was in 1973, the second year in the early torturous struggle to bring Greenwich Associates into being. With just $3,000 of capital, a one-room walk-up office, no clients, no experience in consulting, one employee, and just enough savings to go for a year without any income, Greenwich Associates and I began the scramble to make it. The early seventies were not a great time in financial services: As the stock market fell and

interest rates increased again and again, investment banks, commercial banks, and bond dealers were all cutting costs; they had no compelling need for a new, untried kind of research-based consulting service from a new, untested firm.

In this grim environment, I was surprised to receive a call from Inez Sollami, secretary to Gustave Levy, the senior partner of Goldman Sachs: "Mr. Levy wants to see you Wednesday morning." For weeks I'd been trying to see someone—anyone—at Goldman Sachs, the leading institutional stockbroker, so this was a real break. As I reached for my appointment calendar, she continued, "At seven thirty sharp." I'd never heard of anybody having a business meeting in the office that early in the morning and didn't know what train might get me there, but I certainly didn't care. "Thank you. I'll be there."

On arrival at Goldman Sachs, I was taken to Levy's curious and unique office in the middle of the trading room.

"I understand you have a report on Goldman Sachs and Company."

"Yes, Mr. Levy."

"Call me Gus."

"Yes, sir. We do have such a report, but—"

"I'd like to see it."

"I'm sorry, but I was about to say we cannot offer it to you. Like an underwriting, we offered our service starting nearly two months ago and couldn't get anybody at Goldman Sachs interested before the offering period closed for this year—over a week ago. So I'm sorry to say it's no longer available this year."

"We both know it can't cost you more than $20 to make another copy. And I think you do know I can get what I want on Wall Street."

"Yes, I know. But we promised our clients."

Levy must have thought I was the dumbest guy he'd ever met. He waved his hand in dismissal and turned his attention quickly to other things.

As I left, it dawned on me that I now would have to tell my friend and partner, Allan Munro, that I had not only turned down a fee we desperately needed but also surely jinxed for all time any chance of ever working with Goldman Sachs by offending its legendary senior partner. As it happened, Allan was in California and we had no chance to talk together for two days. By the time we did, I had seen Goldman Sachs partner Bob Menschel while walking along Wall Street: "Hear you saw Gus yesterday." My heart sank: Was Levy so offended by my declining

his offer that he had actually discussed it with his partner? Warmly, Bob continued, "Gus thought you were okay."

I was so relieved—and elated—that as soon as I was far enough along the sidewalk that Bob would not notice, I jumped into the air and clicked my heels, thinking, "Just wait until next year!" We were almost certain to have Goldman Sachs as our client then, because our research on the performance of all the major firms showed good news for Goldman Sachs: It was one of the best.

In the decades since then, one of my great pleasures has been to witness the remarkably consistent, gracious, and professional way that staff members bring to life every day the Principles of Goldman Sachs.

The last time this book was nearly never written is now. Given the remarkable talents and the driving ambitions of the many people of Goldman Sachs, it cannot be surprising that strong differences are experienced at all levels. Some differences are philosophical, some are personal. In the urgency to get on with the business, many hurt feelings and mistakes were never addressed or resolved. Many are revealed here for the first time. If a vote of the partnership were taken today, this book would surely be scuttled.

ACKNOWLEDGMENTS

William S. Rukeyser, as editor extraordinaire, has been my partner, mentor, and friend in the multidimensional challenge of converting draft chapters into a finished book. Sometimes admonishing, always genial, and superbly skillful, he has worked his magic on many levels—therapist, teacher, coach, trainer, cheerleader, and chaplain. We met and worked together when he was establishing *Money* as the best consumer magazine in personal finance and investing. I wrote a short piece, which he edited with a combination of grace, skill, and impact that astonished me over thirty years ago. We lost touch, but when I met another Rukeyser, I asked, "Do you know Bill Rukeyser?" and learned I was speaking with one of his brothers. Getting contact information, I reached out hoping Bill could, perhaps, nominate a capable editor for me to work with. Mercifully, he agreed to edit a book on Goldman Sachs himself. He is a master. Over more than a year of intense work, our relationship continues to be increasingly effective and fun.

Working with deadlines—by taking on too many commitments—has always been part of my career, beginning with sprints across the Harvard Business School campus to slip my written analysis of a case, or WAC, into the slot that would shut tight on the ninth bell for 9:00 on Saturday night, and at least once only making it by the eighth bell. Even though work on this book began twenty-five years ago

and has been a priority commitment for most of the past ten years, as we zoomed toward the final few days when no extensions could possibly be granted, I was precommitted to working in Seoul and Singapore and, despite substantial jet lag, requested a wake-up call at 2 a.m. to keep up with Bill in an hour-long, last-minute final rewrite of a particularly complicated chapter. Even that was fun.

John Gaddis, one of Yale's most popular professors and a superb historian and friend, introduced me to Andrew Wylie, my literary agent, who took a précis for this book to dinner on Shelter Island with John Makinson of Penguin. After discussing several book ideas, Makinson said, "What I really want is a book on Goldman Sachs." Smiling, Andrew pulled out my précis and, before he left the table, a deal was done. Ann Godoff and Vanessa Mobley have made the challenge of meeting submission deadlines—adjusted mercifully three times—more than stimulating and quite inspiring. As our main editor, Vanessa beautifully balanced personal grace and decisive good judgment.

Catharine Fortin and Kimberly Breed have joined with patience and goodwill in the numerous challenges of typing longhand drafts in illegibly small writing with imperfect pens and crotchety facsimiles. Ed Canaday of Goldman Sachs graciously took charge of fact-checking all dates, names, and amounts, but all remaining errors are clearly mine alone.

Linda Koch Lorimer—my beloved wife and best friend—reviewed and critiqued an early draft with her usual unusual ability to provide perceptive insight and advice. Eli Jacobs and David Darst both improved the final text significantly by tightening up the story and the telling.

More than one hundred partners of Goldman Sachs and the nearly as many competitors who have helped me understand the achievements of Goldman Sachs and the world in which they were accomplished have individually and collectively made writing this book one of my most treasured experiences in a very fortunate life. I am forever grateful.

My one regret is that most of the people who make Goldman Sachs the great firm that it is, and most of the work that they do, must go unreported in this necessarily selective sampling of their wide, deep, and continuous collective determination to excel. That's the irony of selfless dedication to teamwork in an organization where exceptional talent, skill, and drive are so consistently "usual." And that's what makes Goldman Sachs the greatest financial institution in the world today.

NOTES

Chapter One Beginnings

1. DeCoppet & Doremus, Charles M. Schott, and John H. Jacqueline.
2. Paul Sachs retired from the business in 1914 and joined the faculty of fine arts at Harvard, where, years later, he and his wife entertained Sidney's son, John Weinberg, for regular Sunday luncheons during his student years at Harvard Business School. Weinberg continued his learning in later life by reading books, particularly on Abraham Lincoln, and collecting Lincolniana. He eventually received honorary degrees from Harvard and Yale.
3. *New York Times*, July 24, 1969.
4. Paul Cabot.
5. Walter Sachs.
6. Joseph, born in Wurzburg, Bavaria, in 1817, had served as tutor to the daughter of a well-off goldsmith named Baer; he eventually fell in love and eloped with the girl, Sophia Baer, and sailed in 1848 to Baltimore, where they raised five children. Just before the Civil War, Joseph moved his family to New York City, where he established a school for boys.
7. Walter joined the firm actively in 1908 and stayed involved until his death at ninety-six in 1980.
8. Walter E. Sachs, Memoirs from Columbia University Oral History Collection, p. 46.
9. Sachs, p. 50. Their New York agent then was Winter & Smillie.
10. Sachs p. 53. The business was run by Siegfried Bieber for many years until he returned to Germany to be a director of Berliner Handelgesellschaf.
11. Sachs, pp. 60–62.
12. A combination of three cigar manufacturers: Wertheim & Schiffer, Hirschorn Mack & Co., and Straiton & Storm.
13. Father of Maurice Wertheim, founder of Wertheim & Co., now part of Schroders.
14. Stephen Birmingham, *Our Crowd* (New York: Harper & Row, 1967).
15. Sachs, p. 79.
16. Her husband, Samuel Hammerslough, who sold men's haberdashery, was Rosenwald's uncle. Reputedly, one of his customers in Illinois, who could never find trousers long enough to fit, was Abraham Lincoln.
17. Kleinwort & Sons had little or no distribution

capability—selling was considered crude and was socially disdained—so they simply held the stocks they had underwritten until World War II. They made a paper fortune, but it didn't last. During the war the British government expropriated all foreign investments of British subjects, and the Kleinworts patriotically put the money into "Daltons"—low-interest government bonds with no fixed maturity date. A decade later, the bonds' market value had dropped by 85 percent.
18. Sachs, p. 111.
19. Ibid., p. 113.
20. Ibid.
21. Ibid.
22. Ibid., p.118.
23. Ibid.
24. Ibid.
25. *Our Crowd,* pp. 334–35.
26. *NewYork Times,* July 24, 1969.

Chapter Two Disaster: Goldman Sachs Trading Corporation

1. Stephen Birmingham, *Our Crowd* (New York: Harper & Row, 1967), p. 336.
2. Hard feelings continued to exist between the two firms until 1956, when Sears Roebuck decided to set up a sales-acceptance (financing) subsidiary and Sidney Weinberg called on Robert Lehman, Philip Lehman's son, to invite Lehman Brothers to resume its historical place in Sears's financings. Even then, there was continuing rivalry over which name would go first. When Gimbel's department store was brought to market, Bobby Lehman said he wanted to honor his father by listing Lehman Brothers in the preferred position. Sidney Weinberg protested: "We can't honor my father—he was a tailor!" Weinberg prevailed, as usual: Goldman Sachs stayed first.
3. Albert Gordon, in discussion with the author, November 2000.
4. Written in collaboration with William T. Foster.
5. In 1923, for example, Thomas McInnerney, president of Hydrox Ice Cream in Chicago, merged his company with Rieck-McJunkin Dairy Co. of Pittsburgh to form the nucleus of National Dairy Products, which then acquired a series of other dairy companies. Postum went public with an issue led by Goldman Sachs, Lehman Brothers, and E.F. Hutton; with acquisitions of such brands as Maxwell House and Jell-O, it eventually became General Foods. Goldman Sachs financed Warner Brothers's conversion to the "talkies."
6. Birmingham, *Our Crowd,* p. 335.
7. Vincent P. Carosso, *Investment Banking in America* (Cambridge: Harvard University Press, 1920), p. 290.
8. By comparison, Lehman Brothers got 12.5 percent of the Lehman investment trust's net earnings. John J. Flynn, *Investment Trusts Gone Wrong* (New York: New Republic Inc., 1931), p. 97.
9. Sachs, p. 144.
10. Including, for a while, 50 percent of Frosted Foods. When Frosted needed substantial infusions of capital to finance growth, Goldman Sachs Trading sold that stake to the other 50 percent owner, General Foods.
11. Flynn, *Investment Trusts,* p. 184.
12. Gordon, discussion.
13. Barrie Wigmore, *The Crash and Its Aftermath: Securities Markets in the United States, 1929–1933* (Greenwood Press, 1986), p. 436.
14. Lisa Endlich, *Goldman Sachs: The Culture of Success* (Little, Brown, UK, 1999), p. 46.
15. Winston Churchill was in the Visitors Gallery that day.
16. Sachs, p. 164.
17. Catchings subsequently went to California and became a radio producer. His son, a classmate of Sidney Weinberg's older son at Deerfield Academy (class of '41), died of leukemia in his senior year.
18. Wigmore, p. 141.
19. Endlich, p. 48.
20. Other Wall Street firms did the same.
21. Endlich, p. 49.
22. Flynn, *Investment Trusts,* p. 111.
23. Harvey D. Gibson of Bankers Trust. See Wigmore, p. 254.
24. Wigmore, p. 465.

Chapter Three The Long Road Back

1. Al Feld, November 17, 1996.
2. The firm had only three hundred to four hundred employees during Weinberg's years.

In 2007 Goldman Sachs employed nearly thirty thousand.

3. *Time*, August 1, 1969, p. 69a.

4. At his peak, Whitney had borrowed over five million dollars in unsecured loans from friends and business associates, plus $2,897,000 from his brother George Whitney and $474,000 from J.P. Morgan & Company. He pledged $657,000 in bonds from the New York Stock Exchange's Employee Gratuity Fund, as well as several clients' securities, to collateralize the large personal loans with which he raised money to meet margin calls. In 111 different transactions, he borrowed money to repay loans that totaled nearly twenty-five million dollars.

5. Leslie Gould, *New York Journal-American*, May 11, 1938.

6. E. J. Kahn Jr., "Profile: Director's Director," *New Yorker*, September 15, 1956.

7. *Fortune*, June 1937.

8. Sachs, p. 175.

9. Arranged through a Goldman Sachs partner, Ernest Loveman, who had developed longstanding friendships with the principals.

10. Kahn.

11. *Fortune*, August 2, 1989, p. 84.

12. Musica had been in and out of trouble with the police and had been in prison twice—once for bribing customs officials and once for grand larceny—but he was charming. When a detective sighted him at Grand Central Terminal and called out, "Hello, Phil!" Musica, who was well into his years of impersonating F. Donald Coster, didn't miss a beat. Explaining confidently that he had gone straight and had a new business in Greenwich Village, he urged the policeman to "come on down for a visit."

13. *Fortune*, August 2, 1989, p.84. Musica, the deputy treasurer, and an agent of McKesson were found, when fingerprinted, to be brothers who had executed a carefully planned scheme to embezzle the funds.

14. *Harper's Monthly*, 1937, p. 586.

15. *Newsweek*, August 4, 1969.

16. *Journal-American*, October 22, 1937.

17. The invitation came through retiring Ambassador Joseph E. Davies. In August 1939, Weinberg crossed the Atlantic on Davies's luxury yacht, *Sea Cloud*. "You were the life of the whole party and with your wit and humor you kept us all in a good frame of mind and made the trip enjoyable and full of interest," wrote another passenger, Richard S. Whaley, chief justice of the U.S. Court of Claims.

18. Weinberg had another reason: His wife and sons would not have gone because it would require taking the boys out of school.

19. *New York Post*, April 26, 1938.

20. *Time*, December 8, 1958, p. 91.

21. Told by Charles Wilson, *New York Herald Tribune*, January 6, 1950.

22. *BusinessWeek*, January 27, 1951.

23. Kahn.

24. Walter Sachs.

25. Kahn.

26. Sachs, p. 203.

27. The sixteen other banking houses named as defendants were Morgan Stanley & Co., Kuhn Loeb & Co., Smith Barney & Co., Lehman Bros., Glore Forgan & Co., Kidder Peabody & Co., White Weld & Co., Eastman Dillon & Co., Drexel & Co., First Boston Corp., Dillon Read & Co., Blyth & Co., Inc., Harriman Ripley & Co., Stone & Webster Securities Corp., Harris Hall & Co., and the Union Securities Corp. Attorneys from ten eminent law firms represented the various defendants, spearheaded by Arthur Dean of Sullivan & Cromwell, Ralph Carson of Davis Polk Wardwell Sunderland & Kiendl, and William Dwight Whitney of Cravath, Swaine & Moore.

28. Continental Can, B.F. Goodrich, McKesson & Robbins, Lambert Co., and Madison Square Garden (for all of which he also served on the executive committee), plus General Foods, Sears Roebuck, National Dairy, Cluett Peabody, and General Cigar. Weinberg averaged 250 meetings a year for twenty years.

29. Revered as the man to see even two decades later, Sidney Weinberg was called on by Dan Lufkin in 1959; Lufkin wanted to tell him about his plan to form a new firm—Donaldson Lufkin & Jenrette—and sought Weinberg's advice. "I won't say you can't do it. And I won't say you won't make it. But getting people to change the firm they rely upon for the money they need is at least as hard as getting people to change their religion. You'll have a long, long road ahead of you and you will have to do everything right to earn the reputation you'll need to have with each organization you want to

be a client." Then he added knowingly: "And the competition on Wall Street is tough."
30. Kahn.
31. Mrs. Weinberg died in 1967. Treasury Secretary Henry Fowler flew from Greece to attend her funeral, and then flew back to Greece.
32. *New York Times,* August 1, 1969.

Chapter Four
Ford: The Largest IPO

1. E. J. Kahn Jr., "Profile: Director's Director," *New Yorker,* September 8, 1956, pp. 50–54.
2. Ibid.
3. The work of Ted Yntema, the CFO, and his successor, Ed Lundy. The complete—and completely private—practice annual reports were produced for several years.
4. Blyth later merged with Eastman Dillon, which merged into PaineWebber, which sold out to UBS.

Chapter Five
Transition Years

1. Whitehead tells this charming story about an experience while stationed in Scotland for D-day training: "On my first night off, I stopped at a little store near the boat landing to buy a newspaper, always a scarce luxury aboard the ship. There was a very pretty girl behind the counter. Her name was Nanette MacGregor. She was seventeen and I was twenty-one. We struck up a conversation and she invited me home for dinner. She had a wonderful family: parents and two younger brothers. A little home cooking was very welcome after several months of navy fare. And so for about a month, I spent my liberty evenings with Nanette. She was very sweet. We'd talk about the war and what we hoped to do with our lives. I grew very fond of her, but it was a pure and platonic relationship. I continued to feel committed to Anne Burnett [whom he had begun dating in college], whose picture was on my bureau on the ship.

"Al MacIntyre had a very different experience on his shift. He met up with a girl who couldn't wait to get to the hotel room in Glasgow. According to Al's reports at breakfast, she was quite insatiable. He said that he'd never before seen anything quite like it, even though he'd gone to Princeton. He actually lost weight because they never got around to dinner. One day, after about a month, Al arrived at breakfast looking particularly badly. I asked him what was wrong. He replied, 'Nanette got drunk and passed out, and I finally had to leave her in the hotel room to get back to the ship on time.'

"'Who did you say?' I asked. 'Nanette,' he replied. 'That's the name of the girl I've been seeing." My heart sank. 'What's her last name?' I asked, and he replied, 'MacGregor.' I could not believe we'd both been seeing the same girl, but as we exchanged more information, we both knew it was true. That night was my last liberty night and I caught the train to Glasgow. Neither of us ever saw her again."
2. Coming out of HBS, Whitehead had two choices on Wall Street: joining Goldman Sachs or joining Equity Corporation with David Milton, who was married to the Rockefeller brothers' sister, Mary.
3. John C. Whitehead.

Chapter Six Gus Levy

1. His widowed mother failed in her hope of marrying one of the daughters to a wealthy European and felt she couldn't face staying in New Orleans, so she moved to the Bronx, where she worked as a seamstress and depended in later years on her son for support.
2. A cousin of Bernard Baruch who adopted a different spelling.
3. Walter Sachs.
4. Janet Wolf Levy's father was a limited partner in Goldman Sachs from 1935 to 1945.
5. Sachs, p. 59.
6. Ibid.
7. Menschel began in 1952 by joining his uncle, who was a floor specialist. "My parents were very pleased: Here I was, twenty-three years old, fresh out of Syracuse University and already a member of the New York Stock Exchange! And my uncle, who had no sons, was also pleased. He taught me the business."
8. Members of the committee included John Whitehead, John Weinberg, George Doty, Ray Young, and Ed Schrader.
9. Michael C. Jensen, *The Financiers* (New York: Weybright & Talley, 1976).
10. Carl H. Tiedemann of DLJ.

11. Among his many other philanthropic commitments, he was treasurer of American Friends of Canada, president of Jewish Philanthropy of New York, treasurer of the International Synagogue at JFK Airport, trustee of the Jewish Museum, trustee of Fordham University and Reed College, and on the Board of Visitors of Tulane University. He received honorary degrees from Syracuse, Tulane, and Mount Sinai School of Medicine.
12. Levy was also chairman of Mount Sinai Medical Center and the Mount Sinai School of Medicine.

Chapter Seven The Wreck of the Penn Central

1. At the time of Penn Central's bankruptcy, total commercial paper outstanding by all issuers was nearly forty billion dollars. Commercial paper came in two types. The larger part was issued directly to investors by giant finance companies like GE Credit, GMAC, and Ford Motor Credit, and $17.8 billion was issued by industrial corporations through commercial paper dealers, of which Goldman Sachs was the leader.
2. Goldman Sachs filed a creditor claim with its insurance company for $87.5 million.
3. Jonathan O'Herron, who had been at the Buckeye Pipe Line subsidiary. *Forbes*, December 15, 1973, p. 22.
4. Robert E. Bedingfield, "SEC's Study of Pennsy," *New York Times*, August 8, 1972, p. 41.
5. Paul A. Gorman.
6. "High Cost Money Hurts the Penn Central," *BusinessWeek*, June 6, 1970. By December 31, 1969, on a consolidated basis Penn Central's long-term debt (including obligations due within one year) was $2.6 billion. Of this, almost one billion dollars was due as payments of principal during the next five years. Payouts of $228 million were due in 1970, $156 million in 1971, $172 million in 1972, a staggering $270 million in 1973, and $160 million in 1974. Making this future even bleaker was the Penn Central's increasing difficulty in borrowing more money to refloat this debt, because there was so little unencumbered collateral left. As the Penn Central prospectus noted: "Substantially all investments and properties included in the balance sheet and substantially all properties of the transportation company . . . have been pledged as security for loans."
7. Actually a subsidiary called Pennsylvania Company.
8. It was hardly normal for a railroad whose chief predecessor companies at one time were gilt-edged investments to borrow short-term Eurodollars and Swiss francs or borrow by issuing commercial paper. Even more unusual, neither the Pennsy nor the Central—unlike a majority of U.S. railroads—had ever before been through the wringer of bankruptcy proceedings. One result was that the Penn Central had never simplified its complex debt structure. It was, instead, a maze of bonds issued by some sixty subsidiary railroads, leased lines, affiliates, and other properties.
9. "The Penn Central's Misguided Gamble," *BusinessWeek*, June 27, 1970.
10. Michael C. Jensen, *The Financiers* (New York: Weybright & Talley, 1976).
11. On February 4, 1970, Goldman Sachs officials were "shocked . . . into immediate action," according to "Goldman Sachs Ordered to Pay," *Wall Street Journal*, December 30, 1970, p. 11.
12. H. Eric Heinemann, "Goldman Sachs Is Sued," *New York Times*, November 17, 1970, p. 63.
13. Including one brought by American Express, which had declined to participate in the November 1970 lawsuit, for $4.8 million, and one by Fireman's Fund for $1.9 million.
14. Peat Marwick Mitchell, the accounting firm named in the action, said in its statement that "the commission has before it no credible evidence which justifies action against the firm" and asserted, "The commission, once again, has seen fit to include auditors in its apparent program to offer scapegoats to the public."
15. In general, a consent agreement is an administrative decision expediting the disposition of cases involving alleged violation of federal securities laws. Although binding on the defendant because of the court's participation, it is not an adjudication because nothing has to be proved or disproved. It is similar to, but not the equivalent of, a plea of nolo contendere, since no admission or denial of charges is made, but usually grows out of an offer by the defendant to settle.
16. "Fraud at Penn Central?" *Newsweek*, May 13, 1974.

17. "Heavy, Heavy," *Forbes*, August 15, 1971.
18. Deposition read in Southern District Court of New York on September 12, 1974.
19. Southern District Court Reporter's transcript, p. 1459 for September 23, 1974.
20. Dun & Bradstreet won dismissal of a suit by Mallinckrodt Chemical charging fraud and negligence in NCO's giving Penn Central a prime rating. The court concluded that NCO had acted in good faith and had sent copies of Penn Central's poor earnings reports at year-end 1969.
21. Robert J. Cole, "Goldman Sachs Loses Case," *New York Times*, October 10, 1974, p. 69.
22. "Goldman Sachs Is Said to Pay," *Wall Street Journal*, March 20, 1975, p. 20.
23. "A Suit Is Averted," *New York Times*, March 22, 1975, p. 41.
24. "Goldman Sachs Ordered to Pay $500,000 in Suit Tied to Penn Central Collapse," *Wall Street Journal*, December 30, 1975, p. 4.
25. "Goldman Sachs Wins Suit," *Wall Street Journal*, June 14, 1976, p. 10.
26. "U.S. Appeals Court Overturns Ruling," *Wall Street Journal*, August 12, 1976, p. D-7.
27. The other 15 percent of the stock would be owned by Conrail employees through an employee stock ownership plan (ESOP).

Chapter Eight Getting Great at Selling

1. After graduating from the University of Pittsburgh, where he studied finance and accounting, Young had gone to Harvard Business School with 240 others in the accelerated program run for the navy. Derwood "Dee" Algar headed sales before Young became a partner in 1958.
2. In 1960, when the firm had 550 people, sales had seventy-four, with thirty-six of them over fifty.
3. Dick Menschel graduated from Syracuse, where he managed the humor magazine; joined the air force; then, with polio, spent eight months at Walter Reed Hospital and Warm Springs, Georgia, before going off to Harvard Business School and eventually joining Goldman Sachs in 1959. He held management roles thereafter. "My first assignment was a real break: working on the issuance of the Federal Street Fund under Mr. Weinberg." The "deal book" for that offering half a century ago sits on the credenza in Menschel's office. In 1968 Menschel became partner in charge of the institutional sales department, selling both stocks and bonds.
4. Mnuchin had joined Goldman Sachs in 1957, straight out of Yale and the army. A champion bridge player with superb card sense, he was almost predestined for Levy's trading desk. "I always knew I wanted to be a trader," he recalled, "even though I didn't know anybody in Wall Street or anything about trading. After Yale and two years in the army as the most undecorated soldier in history, I went to Goldman Sachs, where Gus hired me." (Levy knew Mnuchin's father, a lawyer, through philanthropic work.) Told to report a few weeks later on a specific day at 8 a.m., Mnuchin went in at seven thirty hoping to get off to a good start and make a favorable impression. No such luck. "Gus had forgotten all about hiring me. But he was quick on his feet and said, 'You'll work in bonds for now.'" Mnuchin quickly figured out the real reason he was assigned to bonds: "That had to be because all the seats in equity trading—seven on one side and seven on the other side of the trading desk—were already assigned." After thirty-three years at Goldman Sachs (and earning $8.7 million in his final year), Bob Mnuchin left in 1990 and with his wife, Adriana, renovated and opened the luxurious Mayflower Inn in rural Connecticut. In addition, he built a major art dealership and she developed two retailing chains—Tennis Lady and Cashmere, Cashmere.

Chapter Nine Block Trading: The Risky Business That Roared

1. Managed by Jack Meyer, who went on to head investments at the Rockefeller Foundation and then to head investments at Harvard before establishing his own investment firm, Convexity Capital.
2. At the same time, the New York City pension fund, which had a disproportionate holding in the "Big Mac" bonds created to deal with the city's fiscal crisis—tax-exempt bonds in a tax-free portfolio—was selling those bonds in a wonderfully imaginative way. It conducted highly visible competitive-bid sales of fifty-million-dollar tranches of the bonds to the best bidder among a

group of major banks. All these sales were well covered by the press. Then, using that "fair pricing," the fund sold billions of those same bonds in strict secrecy to large insurance companies.

3. Two firms specialized in odd-lot retail transactions of less than one hundred shares to accommodate smaller trades made by numerous small retail accounts, packaging orders of fewer than one hundred shares into one-hundred-share round lots.

4. Truman Bidwell, a day trader at the NYSE, encouraged both Goldman Sachs and Donaldson Lufkin & Jenrette to engage in block trading. Dick Jenrette recalls, "Biddie came to me because we were both members of Chi Psi fraternity and explained how we at DLJ could do a very good business—at the old fixed-rate commissions—if we would commit a moderate amount of capital to 'inventory' or 'position' blocks of stock or, more often, parts of blocks when the other side was not fully available at that time and at that price." DLJ, Bear Stearns, and Shields & Co. joined in the business, but Goldman Sachs was always the clear leader.

5. Reciprocal business—called "recip" in the jargon of Wall Street—soon resolved into semiformal arrangements at understood rates, such as the equivalent of 8 percent interest for demand deposits maintained at banks or 6 percent of the value of mutual fund shares sold—with both sides keeping close track of the amounts of commission business promised and paid.

6. Sam Stayman, inventor of the Stayman Convention in bridge and one of the managing partners at Strand & Company, a hedge fund, and a friend and bridge partner of Mnuchin's, agrees: "There's a great similarity between trading and duplicate bridge tournaments. In tournaments, you have to imagine what's happening at the other tables, have a feel for the psychology of the situation at the moment, and Bob can do the same with markets."

7. *Institutional Investor,* October 1971, p. 53.

8. Ibid.

9. Ibid.

10. Who went on to be the powerful treasurer of the World Bank.

Chapter Ten Revolution in Investment Banking

1. Admission to partnership required Whitehead to put up five thousand dollars, which, as the firm knew, was all the capital Whitehead had.

2. Weintz recalls that after serving in the air force, "I knew from my years at Norwich Academy, an all-boys school in Vermont, that college for me had to be two things: coed and in a warm climate. So I went to Stanford. Then into sales with Vicks VapoRub. I was very good at it, but it wasn't the career for me. Still, it was great training before going on to the Harvard Business School. Coming out of HBS, I wasn't sure what to do next, but a classmate, George Strong, urged me to interview with Goldman Sachs, saying, 'It'll be great practice for you because they're *very* thorough.' So I did and met [partner] Vern Horton, who had a great personality, and we hit it off well. This was even after he asked me if I'd taken any finance courses and, when I told him which ones, he'd asked, 'They're required, aren't they?' and I'd sheepishly said yes. Anyway, they invited me down, and I agreed because at the very least it was a free trip home. One Saturday morning, I was told, 'General Doriot wants to see you!' I ran right over with no shave and no tie. [Georges Doriot, an austere Frenchman, had served in U.S. Army procurement during World War II and, while a popular and influential professor at Harvard Business School, continued to use his military title.] "Doriot hit the roof when he saw me so disheveled and promptly sent me back to my dorm to get shaved and dressed. He'd been called by Goldman Sachs to ask what he thought of me. Doriot was not at all keen on Wall Street but acknowledged it would be useful to 'have a few of my boys down there' and encouraged me to go. During the next few weeks of job interviewing, Goldman Sachs was *everywhere*. I interviewed at Owens Corning Fiberglas—with Jim Weinberg. At U.S. Steel, I interviewed with Bay Estes, who had been at Goldman Sachs. And it was the same at another place. I called my father and said, 'Dad, this Goldman Sachs is really wired in. They're really in on what's going on.' So I joined Goldman Sachs in 1954 at $4,200."

3. *Institutional Investor,* June 1987, p. 29.

Chapter Twelve
The Two Johns

1. *Institutional Investor,* November 1977, pp. 21–27.
2. John Weinberg and John Whitehead, Memorandum to partners, October 27, 1976.
3. *Euromoney,* June 1990, p. 33.
4. *Euromoney,* January 1990, p. 38.
5. *Euromoney,* November 1992, p. 59.
6. Irwin Ross, "How Goldman Sachs Grew and Grew," *Fortune,* July 9, 1984, p. 158.
7. Roy C. Smith, *The Money Wars* (Truman Talley Books, 1990), p. 329.
8. Richard House, "Why Goldman Sachs Rankles Its European Rivals," *Institutional Investor,* December 1992, p. 71.
9. *Euromoney,* June 1990, p. 34.
10. *Forbes,* November 23, 1992, p. 115.
11. Doty had graduated from Fordham and Columbia Business School, worked at Price Waterhouse, and then switched to Lybrand.
12. Doty was not the first partner in charge of administration: Levy had called investment banker Myles Cruickshank back from retirement to do the job, and Cruickshank was proving that the concept of having a full-time administrative manager was effective when he died suddenly of a heart attack.
13. When new partners were being named, if you were not going to get "the call," one of the partners you worked with would take you aside the day before the announcements: "Don't come in tomorrow, okay?"
14. *Forbes,* November 23, 1992, p. 115.
15. *New York,* November 14, 1983, p. 14.
16. Paul Ferris, *The Master Bankers* (New York: William Morrow & Company, 1984).
17. *BusinessWeek,* "How Playing the Tortoise Paid Off for Goldman Sachs," May 7, 1990, p. 130.
18. *Financial Times,* January 18, 1993, p. 31.

Chapter Thirteen
Bonds: The Early Years

1. And father-in-law of partner Roy Smith.
2. With Jim Gorter, Henry Fowler, Richard Menschel, Ray Young, and Levy.
3. Simon was offered the same 5 percent of the partnership that Weinberg and Whitehead then had.
4. After graduating from Dartmouth in 1961, Downey went into the army and then joined Liberty Mutual in sales before moving to R.W. Pressprich.
5. Not all niches were created equal: There was a strong negative public reaction against large corporations getting a tax break by doing huge industrial revenue bond financings—U.S. Steel had a one-billion-dollar issue—and in 1968, such financing was prohibited except for pollution-control projects. However, as Whitehead correctly anticipated, "There will be other types of municipal financing."
6. Michael Mortara in mortgages was a stellar exception: He accepted and was accepted by Goldman Sachs and became a major contributor until his premature death in 2000.
7. The Black-Derman-Toy model used the binomial tree framework of the Cox-Ross-Robertson model for valuing equity options.
8. Emanuel Derman, *My Life as Quant: Reflections on Physics and Finance* (Wiley, 2004), p. 285.

Chapter Fourteen Figuring Out Private Client Services

1. Goldman Sachs had been in the individual or retail brokerage business since the late 1940s—but with little volume. In those days, one hundred thousand dollars of gross annual commissions with a payout to the salesman of thirty thousand dollars was considered good business.
2. Compensation was changed from a share in commissions generated—which had encouraged transactions and turnover—and linked to asset-management fees. While it would take time to build a base of business large enough to generate comparable income for the individual salesman, the rearrangement aligned individual incentives with the firm's business objectives. Personal incomes and firm profits both rose. Private wealth advisers, as they were now called, could concentrate on the core decision—setting the right asset mix—for each investor and leave the complexities of continuous implementation to investment specialists. This division between marketers and execution specialists, so reminiscent of John Whitehead's revolutionary restructuring of investment banking, converted PCS from an

"eat what you kill" hunter business to a sustained "agricultural" business that contributed steady, highly valued fee-based earnings in time to make an important positive contribution to the success of the firm's IPO.

3. Born into a lower-middle-class family in Buffalo, Dan Stanton lost his father when he was four years old. His mother became a high school teacher and put herself through law school, became a state attorney general and a judge, and eventually served on the New York State Supreme Court. Dan went to a Jesuit college, sold encyclopedias for Britannica, earned an MBA at Columbia, and got a job at Goldman Sachs in 1981.

Chapter Fifteen J. Aron: Ugly Duckling

1. Trading in interest-rate futures began in 1975 and developed slowly in the first few years.

2. Tom Israel of A.C. Israel & Co., a commodities firm.

3. Customers were given code names or account numbers because the central banks of major countries insisted on privacy and everyone knew that an employee might, intentionally or unintentionally, tell somebody something somehow about a major country's monetary secrets.

4. The imperfection in the hedge was that London gold bars weighed four hundred ounces, while New York or Comex bars weighed one hundred ounces, so there was a small specific risk of having to pay a premium price to convert from one size to the other.

5. Metallurgy Hobshen of Belgium.

6. ACLI, a successor firm to A.C. Israel, was acquired by Donaldson Lufkin & Jenrette during this same period. Salomon Brothers's first major experience with commodities had come in the late 1960s when it went to A.C. Israel to get help deferring partners' taxable income. The technique arranged was to go long September "old crop" cocoa and short December "new crop" cocoa. This arrangement worked far better than expected: Not only were taxes deferred, but September cocoa went to unanticipated high prices, making a memorable profit for the partners of Salomon Brothers—and creating a very favorable view of commodities.

7. Endlich, p. 95.

8. *New York*, November 14, 1983, p. 16.

Chapter Sixteen Tender Defense, a Magic Carpet

1. After earning his MBA at Wharton in 1969, Bob Hurst joined Merrill Lynch, built up his clientele over the next five years, and became that firm's youngest vice president. In 1974, when a senior Merrill Lynch executive was transferred into investment banking and started calling Hurst's clients and acting as though he was their main banker, Hurst called Bob Conway at Goldman Sachs to say that he might be interested in a switch. Interviews were arranged with Ross Traphagen and Jim Weinberg in IBS. They went well, so Hurst met with John Whitehead. "He gave me the best 'negative' sale you can imagine, saying things—one right after another—like: 'You're doing so very well at Merrill Lynch, surely you wouldn't want to have to start all over from the bottom of the ladder at Goldman Sachs'; 'We are very reluctant to bring people in laterally, and you would be seen as an outsider'; 'You must recognize that it will take considerable time for you to prove yourself externally with the companies you'll be assigned and even harder to prove yourself internally at Goldman Sachs.' By the time Whitehead had put down all these negatives—which, of course, I assured him, challenging as they might be, I was sure I could overcome—he had me selling myself on a switch to Goldman Sachs in the most effective way!"

Chapter Seventeen The Uses and Abuses of Research

1. Bowen was an early president of the New York Society of Security Analysts.

2. After four years as an undergraduate at Columbia University and one unhappy year at Columbia Business School, Ellis got a job in research at Bank of New York under Carter Bacot, who went on to become CEO. Ellis's father was a retailer, and Joe had worked in the store, so he became a retailing analyst at BoNY. After five years at the bank and a second recruiting invitation, he joined Goldman Sachs, where he became the first analyst without managerial responsibility to become a partner. He stayed twenty-eight years.

3. Einhorn went to Rutgers and the University

of Illinois for its PhD program, but his plans for an academic career got aborted by a phone call. "I was teaching a course in investments using the textbook written by Cohen, Zinbarg, and Zeikel and was looking for a summer job. My dad knew an HR manager at Prudential and found there might be an opening in economics. One evening, I was startled by a phone call—from Ed Zinbarg, one of our textbook's authors. He was chief investment officer at Prudential. I started there and then went on to Goldman Sachs."

4. Patrick McGeehan, "Goldman Sachs Releases Stock Analyst," *Wall Street Journal*, May 28, 1999.

5. The fifty million dollars intended for investor education ran into a political squall within the SEC and got stymied. The professionals who had volunteered to serve the public interest all resigned in protest.

6. Patrick McGeehan, "Goldman Sachs Moves to Tighten Stock Analysts' Independence," *New York Times*, February 20, 2002.

Chapter Eighteen
John Weinberg

1. The IRS guidelines, structured to prevent individual investors in small companies from unfairly getting capital-gains tax treatment on distributions that were really dividends, specified exactly what constituted maintaining an investor's percentage ownership and therefore what constituted a dividend rather than the proceeds of a sale. The arrangement between DuPont and Seagram followed the guidelines precisely but achieved a result directly opposite to the IRS's expectation. Using derivatives and a time-structured agreement, the payment from DuPont to Seagram was clearly a dividend as defined by IRS guidelines. (Under Canadian tax law, which affected Seagram, the dividend was also tax-free at the Canadian corporate level.) Specifically, Seagram was paid one billion dollars in cash and $7.3 billion in ninety-day notes with equity warrants worth $440 million, and it retained 8.2 million shares. The warrants would allow Seagram to purchase forty-eight million shares of DuPont at $89 for a period of sixty days in 1997, fifty-four million shares for sixty days in 1998, and fifty-four million at $114 in 1999. Because Seagram got warrants to buy 156 million shares—exactly equal to the 156 million shares it sold—it was deemed to have maintained exactly the same beneficial equity interest in DuPont. The reality that the warrants would never be exercised simply didn't matter. Soon after the repurchase, Congress introduced legislation to change the law governing this type of transaction.

2. *American Lawyer,* November 1981. Weinberg's serving on Seagram's board of directors also precluded Goldman Sachs from engaging in lucrative arbitrage.

3. *New York Times*, August 16, 1984.

4. John Weinberg's other directorships included Knight-Ridder, Witco Chemical, McKesson & Robbins, Cluett Peabody, Cowles Communications, Bulova, General Development, Van Ralte, Capital Holding—as well as Seagram and DuPont. Weinberg also served as a charter trustee of Princeton and on the boards of Deerfield, Teachers College, New York Hospital, the Japan Society, the China Medical Board, the Economic Club of New York, and the American Arbitration Association. He was the only investment banker on the Business Council, the prestigious group organized by his father at FDR's request.

5. One cheery paternal invitation to "come for dinner and stay the night" was given without concern that the room and board would be proffered at J. P. Morgan's stately home in Washington, D.C., being used during the Korean War by Sidney Weinberg and his two senior colleagues on the War Production Board, General Lucius D. Clay and Charles E. "Electric Charlie" Wilson—or concern that the younger Weinberg was then a very junior officer in the Marines.

6. *New York Times*, August 16, 1984.

7. Robert J. Cole, "Low-Profile Leader Takes Charge," *New York Times*, August 16, 1984, p. D5.

8. Dorothy Rabinowitz, "A Cautionary Tale," *New York*, January 8, 1990, p. 35.

9. "Goldman Suffers Some Blemishes," *Wall Street Journal*, January 18, 1990, p. C-1.

10. Weinberg and his wife, Sue Anne, who studied for a doctorate at Columbia Teachers College, were married for over forty years.

11. Managing director of Sumitomo Capital Markets Inc., Kondoh was a brilliant maverick, fluent in English, and a high-ranking graduate of the elite University of Tokyo. Assigned to interna-

tional planning, he performed a key role in a two-million-dollar 1985 strategic planning exercise for Sumitomo by McKinsey & Company.
12. Morgan Stanley's market value at the time was a little higher—three and a half times book.
13. Roy Smith and Michael Coles were both on Gant's negotiating team. After going limited, Coles served as an adviser to Sumitomo's New York branch. (He gave his retainer fee to charity.)
14. Voting rights were never offered and never requested.
15. Before the first five years were up, Bob Rubin wanted to press for an extension. Don Gant would have waited longer, knowing that Sumitomo wouldn't want to lose face by having the deal come apart and believing that waiting could create time pressures that might enable Goldman Sachs to obtain more favorable terms, such as reducing the 12.5 percent to 10 percent. Rubin, Gant, and Weinberg went to Tokyo for a spectacular ceremonial dinner with Sumitomo executives, at which Rubin said Goldman Sachs would like to extend the relationship ahead of schedule. The Japanese were more than pleased.
16. Gant was well advised by Rodger Cohen, who had had an office in Japan and who later became managing partner of Sullivan & Cromwell.
17. Fifty years after the war, Weinberg recalled how harsh combat had made both sides: "The Japanese never signed the Geneva Convention on war conduct, which covered taking and holding prisoners. If you took a pillbox or something, Japanese soldiers would come out with their hands up—holding grenades behind each hand—until they got close enough that you might see the grenades and then they would throw them at your unit. The battalion commander came around saying, 'This will not be in writing, but we are not accepting any more surrenders.' We captured a group of Japanese soldiers in an old copper-mine tunnel. I went over thinking I'd sit in the shade in the tunnel. My sergeant suggested I go elsewhere. I said I'd planned to sit in the shade. I was eighteen then, too young for what they planned to do. So my sergeant says, 'Sir, get the fuck away from here!' And off I went. My gunnery sergeant was a real old-corps Marine who asked me one day if I'd ever killed a guy. "Not that I know of." So my sergeant tells me that won't do and sets up to change it. I was a pretty good shot in those days . . . so it didn't take very long."
18. Weinberg joined the Marines in World War II as a private, rising to second lieutenant. Called back to service in the Korean War, he mustered out as a captain. At his funeral, the honor guard folded the American flag into the traditional perfect triangle for presentation to Sue Anne Weinberg. The recessional was the "Marines' Hymn."
19. Weinberg's home was in the nearby town of Greenwich.
20. *Economist*, September 29, 1990, p. 93.

Chapter Nineteen
Innocents Abroad

1. Brown's father had been in the Occupation forces, so he grew up speaking Japanese. He joined the Jesuits, who sent him to teach and learn economics at Harvard Business School, but in Boston he met a Japanese woman who was studying at the New England Conservatory of Music, fell in love with her, left the church, and joined Citicorp, where he worked in a joint-venture consulting company with McKinsey.
2. Coles was born in England, skipped college, flew in combat in Korea for the Royal Navy, fell in love with an American, and applied to and was accepted by Harvard Business School before joining Goldman Sachs.
3. Four years later, the firm had three times as many people—180—and was moving into offices in the Old Bailey office complex.
4. Established as First International Bank Ltd. in 1973 by the First National Bank in Dallas, the unit had been one of the more aggressive UK merchant banking subsidiaries of a U.S. commercial bank until reined in by its parent in 1979, which caused several senior people to quit. When acquired by Goldman Sachs, it had a dozen employees and loans outstanding of only forty million dollars.
5. After Big Bang, J.P. Morgan nearly acquired Wood Mackenzie but called off their deal at the altar. Wood Mackenzie subsequently merged with the merchant-banking firm Hill Samuel & Company, and the merged firm was later combined into NatWest Securities, the stockbroking arm of National Westminster Bank.
6. Another strategic opening not taken can be

traced back to Whitehead's experience at Haverford College. Edmund Stennis left Germany in the early thirties because he was so opposed to Hitler and taught at Haverford College, where his students included Whitehead, who recalls that Stennis rebuilt his family fortune through astute investing while teaching. As Whitehead explains, "Stennis had contributed about one-third of the capital Siegmund Warburg needed to launch New Trading Company—which fledgling firm later became S.G. Warburg & Company—so it was not surprising that Stennis introduced me to Siegmund Warburg. We became good friends and I visited him several times at his home in Switzerland. Siegmund maintained in public that he'd retired from Warburg's, but he actually kept very tight control with telex instructions on very specific operational matters—three times every day."

Goldman Sachs might have combined with S.G. Warburg: One firm was the leader in the United States but not significant in the UK; the other firm was powerful in the United Kingdom but not in America; Neither was strong on the European Continent—and both needed to become strong in each other's market to be truly "international." Whitehead explained why that didn't happen: the subject "had never been even considered because we just don't believe in expanding through acquisitions. Besides, we would have had problems with their having several quite powerful but much, much older partners. Also, they have a tendency, as we saw it, toward what might be patrician to some, but to others could seem like arrogance. Slow and cautious we may well be, but we always want to build up our own, one step at a time."

7. Mulvihill was the same "uncle" who advised younger stars: "Weddings, bar mitzvahs, and funerals are all once-in-a lifetime events in the employee's life. Go to every one you possibly can—and always get there at least fifteen minutes early, so you'll have plenty of time to make friendly small talk with the other people who care too."

8. Ward and Mayhew later became friends. Mayhew's son got a job at Goldman Sachs and Ward spent weekends at Mayhew's country home. Knowing Mayhew was an old Etonian but not a college graduate, Ward decided on another occasion to have some fun with him. "What did you study at Cambridge, David?"

"I didn't go to Cambridge," came the quick, quiet reply.

"Oh, not Cambridge. Well then, what was Oxford really like?"

"I didn't go to Oxford," came a still quieter reply, and then, in a combination of apology and drawing a "do not cross it" line in the sand, Mayhew went on: "In my day, most young boys did not bother going to university."

Chapter Twenty-one How BP Almost Became a Dry Hole

1. The market fell 12.8 percent on October 28, 1929, "Black Monday," the worst single day of the 1929 crash.

2. James Hanson, chairman of Hanson Trust, had secretly called on Chancellor of the Exchequer Nigel Lawson at No. 11 Downing Street in May 1985, offering to buy the whole block of BP. Lawson declined, explaining that a wide shareholding would be sought, not a single buyer.

3. Nigel Lawson, *The View from No. 11*, p. 758.

4. Two smaller government companies had already been privatized: Amersham for seventy-one million pounds, followed by Britoil for £549 million.

5. Clement Attlee's Labour government gave five reasons for nationalization in 1945: improve labor relations; promote full employment; increase productivity; make regulation of monopoly more efficient; and replace short-term expediency with broader national priorities.

6. Most British underwriters kept 5 percent of their total participation; BP's advisers—Rothschild and S.G. Warburg—kept 10 percent. Schroders's loss on its £10 million underwriting was only a very tolerable £1.5 million.

7. Lawson, *View from No. 11*, pp. 774–75.

8. The Labour Party's spokesman had apparently resolved in advance to attack Lawson's decision; he evidently had been led to believe Lawson would simply defer the matter. Surprised by Lawson's announcement, he immediately reversed his own argument, saying the issue should have been postponed and opening himself up for a classic parliamentary putdown as Lawson, who knew Gavyn Davies had worked in the past for Labour,

mocked him in swift reply: "The Labour Party today is simply the friend of Goldman Sachs!"
9. The same accounting treatment was used for the Maxwell settlement and for the fine in the so-called Analysts settlement.
10. Lawson, *View from No. 11*, p. 275.

Chapter Twenty-two
Changing the Guard

1. Rubin had a subtle, graceful style and a quirky sense of humor that had special meaning for the brilliant young people who worked with him. Some of the most treasured stories were trivial in substance but not in their meaning to the insiders. For example, Rubin and Brosens often shared a cab uptown. Rubin always got out first and always paid the fare, tipping generously. One night, Brosens protested that he should at least split the fare. Rubin shook his head. Smiling, Brosens reached into his pocket and pulled out a quarter, which he ceremoniously presented to Rubin, who looked at it solemnly, paused, and then observed quietly with exaggerated ceremony, "You're overpaying me," and then paused again before saying, "Let me think about that." After a still longer pause, he came to his considered, final conclusion: "No. that wasn't really right. You wouldn't be overpaying me. You'd be *way* overpaying me"—and smilingly piled out of the cab.
2. Linda Sadler, "Goldman Is Being Aggressive," *Wall Street Journal*, January 9, 1985, p. 4. The market-share numbers came from Securities Data.
3. Rich Friedman (no relation) was the operating head of the unit.

Chapter Twenty-three
Transformation

1. Fischer Black had understood the power of technology in trading securities early, and in 1971 wrote a prescient paper: "Toward a Fully Automated Exchange."
2. Black and Scholes wrote a paper in 1973 showing both their derivation and Merton's, but it was so arcane that professional journals repeatedly rejected it until, after several years, Merton helped them get it published.
3. Partly at the suggestion of Jack Treynor, who had known him at Arthur D. Little.
4. Perry Mehrling, *Fischer Black and the Revolutionary Idea of Finance* (John Wiley & Sons), p. 219.
5. Mehrling, *Fischer Black*, p. 12: Svi Bodi interviews with Fischer Black in July 1989.
6. Stanley Diller, former professor at Columbia Business School, made a similar contribution in fixed income.
7. In February 1990, Black moved over to the fixed-income management group in GSAM, and in late 1992 he moved to fixed-income research.
8. Mehrling, *Fischer Black*, p. 241.
9. Ibid., p. 284.
10. Ibid., p. 97.
11. The arithmetic average of 1 and 3 is $(1 + 3)/2$, or 2, while the geometric average of 1 and 3 is $(1 \times 3)/2$, or $1\frac{1}{2}$.

Chapter Twenty-four
False Starts in Investment Management

1. Capital Group Companies manages the American Funds group of mutual funds for individual investors, Capital Guardian Trust for institutional accounts, and Personal Investment Management Services for wealthy-family funds. Capital Group Companies is one of the world's largest and most capable investment-management organizations. (See my book, *Capital*, published by John Wiley & Sons, 2004.)
2. Later, in the 1980s and 1990s, Merrill Lynch, Morgan Stanley, and Credit Suisse First Boston each built a large investment management business.
3. Later James Coxon came over from London to head up sales. He did do some successful selling.
4. Anise Wallace, "New Division Is Planned by Goldman," *New York Times*, May 9, 1989, p. D5.
5. Michael Siconolf, "For Just $1,200, You Too Can Be Goldman Client," *New York Times,* April 6, 1990, p. C-1.
6. Barbara Donnelly, "Goldman Offers Fund of Its 'Top 50' Picks," *Wall Street Journal*, June 21, 1991, p. C-1.
7. McNulty nearly went to another firm when he came out of Wharton. "Do you have any plans?" asked George Ross, head of Goldman Sachs's office in Philadelphia and a repetitively successful

recruiter of Wharton's best MBAs. It was a Sunday afternoon. "Yes, I'll be joining Salomon Brothers on Monday," said McNulty. Stormed Ross in reply: "I'll be goddamned! No way! You be near your phone tonight, ready for a call!" Later that evening Ross called to say he had talked with Richard Menschel and he was now making a firm offer. McNulty accepted and joined PCS to work in Florida. "Goldman Sachs had a very special feeling about it. Joining was like coming home. The work was a true vocation."

8. Smirlock paid the SEC a fifty-thousand-dollar fine to settle the charges.

Chapter Twenty-five Robert Maxwell, the Client from Hell

1. Maxwell had a twenty-million-pound life insurance policy underwritten by several Lloyd's of London syndicates. The policy would not pay off if death were due to natural causes, such as a heart attack, but would be triggered if death were due to an accident or murder. Dr. Iain West, head of forensic medicine at a London hospital, prepared the British pathologist's report.

2. Gordon Thomas, *Gideon's Spies: The Secret History of the Mossad* (New York: St. Martin's Press, 1999), p. 219.

3. Nick Davies, *Death of a Tycoon* (New York: St. Martin's Press, 1992), p. 339.

4. The terminology used by British regulators.

5. In late 1985, Maxwell acquired a substantial stake in Britannia Arrow (previously called Slater Walker Securities), which had acquired the investment firm MIM from Aetna. Britannia Arrow later acquired Invesco Capital Management. The investment firms were combined and took the name Invesco MIM PLC in early 1990.

6. Department of Trade and Industry, Report, 1974, p. 7. Under British law, the pension funds were not required to have trustees.

7. Ibid.

8. Ibid., p. ix.

9. Maxwell organized Bishopsgate Investment Management, whose sole business was managing the MCC and Mirror Group pension funds. All but one of BIM's directors were directors of Maxwell's private companies. Inexplicably, Britain's Investment Management Regulatory Organisation licensed Bishopsgate under the Financial Services Act of 1986, which is why Maxwell had access to the funds' assets. As a result, the British government arguably had a moral responsibility to recover the funds lost or purloined.

10. Ibid., p. xv.

11. Ibid., p. xvi.

12. Only arm's-length transaction business was to be done. Goldman Sachs was not to act as an agent for Maxwell, and he was not to be a client of the firm.

13. Peter J. R. Spira, *Ladder and Snakes* (privately printed, 2005), p. 280.

14. His talent as a trader was real. In 1991, when the Vuitton family wanted to sell a $320 million block of LVMH shares, their traditional banker, Banque Paribas, offered to buy the shares at a discount, but Sheinberg won the trade by bidding at the market. He then outmaneuvered short-sellers by buying two hundred million dollars more shares and then, as the shorts bid up the price to cover their short positions, reselling to institutions on the basis that a premium was justified by the unique company, its unique value, and a unique opportunity to obtain good-size positions. Sheinberg played his cards skillfully—and, as a trader, made a profit of over ten million dollars.

15. Department of Trade and Industry, Report, 1991, p. 25.

16. John Mason, "Maxwell Trial," *Financial Times*, September 23, 1995, p. 6.

17. Fife's personal share of the settlement was four million dollars. Reserves—at a larger amount—had been taken in 1991, 1992, and 1993, so charges would have to be shifted back and changed to the correct amount now that the settlement had been set at $254 million.

18. Anita Raghavan, "Goldman Sticks to Plan on Allocating Settlement Lost," *Wall Street Journal*, April 14, 1995.

19. Norma Cohen, "Sheinberg Steps Down," *Financial Times*, November 29, 1994, p. 30. Mirror Group Newspapers's pension fund trustees filed lawsuits in New York seeking fifty-seven million dollars from both Sheinberg and Goldman Sachs. As the *Wall Street Journal* reported: "Despite the fine, Goldman tried to distance itself from the Maxwell matter. 'The regulatory glitches have nothing to do with Robert Maxwell,' said

Gregory Palm, a Goldman partner and co-general counsel. 'They really aren't Maxwell related,' he said. 'They were back-office accounting and computational errors that had nothing to do with who was on the other side of the trade.' He added: 'In any transaction of the same type, the same problem could have arisen.'" The Financial Services Authority's disciplinary order specified that "SFA did not conclude that Goldman Sachs or any of its personnel participated in any illicit conduct with, or were aware of illicit conduct by, Maxwell or any entity controlled by or associated with him."

20. Michael Siconolfi and Nicholas Bray, "Britain Orders Goldman Sachs to Pay a Penalty," *Wall Street Journal*, June 17, 1993, p. A-6.

21. DTI Report, p. 28.

22. G. Rascal Zachary, "Goldman, Coopers Are Cited in Report on Maxwell Collapse," *Financial Times*, April 2, 2001.

23. "Maxwell Trial: Goldman Sachs May Have Wrecked Deal," *Financial Times*, October 19, 1995, p. 11.

Chapter Twenty-six Making Arbitrage a Business

1. Calm and smooth as he usually was, Tenenbaum was not *always* detached. On occasion, Tenenbaum's frustrations reached overload and he showed a terrific temper—once pulling the telephone out of the wall and throwing it across the trading room.

2. Robert Rubin grew up in Miami, Florida, and came to Goldman Sachs after Harvard College, London School of Economics, Yale Law School, and two years of practicing law at Cleary Gottlieb.

3. During the 1970s—as the stock market averages fell, inflation rose to record highs, underwriting volume plunged, and profitability on Wall Street dried up—most of the other firms cut back on arbitrage, but Goldman Sachs got even more active. With almost no real competitors, it nearly had the market—and the profit opportunities—to itself.

Chapter Twenty-seven J'Accuse

1. Lisa Endlich, *Goldman Sachs: The Culture of Success* (New York: Little Brown, 1999), p. 113.

2. James Buchan, "Handcuffs on Wall Street," *Financial Times*, February 16, 1987.

3. "Suspicious Trading," *Wall Street Journal*, February 12, 1988, p. 1.

4. By selling and promptly rebuying, Freeman effectively deferred settlement by a few days while maintaining his position. The "financing" cost him one-eighth of a point in price change and would lead to a massive change in his life.

5. Siegel was the first in his family to go to college, determined to advance as far and as fast as possible and not repeat his father's going bankrupt at forty-seven. Robert Siegel and his brother had owned three shoe stores serving a middle-class market near Boston. They struggled to survive as retailers of American-made shoes in competition with low-cost imports and efficient chain operations.

6. Siegel was close with Ivan Boesky, investigators found. He had invited Boesky to play tennis in the spring of 1982. Boesky arrived in a pink Rolls-Royce. When Siegel, then thirty-four, expressed concern about the future of his firm and said he was sure it was cramping his own business, Boesky offered a position in his firm, Ivan F. Boesky & Company. Boesky called that summer and invited Siegel to meet at New York City's Harvard Club for a drink. Guiding the conversation to personal finances, Boesky renewed his job offer. Siegel demurred but had an alternative: He could consult to Boesky on possible takeover situations and earn consulting fees on the side or a year-end bonus. Both men knew just what they were saying, without being explicit. Since Boesky was such an active trader in so many stocks, Siegel's tips would be easily mixed in with Boesky's other trading and go unnoticed, particularly if the trades were done well in advance of any specific deal. "Let's have coffee" became their telephone signal for a personal meeting.

7. Other call holders in the arbitrage department agreed and sold too. One arbitrageur was away that day and did not sell: Bob Rubin.

8. Sarah Bartlett, "A Top Trader at Goldman Sachs Pleads Guilty," *New York Times*, August, 1987, p. 1.

9. In a case involving Equity Funding and an analyst named Ray Dirks, who first identified a massive fraud, the SEC argued that when

an expert got an apparently innocuous piece of data that he could fit with other pieces to form a decisive insight, he had made himself an insider. The Supreme Court rejected this approach for outsiders with no fiduciary responsibility to the corporation.

10. James B. Stewart, *Den of Thieves* (Simon & Schuster, 1991).

11. Levine was, in fact, typical of the people who lie, cheat, and steal in various fields: counterfeiters of papal bulls in the Middle Ages, scientists who falsify data on experiments to get publishable results, housewives who cheat on their husbands, and citizens who play games on expense reports or on income taxes. Deceivers typically focus on their own immediate gain and deny or discount the penalties and percentages of getting caught, wrapping themselves and their thoughts in private delusions. While each delusion is singular in its details, they follow an intriguingly consistent pattern. Most get involved gradually, never quite recognizing or admitting to themselves that they have broken their own promises or have broken the norms of the community in which they live. Most deceivers are new to their community—which is partly why most feel so little loss in flouting community rules. They have little invested in their connections with the established norms, the reasons the norms were established, or the reasons for adhering to them.

12. *New York Times,* January 10, 1986.

13. James Sterngold, "Goldman Aide Tied to Insiders," *New York Times,* October 9, 1986.

14. *The Economist*, February 21, 1987, p. 81.

15. Endlich, *Goldman Sachs,* p. 118.

16. Confirmed recently directly to the author by the then head of investment banking at Kidder Peabody and the then CEO of Drexel Burnham.

17. *Den of Thieves,* p. 155.

18. Boesky's total position of 1.8 million shares worth $42 million was four times the peak position at Goldman Sachs.

19. Christopher Byron, *New York* magazine, September 1989.

20. Edward Oakley Thorp, *Beat the Dealer* (New York: Blaisdell, 1962).

21. "Small Securities Firm Links Drexel's Milken, Goldman's Freeman," *Wall Street Journal*, April 6, 1988, p. 1.

22. Thorp was never involved in or even aware of the activities that were questioned. His office was in Newport Beach, two thousand miles away from Princeton. Thorp was engaged in quantitative research and the development of sophisticated investment ideas.

23. "Freeman's Attorney's Battle," *Wall Street Journal,* November 28, 1989, p. B14.

24. Laurie P. Cohen and Milo Geyelin, "Freeman Sentenced," *Wall Street Journal,* April 18, 1990.

25. Freeman tutored and coached basketball at Boys Harbor Inc., a social-service agency in East Harlem, New York. He was free to act as an unregistered investment adviser and, after three years, to act as a registered investment adviser.

Chapter Twenty-eight
Building a Global Business

1. Fife had offered to go two years before, but Bob Conway got chosen. Then Fife's first wife died after a long struggle with a virulent cancer. Jim Gorter raised the question of Fife's going to London as the two men were driving away from the meeting at which they had arranged the sale of Bank of America's headquarters building for $555 million—a price chosen because the building was at 555 California Street—to Shorenstein Properties. That price was much higher than any other bid, but real estate prices were low and soon to rise substantially, so the investment was a great success. Fife had started his career at Blyth & Company and transferred to Goldman Sachs's San Francisco office as a vice president in investment banking.

2. In the equities division, language fluency was more common than in investment banking. Partner Bill Landreth spoke French.

3. When Fife arrived, Goldman Sachs had three hundred people in London; a decade later, it had two thousand—a nearly sevenfold increase.

4. Exceptional leaders already building business in London included Bill Landreth in security sales and James MacLaren in investment banking.

5. Philip Rosen was retained to identify Goldman Sachs's public relations weakness and produced a list of twenty-five things wrong about Goldman Sachs.

6. Originally leased by Bob Wilson, who was exiled to London after presiding over the Penn

Central commercial-paper fiasco, and later used by Roy Smith and Bob Conway.

7. De la Dehesa was Secretary of State for Economy and Finance. Sheinberg knew him because he covered central banks.

8. By 1991, "country adviser" was replaced by "international adviser" to reflect the reality that many advisers were actively involved across the world in the firm's activities and sometimes only a little in their home countries. The vice-chairman title was dropped.

9. Mayoux graduated from Ecole des Hautes Etudes Commerciales (HEC) and Ecole Nationale d'Administration (ENA), was appointed Inspecteur de Finances, and served as a special adviser to the minister of Finance. For twelve years, he was CEO of Crédit Agricole, Europe's largest retail bank, chaired various reform commissions, and reorganized the steel industry as CEO of Sacilor. He then served as CEO of Société Générale, the bank where he is now honorary chairman. He is a commander of both the Légion d'Honneur and l'Ordre National de Mérite. Despite his many distinctions, Mayoux was not an immediate success when he first met senior people in New York. Bob Rubin, Steve Friedman, and Geoff Boisi did not go for him. But nobody said Fife could not hire Mayoux, so he went ahead.

10. Prodi defeated Silvio Berlusconi, who defeated Prodi in the next election and then lost to Prodi again a few years later. Berlusconi won reelection in April 2008.

11. When the telephone system of Greece announced its intention to privatize, Goldman Sachs couldn't find a way to avoid paying a bribe. So the firm opted out. The mandate was won by Morgan Stanley—but years later the deal had still not come to fruition.

12. Sutherland had also been attorney general of Ireland and commissioner of Competition for the European Community in Brussels.

13. After Telefónica, privatizations of other big Spanish concerns—Repsol and Endesa—and ADR offerings for giant private banks—Bilbao Vizcaya and Banco Santander—followed, and Goldman Sachs was regularly earning fees of $20 million every year for its work in Spain. Success in Spain helped open opportunities in Latin America, as well as across Europe. And success with Telefónica soon led to a series of telecom privatizations in Holland, Denmark, and Mexico, where Goldman Sachs was chosen to manage the massive privatization underwriting for Telefonos de Mexico (Telmex)—with a $20 million fee. The grand finale was the privatization of Deutsche Telekom with a fee close to $40 million.

14. Goldman Sachs had not developed the giant BP privatization transaction into a business relationship.

15. Plaut took over from Paul Achleitner, who led Goldman Sachs's German business for five years before he left to be finance director of Allianz, the giant insurer based in Munich.

16. Siemens was also the first major German corporation to use management consultants. In the 1980s, it retained both McKinsey and Boston Consulting Group to do studies and to have a direct comparison to see which firm did the best work—at the best fee.

17. In February 1999—right at the peak of the Internet bubble—Goldman Sachs helped Siemens spin off its semiconductor business in an €8 billion IPO. At €35 per share, demand was so strong—retail customers oversubscribed the issue an incredible 250 times—that follow-on investor bidding took the price up nearly threefold to €100. A few years later, the share price was at €8. "I should have known we were in a bubble," says Plaut sheepishly. "Capital Group took zero shares and Fidelity simply flipped it."

18. Klaus Luft also arranged an "impossible" mandate as a German working with Bob Rubin: NCR's defense against AT&T.

19. ICBC has 20,000 branches and 100 million retail customers, and is about twice as large in assets as the next largest bank in China.

Chapter Twenty-nine
Steve Quit!

1. The Bishop Estate had been a customer of bond salesmen Fred Stack, who developed a close relationship that led to discussion of a possible investment similar to Sumitomo's. Corzine met the Estate's key people at a Marriott near Dulles Airport for a preliminary discussion and then flew to Hawaii for a brief closing session.

2. Anita Raghaven and Michael Sicondolfi, "Fried-

man Steps Down as Goldman Chairman," *Wall Street Journal*, September 14, 2004, p. C1.
3. Ibid.
4. Michael Carroll, "Inside Goldman's College of Cardinals," *Institutional Investor*, October 1994.

Chapter Thirty
Collecting the Best

1. Goldman Sachs was the first to recruit Harvard MBAs in the 1920s. The Depression ended that practice.
2. Robert Levering, Milton Moskowitz, and Michael Katz, *The 100 Best Companies to Work For in America* (Reading, Mass.: Addison-Wesley, 1993).

Chapter Thirty-one
Jon Corzine

1. Corzine grew up in Wilkie Station, Illinois (population 500), and earned an MBA at the University of Chicago. He met his future wife, Joanne, in kindergarten. They grew up together and were married for thirty-three years, but divorced when he went into politics.
2. Don Gant led the 1987 negotiations and Jon Corzine led the 1989 negotiations.
3. Corzine asked partner Bob Litterman, a stellar "quant," to study risk management and develop one overall risk management system to replace the two-inch-thick daily computer printout he was then getting with reports of positions in each of dozens of separate trading units. Applying VaR (value at risk) metrics, Litterman made it possible to establish risk limits for each trade. Previously, as most traders accumulated trading profits, their self-confidence rose and their risk taking grew geometrically. Surprisingly, once VaR was established, most traders preferred knowing their limits.
4. Boris Groysberg, Sarah Mathews, Ashish Nanda, and Malcolm Salter, "The Goldman Sachs IPO," Harvard Business School Case 9-800-016, revised April 14, 2006, p. 11.
5. Laura M. Holson and Andrew Ross Sorkin, "Telecommunications Powerhouse; Goldman Sachs Rules as Industry Is Transformed in Europe," *New York Times*, December 13, 1999, p. C1.
6. A major dinner meeting with AIG that included Corzine was organized by others.
7. Corzine says he wasn't entirely alone. He recalls taking with him Chris Flowers, the banker in charge of financial institutions, who went on to a spectacular success in private equity after leaving Goldman Sachs.

Chapter Thirty-two Long-Term Capital Management

1. Sandy Weill had comparably great motivation for ordering his traders to unwind all their "perfect arbitrage" positions: The merger of Salomon Smith Barney and Travelers with Citibank was scheduled for completion that same October.
2. The main role of the Fed was to protect the group from charges of illegal collusion.
3. Corzine's recollection differs: He says the discussions with Buffett were fully disclosed to the entire group of bankers.
4. Today Corzine says the management committee knew—or at least Roy Zuckerberg knew, with the implication that he must have told all the others. This is the kind of explication that earned Corzine the nickname "Uncle Approximate" and so upset his senior partners.

Chapter Thirty-three Coup

1. It was determined at the executive committee meeting that Paulson would immediately be made co-chairman and then, at the June partners meeting, would additionally be made co–senior partner by vote of the partnership.
2. "Chief Resigns from Shared Post, at Goldman" *New York Times*, January 12, 1999, p. C1.

Chapter Thirty-four
Getting Investment Management Right

1. In Investment Banking, Suzanne Donnahoe had worked with Milton Berlinski on sales and acquisitions of investment-management firms. In the mid-1980s, David Blood went directly from Harvard Business School into the investment banking division. Soon, even before being made a vice president, he was heading the debt capital markets division with David George and Jon Corzine. Because Blood had lived in Brazil and spoke

both Spanish and Portuguese, he was assigned to cover Latin America in 1989–90 from New York City. In 1992, he joined John Thain in the bond division for four years and transferred to London.
2. Their first strategy was actually "2 × 2 × 2"—$200 billion in assets with $200 million in profits by the year 2000.
3. In 1995, investment manager Cliff Asness got a $5 million bonus—the largest paid to any nonpartner—but he knew it was just a small fraction of the profit he had made for the firm, so he quit to launch his own hedge fund and took three credit analysts with him. There was a silver lining to the storm clouds: partner Bob Litterman, the firm's risk manager for trading, transferred over to develop a global risk-management capability for GSAM called PACS. It matched portfolio construction to each client's specific investment goals, using rigorous product specifications with "risk budgets" of "tracking error" and risk measurement based on the concept that 100 percent of the risk accepted by each client should be used to achieve superior long-term performance.
4. Later Berlinski negotiated the ultimate purchase of RCM by Germany's Dresdner Bank—which also bought Kleinwort Benson, the distinguished London merchant bank with a sizable asset-management business that had participated in Kleinwort Benson McCowan.
5. Commodities Corporation was based on Helmut Wyman's theories of profits in speculative markets.
6. GSAM was managed by Ford and Blood until Ford went limited, after which Blood managed the organization for four years from London.

Chapter Thirty-five Paulson's Disciplines

1. After William Clay Ford Jr., CEO of Ford, got an allocation of 400,000 shares of Goldman Sachs in the IPO—the largest allocation to an individual—a Ford shareholder sued, alleging the allocation was a reward for Ford Motor's business with Goldman Sachs and claiming that any gain on the shares belonged to the company. While a Ford committee concluded that Mr. Ford had not acted improperly, the company agreed to settle in November 2004, and Goldman Sachs agreed to pay $13.4 million—$10 million to a Ford charitable trust (relieving Ford of a prior commitment) plus legal expenses. The firm, denying any wrongdoing, said that Mr. Ford was the kind of long-term investor it most wanted. Ford sold his shares immediately and gave the $4.5 million profit to charity. John Thornton is a Ford director and had befriended Ford at Hotchkiss School. (Jenny Anderson, "Ford Settles Investors' Suit Over IPO of Goldman," *New York Times*, November 4, 2004, C-4.)
2. *BusinessWeek*, May 17, 1999.
3. Patrick McGeehan, "Goldman Sachs to Acquire Top Firm on Trading Floors," *New York Times*, September 12, 2000, p. C2.
4. "Lex Column: Goldman Sachs," *Financial Times*, September 12, 2000, p. 26.
5. Neil Weinberg, "Fear, Greed and Technology," *Forbes* 165, no. 11 (May 15, 2000), p. 170.
6. President George H. W. Bush and his wife, Barbara, were in the residence, so Paulson got a chance to renew his acquaintance with "41."

Chapter Thirty-six Lloyd Blankfein, Risk Manager

1. While Blankfein did not use the term, his presentation is described by others as "Lloyd's 'fork in the road' speech." Blankfein's unorthodox persistence was adumbrated early in life by his strategy in dating a Wellesley College student who lived in Kansas City: He took a summer job at Hallmark to be near her. They did not marry.
2. Bethany McLean, "The Man Who Must Keep Goldman Growing," *Fortune*, March 17, 2008, p. 131.
3. Ibid.
4. David Viniar went to Bronx High School of Science and Union College, graduated from Harvard Business School in 1980, joined Goldman Sachs, and made partner in 1992. He served under John Thain and became CFO in 1999.
5. Specifically, the focus was on ABX 06-2 and a subindex of it linked to the lowest-quality credit.
6. Kate Kelley, "How Goldman Won Big on Mortgage Meltdown," *Financial Times*, December 17, 2007.
7. The creation and collapse of the subprime mortgage securities market and the harm done to many marginal borrowers and the enormous losses taken by financial institutions were malign exam-

ples of how wrongly financial markets can behave when free of well-established internal disciplines or regulation by industry umpires or governments. The impact of the collapse was enormous. The hurt to leading institutions—Citigroup, UBS, Merrill Lynch, Morgan Stanley, and many others—was large, swift, and visible. The hurt done to individual families will be largely private, personal, and invisible—but dream-destructive.

Traditionally, a mortgage lender's loan officer was trained in credit judgment and, while rewarded for making loans, was penalized for bad loans. His or her career depended on doing good conservative work to build profitable volume while not making mistakes. The mortgage lending institution acted as principal, lending its own money and keeping the loan on its own books.

All this changed with the securitization of mortgages, particularly the subprime mortgage loans most colorfully defined as "ninja" loans, made to individuals—usually young, first-time home-buyers—with *n*o *i*ncome, *n*o *j*ob, and no *a*ssets. Many of these borrowers saw house prices rising steadily, knew interest rates were low, and could borrow on interest-only (IO) terms, with no principal payments due for the first five years. Since house prices were rising faster than the rate of interest, increasing numbers of borrowers appeared to make money on the expanding differential—so, increasingly, houses got bought on speculation. Meanwhile, mortgage bankers who originate mortgages sold off their loan portfolios as securitized assets through Wall Street firms that competed for the lucrative underwriting business. Competing for volume, mortgage banks gave their officers incentives to drive for volume and made it easier to produce volume by cutting the traditionally required down payment from 20–25 percent of the purchase price to just 5 percent—or even less.

Wall Street underwriters made large profits selling securitized mortgages. They competed for market share, paying large bonuses to those who won the most volume. Credit agencies, competing with each other for the fees they got paid by the issuers, gave high ratings to mortgage-backed securities. As the underwriters eased into mortgages of lower and lower quality, nobody called out "The emperor had no clothes!" and the volume increased—increasing profits and incentives to originating lenders, profits and bonuses to underwriters, and profits and market share to rating agencies, while borrowers appeared to profit on the ever-expanding speed between the interest cost of the mortgage and the rising price of the house.

Mortgage securities, collateralized by larger, diversified portfolios of mortgages, were then "sliced and diced" into several different tranches, each with its own creditworthiness and its own credit rating. When individual mortgages in that portfolio went into default—as some were sure to do—the highest-quality tranche was fully protected because the portfolio of collateral was larger than the volume of securities sold. In addition, insurance against loss was purchased in order to obtain the best possible interest rates. Not surprisingly, a few insurance companies specialized in this type of insurance and competed with each other for more business.

The different tranches—with credit ratings ranging from AAA to BBB—offered different rates of interest and were sold to different groups of buyers. Since the lowest-quality tranche could not be sold, banks had to keep the worst "junk"—but could, according to the banks' permissive accountants, off-load them to Cayman Islands companies created for that very purpose and thus called Special Purpose Vehicles.

Meanwhile, all over the world, investment managers, banks, insurance companies, pension funds, and others reaching for higher-interest securities with high credit ratings, bought more and more securities backed by mortgages of lower and lower quality taken out by ninja borrowers.

Thirty years ago, the median down payment required of a first-time buyer was 18 percent. In 2005–2006, the median payment was only 2 percent—and half the buyers put nothing down. The tiny equity could be okay if house prices always rose, but in 2007 the average house price dropped nearly 9 percent. As a result, some fifteen million homeowners owed more on their mortgage than their houses were worth in the market.

Several factors combined to appear to justify AAA ratings, which were, in retrospect, miscalculations of several risks: relying on historical loss experience without adjusting for real changes

in the whole system of mortgage origination; taking too much comfort in geographical diversification when other factors had become more powerful and were not diversified; taking too much comfort in the history that house prices in the United States had never, on average, declined year-to-year; and an inability to model or predict borrower behavior—including fraud—in a declining market for house prices.

Then house prices, instead of rising at record rates, began to fall—for the first time since the Depression—because the ratio of house prices to rental rates had gotten way above trend; because mortgage terms could not get even easier and had already attracted marginal house buyers and speculators; because overbuilding was flooding the market (leaving numerous vacant houses with overgrown lawns and FOR SALE signs), which pulled prices downward; and because borrowers had zero or even negative equity in their houses, making it more rational to walk away than to keep paying on the now-too-large loans. While no one or two of these problems would have had serious consequences, the confluence of adversities created combinations that were cataclysmic, particularly in California.

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ABOUT THE AUTHOR

Charles D. Ellis is the author of fourteen books, including *Winning the Loser's Game*, *Capital*, and the biography *Joe Wilson*. For thirty years he was managing partner of Greenwich Associates, the international strategy consulting firm he founded that serves virtually all the leading institutional financial service organizations around the world. A graduate of Yale, Ellis earned his MBA from Harvard and his PhD from New York University. He has taught the investment management courses at both Harvard and Yale, and consults on investing with international clients in America, Australia, New Zealand, Singapore, Saudi Arabia, and Vietnam. Ellis has served on the boards of Harvard Business School and Phillips Exeter Academy, and is currently chairman of the Whitehead Institute for Biomedical Research, a trustee of the Robert Wood Johnson Foundation, a director of Vanguard, and a trustee and chair of the investment committee at Yale University.

Unholy Trinity

The IMF, World Bank and WTO

(Second Edition)

Richard Peet

About the author

Richard Peet is Professor of Geography at Clark University. He grew up near Liverpool and attended the London School of Economics, the University of British Columbia and the University of California, Berkeley. His main interests include development, policy regimes, globalization, power, social theory, philosophy and Marxism. He was for many years editor of *Antipode: A Radical Journal of Geography*. He also co-edited *Economic Geography* and is now editor of *Human Geography*, a new journal. He is the author of twelve books, including (with Elaine Hartwick) *Theories of Development* (2008), (with Michael Watts) *Liberation Ecologies* (2004) and *Geographies of Power* (2007).

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Prefaces

Preface to the first edition

This book comes from the committed efforts of a group of faculty, graduate students and undergraduate students at Clark University, Worcester, Massachusetts. The idea was to produce a critical study of three powerful global institutions – the International Monetary Fund, the World Bank and the World Trade Organization – set in the historical context of a study of the Bretton Woods agreement, and in the ideological context of a critical survey of the principles of neoliberalism. The way we wrote the book went something like this. The process began with an initial survey of the three institutions by one of the student authors in summer 2000. In autumn 2000 and spring 2001 small groups of graduate and undergraduate students researched and wrote first drafts of the four main chapters (2–5). Between summer 2001 and autumn 2002, the senior author rewrote most of the texts contained in the drafts, composed Chapters 1 and 6, and did extensive additional research (with help from two of the graduate student authors) on all the topics covered, before delivering the manuscript to the publisher in early October 2002. The senior author is therefore responsible for the accuracy of the statements made in the book and for the opinions expressed in it.

The book covers some complex ideas; however, we have tried to write in a style understandable to people who are far from being experts in this area, but wish to know much more about globalization and global institutions. At times the going gets to be difficult as we cover a lot of complicated history, and some closely argued contentious issues, quickly but densely. The reader, of course, can work through all this in any way she or he wishes, including skipping most of the boring parts to get to the 'good bits,' usually toward the end of each chapter. But we put a huge amount of time and effort into those detailed parts, including not a few headaches, at least on the part of the senior author, and we ask that you persevere rather than throw the book down in exasperation or, worse, read it as an alternative to counting sheep. The critical conclusions that we reach are based in the histories of the institutions. Note that we do not

say based 'on' these histories, for the reading and the discussion we engaged in tended to intensify rather than form our opinions – that is, we found even more than we were indeed looking for! The main thing is, the book is best when read in its entirety.

Richard Peet would like to thank Robert Molteno of Zed Books for his informed help and his patient endurance. Richard particularly thanks Elaine Hartwick, his wife, for her deep and loving support during the eighteen months of hard work that made this book possible, and for her direct help, especially in the closing days of the book's completion, in editing parts of the manuscript and subjecting the ideas to critical scrutiny. He also thanks his children, Eric (aged two) and Anna (aged two months), and hopes that when they get to read this some time in the future they will understand why Daddy had to burrow in the basement when they wanted him to play … not always, though! We hope that this sacrifice to the Trinity is worthwhile.

LEOMINSTER, MA
OCTOBER 2002

Preface to the second edition

Things changed so much after 2002 that we had to update the book and change its emphasis in 2008. All the chapters have been significantly altered. And the concluding chapter is entirely new. The senior author did the writing and is now solely responsible for the book. Many of the ideas in the book came originally from the junior authors of the first edition: Beate Born, Mia Davis, Matthew Feinstein, Kendra Fehrer, Steve Feldman, Sahar Rahman Khan, Mazen Labban, Ciro Marcano, Kristin McArdle, Lisa Meierotto, Marion C. Schmidt, Daniel Niles, Thomas Ponniah, Guido Schwarz, Josephine Shagwert, Michael Staton, and Samuel Stratton. Their hard work and critical thinking is acknowledged with gratitude. He again thanks Elaine Hartwick, for listening, discussing, and contributing her ideas, as well as putting up with his frequent disappearances down into the depths of our basement. And we both thank our kids, Eric, now eight, and Anna, now six, for their endurance too. Eric tells me he doesn't believe in God. I advise him: don't tell anyone.

LEOMINSTER, MA
AUGUST 2008

Abbreviations

BIS	Bank for International Settlements
CDF	Comprehensive Development Framework (World Bank)
CRU	collective reserve unit
CTE	Committee on Trade and Environment (of the WTO)
DSB	Dispute Settlement Body (of the WTO)
DSU	Dispute Settlement Understanding (of the WTO)
EEC	European Economic Community
ESAF	Enhanced Structural Adjustment Facility (IMF)
FAO	Food and Agriculture Organization (of the UN)
FDI	foreign direct investment
GAB	General Arrangements to Borrow (IMF)
GATS	General Agreement on Trade in Services (WTO)
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
HIPC	Heavily Indebted Poor Country Facility (IMF)
IBRD	International Bank for Reconstruction and Development
IEO	Independent Evaluation Office (of the IMF)
IIF	Institute of International Finance
ILO	International Labour Organization
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
ITGLWF	International Textile, Garment and Leather Workers' Federation
ITO	International Trade Organization
LDC	less developed country
LOTIS	Liberalization of Trade in Services
MFN	most favored nation
NAB	New Arrangements to Borrow (IMF)
NAFTA	North American Free Trade Agreement
NBA	Narmada Bachao Andolan (Save the Narmada Campaign)
NGO	non-governmental organization
OPEC	Organization of Petroleum Exporting Countries

PRGF	Poverty Reduction and Growth Facility (IMF)
PRSP	Poverty Reduction Strategy Paper (IMF)
SAP	structural adjustment program
SAPRI	Structural Adjustment Participatory Review Initiative
SAPRIN	SAPRI Network
SDR	special drawing right (IMF)
SDRM	Sovereign Debt Restructuring Mechanism
TPRB	Trade Policy Review Body (of the WTO)
TPRM	Trade Policy Review Mechanism (WTO)
TRIMs	Agreement on Trade-Related Aspects of Investment Measures (WTO)
TRIPs	Agreement on Trade-Related Aspects of Intellectual Property Rights (WTO)
UNCTAD	United Nations Conference on Trade and Development
UNICEF	United Nations Children's Fund
WDM	World Development Movement
WHO	World Health Organization
WTO	World Trade Organization

ONE
Globalism and neoliberalism

Capitalism has been international in scope since the Europeans went out to 'discover the world' some five hundred years ago. Ideas, capital, labor and resources drawn – with not a little violence – from societies ranged across the globe made possible the rise of European capitalism. And measured by mass movements across global space, such as the migration of people, or direct investment, capitalism in the early twenty-first century is only as international in scope as it already was by the late nineteenth. Yet, for some time now, a new sense of globalism has grown among people who think for a living and, what is more, whose ideas command respect. The recent intensification of long-distance interchange, many people think, has resulted in a new global era and, perhaps, a new, more worldly type of human existence.

What is this thing called 'globalization'? Definition of the term is still being contested. But there are several, similar uses, with fairly wide acceptance. The sociologist Roland Robertson (1992: 8) understands globalization to be 'the compression of the world and the intensification of consciousness of the world as a whole.' Anthony Giddens (1990: 64), another sociologist, speaks of 'the intensification of world-wide social relations which link distinct localities in such a way that local happenings are shaped by events occurring many miles away.' And the geographer David Harvey says that late-twentieth-century people 'have to learn to cope with an overwhelming sense of *compression* of our spatial and temporal worlds' (1989: 240; original emphasis).

These brief descriptions reveal two consistently related themes: global space is effectively getting smaller ('compressed') in terms, for instance, of the time taken for people, objects and images to traverse physical distance; as a result, social interactions are increasing across spaces that once confined economies and cultures. So change seems to have occurred in the scale at which even daily life is led, especially in terms of the reception of images and information, the more spatially fluid of the many elements that influence opinions, beliefs and tastes.

The human experience has globalized as the times separating spaces have collapsed. Putting this a little more realistically, an increasing proportion of people now live a geographically schizophrenic life in which the intensely local intercuts with the extensively global. Understood this way, globalization offers beautiful opportunities for disparate peoples to know and, perhaps, appreciate each other by living 'closer' together. A globalized humanity, still composed of somewhat different peoples, at last becomes possible. In this sense, globalization should be welcomed as the last act of the Enlightenment.

Behind these optimistic statements, however, lurks the possibility of something quite different. For the particular *way* in which globalization is brought about might destroy its inherently liberating potential. Giddens, for instance, goes on to refer to globalization as 'influence at a distance.' And this raises the question: whose influence? Globalization might be accompanied, even caused, by a concentration of power. So the 'communications media' that technically annihilate space saturate everyone with the same images, creating a new and more unpleasant future by homogenizing what necessarily becomes merely a virtual experience. The multinational corporations that integrate production systems into one global economy might use the opportunity simultaneously to dominate competing labor forces and to manipulate more effectively a world of consumers. Finance capital concentrated in New York, London and a few other global cities could more efficiently invest, disinvest, speculate and operate in every corner of the world. And global governance institutions, such as the World Bank or the International Monetary Fund (IMF), might bring huge swathes of entire continents under the same pernicious, undemocratic control. So rather than disparate peoples simply interacting more as space collapses, we might instead have a process in which one culture dominates the others, or one set of institutions controls all others. That is, as the space of a single global experience expands, the institutions that control economies and project cultural themes accumulate into larger entities and condense into fewer and more similar places ('world-class cities'). Or putting this again more realistically, we find a tendency toward the concentration of power accompanying globalization – and ruining its humanitarian potential.

Yet as the dialectic suggests, for every tendency toward homogenization there is a counter-tendency that reacts against it, in the direction of the reassertion, sometimes even the resurrection, of difference. And for every move in the concentration of control, there

is a counter-move that decentralizes power. So we find globalization as Westernization contested by diverse counter-tendencies, social movements ranging from sea turtle activists to al-Qaida terrorists. This contestation cannot be described simply as a clash of civilizations along regional 'fault lines' as with Samuel Huntington (1996) – the interpenetrations and interactions are far too complex to be comprehended by such a simple geographical imagination. For example, many environmental activists adhere to Eastern religious principles, while al-Qaida militants communicate via the Internet. Globalization is much more of a geographical mix. Understanding globalism, its cultures and institutions, requires careful attention to detail. Yet this need not mean waffling around in that academic style where almost saying something is regarded as declarative adventurism. There are some dependable generalizations that can be made, certainly about global governance institutions, and the hegemonic ideas these propagate, which yield insights into the present set of complex processes that make up globalization.

In this book I take the side of those critical of the way the existing global economy has emerged, and I take exception to the way in which it is currently organized, controlled and run. I am particularly critical of the objectives pursued by governance institutions, in terms of the economies that have resulted and the consequences for peoples, cultures and environments. I argue that globalization has been accompanied by the growth in power of a few prodigious institutions operating under principles that are decided upon undemocratically, and which drastically affect the lives and livelihoods of a world of peoples. I argue that the world has become more unequal and unstable as a result of financialization, private and quasi-public. But I concentrate on one particular type of institution, what is sometimes called the 'global governance institution,' as the focus of this book. In this phrase, 'governance' refers to quasi-state but unelected control and regulation of economic plans and programs, 'institution' refers to a centralized body of experts who share a common ideology, and 'global' refers to the area being governed. I concentrate on the increasing influence, within these institutions, of a single ideology that I, and many other critics, term 'neoliberalism.' So I am dealing with neoliberal globalization, not just globalization as a neutral spatial process. And neoliberal globalization is the focus of my critique, not globalization in general, and certainly not as potential.

Consequently, I argue that many of the social movements that

appear to resist globalization in general actually resist the *kind* of globalization produced by neoliberal ideas, policies and institutions in particular. I argue further that this distinction, between globalization as humanitarian potential and neoliberal globalization as dominating reality, is under-appreciated, to the point of being disastrously misunderstood. This is because the neoliberalism that now informs even conventional thinking about globalization has achieved the status of being taken for granted or, more than that, has achieved the supreme power of being widely taken as scientific and resulting in an optimal world. So resistance to neoliberal globalization is seen as resistance to globalization in general, a new kind of Luddite opposition to the technically and economically inevitable. For instance, resistance to free trade is seen as protest against trade in general, when what the protesters want instead is fair trade. When thousands of people demonstrate at each world economic summit the lament is that the protesters, 'prone to violence,' simply don't understand, are divided, misled, propose ridiculous things such as the end of capitalism, and have no idea what they want instead. Protest against the actually existing, neoliberal globalization is taken as an offense against Reason, Progress, Order and the Best World Ever Known to Man. Yet a global system that cannot know its own faults, no matter how disastrous their consequences, is the reverse of that humanitarian potential, open to a world of difference, that I envisioned earlier as globalization's promise. How did this happen?

From liberalism to Keynesianism

The central economic beliefs of Western capitalism were first set down systematically by philosophers and political economists such as Thomas Hobbes, John Locke, David Hume and Adam Smith, writing mainly in seventeenth- and eighteenth-century Britain. These founding philosophers thought hard on behalf of a new class of manufacturing entrepreneurs then coming to the fore. Essentially their philosophies rephrased more exactly modern beliefs emerging from new kinds of economic and social practice. Adam Smith's *The Wealth of Nations*, published in 1776, laid out a liberal theory of individual economic effort in a society characterized by competition, specialization and trade (Smith 1937). For Smith, capitalism left to itself had its own silent rationality ('invisible hand'), which magically transformed private interest into public virtue – with 'virtue' interpreted as an efficiently organized, growing economy capable of providing benefits for every-

one. This classical liberalism was progressive in that it questioned the authority of the landowning nobility, the grand merchants and the monarchical state, with their conservative ideas of divine rights, family values, feudal loyalties and patriotic duties. By comparison, classical liberalism was on the side of science, evidence, rationality and at least partly reasoned values (God still being needed as moral guarantor). This early liberal doctrine reacted critically against an even earlier mercantilism, in which governments intervened directly to guide the development of national economies in the interests of the accumulation of state power. By comparison, liberalism championed the rational, acquisitive but philanthropic entrepreneurial individual and the organizational efficiency of self-regulating (as opposed to state-regulated) markets. 'Natural liberty implied free competition, free movement of workers, free shifts of capital, and freedom from government intervention' (Lekachman 1959: 89).

The economic principles first elaborated by Smith were refined into a political-economic theory of liberal reform by the 'philosophical radicals,' a group active in London in the 1820s and 1830s. The most important of these was David Ricardo, a self-made millionaire from speculating in the London financial markets, and a writer of pamphlets, tracts, books and letters to the *Morning Chronicle*. Ricardo's formulation of trade theory, containing what Nobel laureate Paul Samuelson later called 'four magic numbers' representing the labor needed to produce wine and cloth in Portugal and England, became established as the classical source of the theory of comparative advantage that has guided liberal and neoliberal trade theory ever since. Ricardo (1911 [1817]: 80–81) argued that 'each country producing those commodities for which by its situation, its climate, and its other natural or artificial advantages it is adapted, and by their exchanging them for the commodities of other countries' would result in an increase in global production and the 'universal good of the whole.' He then argued that Portugal should specialize in wine production (mainly agricultural), for which it had the largest comparative advantage, and England should specialize in cloth production (mainly industrial), for which it had the least comparative disadvantage. Yet exactly this specialization had already resulted in centuries of unequal exchange to the concentrated benefit of Britain (Sideri 1970). 'Free trade' actually creates a spatial arena open to domination by economically and politically powerful countries, like Britain in the eighteenth and nineteenth centuries, and dominant

classes, like the British industrial bourgeoisie. In other words liberal theory was completely committed to class and national interests, while posing as a fine set of principles good for everyone.

Then, in the second half of the nineteenth century, these same economic ideas were further reformulated into mathematical, 'scientific' laws of market economies by neoclassical economists. Basically, neoclassical economic theory asserted that, under conditions of perfect competition, markets yield a long-run set of prices that balance, or equilibriate, the supplies and demands for each commodity. Given certain conditions – such as the preferences of consumers, productive techniques, and the mobility of productive factors – market forces of supply and demand allocate resources efficiently in the long run, in the sense of minimizing costs and maximizing consumer satisfaction. And finally, all participants in production receive incomes commensurate with their efforts. Capitalism is therefore the best of all possible economic worlds.

The market economies, however, organized by individualistic liberal principles, proved to be susceptible to system-threatening depressions. Also the vast material benefits generated by competitive productivity stuck stubbornly to the hands of the new class of entrepreneurs. As these gross deficiencies were revealed, political struggles, marked by violent and widespread protests, were enlarging the voting franchise from one restricted to property-owning men to one that included property-less working men, and women, who had previously been deemed 'sub-rational.' Then, too, soldiers returning from two great wars demanded that the freedom for which they had risked all include a greater share of the material benefits they themselves were producing. This entailed a new kind of political state that intervened to regulate the economy not merely in its own (state) interest, as with the earlier mercantilism, but for the benefit of the great majority of the peoples of the Western democracies. In other words, the bourgeois liberal state of the nineteenth century was forced by crisis, protest, wars and enfranchisement to become, by the mid-twentieth century, the liberal ('New Deal') state in the United States and the socially democratic, more interventionist, state in western Europe.

Politics in these new kinds of social economies included the right of the state to intervene directly to regulate the market economy and the new powers of democracy to redistribute wealth and equalize incomes. Post-war political economy used state intervention, exercised through various levels of planning and public ownership, in

its social democratic versions, and fiscal and monetary policy in its liberal-democratic versions, to stabilize economies and redistribute income through welfare programs, unemployment compensation, the subsidization of education and the free provision of social services. At the same time, in the colonial countries, nationalist movements for independence frequently included the socialist ideal of state direction of economies in the interests of popular social and economic development. In the Third World, dependency theory argued that accepting a production position allocated by the existing global division of labor meant accepting agricultural- and resource-based specializations that transferred income to the already rich countries at the centers of power. Most dependency theorists called, instead, for greater national economic autonomy, import substitution industrialization, and various levels of state ownership of key economic activities. All these political-economic doctrines favored state intervention in guiding what otherwise were usually staunchly capitalist economies. For this exact reason they faced strong opposition – from business interests and orthodox cultural institutions, from elements of the Republican Party in the United States, and from reactionary fractions of conservative parties elsewhere.

The economic theory informing this new kind of twentieth-century liberal capitalism came from John Maynard Keynes (1883–1946). Keynes was skeptical about many of the postulates of the neoclassical approach – for example, the notion that wage-earners were maximizers or that unemployment was voluntary. He argued that the level of employment was determined by demand for goods and services and that real investment by businesses was the crucial component of this demand. In turn, business investment resulted from decisions made by entrepreneurs under conditions of risk, with the key variable being 'expectation,' or the degree of investor confidence. The government could influence this confidence through interest rates and other monetary policies, although Keynes himself doubted that merely changing interest rates would be sufficient to alter business confidence and thus investment significantly. Subsequently, conservative Keynesian economists have seen the manipulation of interest rates as a relatively non-bureaucratic, non-intrusive method by which the central bank of a country tries to influence national income and employment. Liberal Keynesian economists, by comparison, see government deficit spending as a more effective measure: the 'liberal' part being that deficit spending can be used by the state to improve

social and welfare services. While favoring the latter course, Keynes thought that mere government *spending* was the crucial bit. When capital was scarce, saving was beneficial to an economy. But when unemployment rose, thrift impeded economic growth, and the government should spend and spend again. In general, Keynes proved theoretically what depressions had long shown in practice: that free markets do not spontaneously maximize human well-being (I discuss Keynes at greater length in Chapter 2).

In the post-war period, Keynesian economists tried to design policies that would maintain full employment in the liberal social democracies of the West. Keynes's ideas were elaborated further by the Cambridge economist Roy Harrod, who looked at how economies could be made to grow at a steady rate, and the US economist Evsey Domar, professor at Brandeis University, independently investigating the circumstances under which a growing economy could sustain full employment. The resulting Harrod–Domar model focused Keynesian theory on the relations between savings, investment and output. For Harrod the chances of a capitalist economy growing at a steady state, with full employment, were low. Instead an economy would fluctuate between periods of unemployment and periods of labor shortage. Interest rate policies and public works, put into effect by interventionist states, could decrease fluctuations and increase the possibility of steady growth. In the Domar (1947) version of the theory, emphasis was placed more on the savings rate, which financed investment and achieved a desired rate of growth. In the synthetic Harrod–Domar model, increasing economic growth basically involved increasing the savings rate, in some cases through the state budget. Development policies based on Harrod–Domar were used in left-leaning countries in the 1950s – for example, India's first Five Year Plan between 1951 and 1956. In general, post-war Keynesian economic theory established the legitimacy of state intervention in market economies with the aim of achieving growth and employment levels decided on the basis of social policy. Since Keynes, economists have divided into camps favoring the invisible hand of the market or the visible hand of state planning in guiding economic growth. And for thirty years following the end of the Second World War Keynesian intervention generally prevailed, certainly in the western European social democracies, less certainly and in a different form in the East Asian industrializing countries, but in a far more muted form in the United States. As Walter Heller, chairman of Lyndon Johnson's Council of Economic Advisors, said in

1965, in the 'age of the economist' the American political elite had to accept Keynesianism, a sentiment echoed a few years later in Richard Nixon's phrase 'we are all Keynesians now!' (Gilpin 2001: 70).

Neoliberalism

The main opposition to Keynesianism came eventually not from the external threat of communism, as most histories have it, but from internal movements for 'reform' started by neoliberals. Neoliberalism is an entire structure of beliefs founded on right-wing, but not conservative, ideas about individual freedom, political democracy, self-regulating markets and entrepreneurship. Neo*liberalism* renews the beliefs of early modern, and especially nineteenth-century, British 'classical' liberalism. *Neo*liberalism relates positively to its nineteenth-century ancestor, but critically to its twentieth-century predecessor, especially social democratic Keynesianism. So the classical liberal past is remembered in the neoliberal present not merely as received wisdom, but also through a series of creative re-enactments that respond to changed circumstances. Hence contemporary neoliberalism's obsession with the deregulation of private enterprise and the privatization of previously state-run enterprises, this time in critical reaction to Keynesian social democracy rather than liberalism's earlier reaction to mercantilism. Classical economic liberalism is recalled too within a new domain of geopolitical power relations. It openly, proudly and self-righteously displays a right-wing, ideological, political zeal, stemming from the West's 'defense of freedom' during the cold war, when liberal capitalism battled totalitarian communism. Likewise, it basks in the aura of a market triumphalism stemming from the collapse of the Soviet Union in what Francis Fukuyama (1989) mistakenly called 'the end of history' – that is, the apparent ending of all political alternatives to liberal democracy (he forgot about Islam and its many political offshoots). And when this aura was rudely disturbed by the events of 11 September 2001, neoliberalism revealed what had been there all along – American militaristic domination based on an ability to kill in quantity, anywhere in the world, within twenty-four hours of a presidential declaration of emergency.

Classical liberalism was remade into a more exact neoliberal ideology at a number of coordinated centers of influence and persuasion: the Austrian School of Economics in Vienna in the early twentieth century, the London School of Economics in the 1930s, the Institute of Economic Affairs, the Centre for Policy Studies and the Adam Smith

Institute, all in London, the ordo-economics school of Walter Euchan and Franz Bohm at Freiburg and the Hoover Institution at Stanford University in California, to mention but a few. The intellectual capital of neoliberalism, however, is undoubtedly the Chicago School of Political Economy. This influential school of thought was started by Frank H. Knight, a liberal in the nineteenth-century sense, a critic of New Deal (twentieth-century) liberalism and a believer in the ideal of the creative, active, free individual. Knight was followed by a second generation of liberal revivalists, including Milton Friedman, George Stigler, James Buchanon, Gary Becker and Robert Lucas, who likewise favored self-interested, competitive behavior in economy, polity and just about everything else – Becker, for example, thinks that knowledge of markets illuminates questions of race, education and the family. The rightist politics of the Chicago School were translated by Friedman into the apparently scientific, neutral mathematical codes of monetarist economics (that is, the idea that macroeconomic problems such as inflation and indebtedness derive from excessive government spending driving up the quantity of money circulating in a society). These ideas were spread in popular versions carried by sympathetic mass media, an industry that also abhors state regulation. So Friedman's articles were regularly carried by *Newsweek*, while Friedrich von Hayek's *The Road to Serfdom* (1956) was carried in shortened form by *Reader's Digest*. Neoliberalism vitally affected the return of economics to its classical and neoclassical past. Thus the Smith of the neoliberal revival is a proponent of individual selfishness – 'give me that which I want, and you shall have this which you want' (Smith 1937: 14) – rather than Smith the modern moralist (Smith 1976), who thought that selfishness should be both self-regulated and externally limited. (Indeed, Smith himself preferred 'self-interest,' as with personal striving mitigated by virtue, as the prime motivator of economic behavior. Rather than pure selfishness, he said, justice should be the basis of society – Fitzgibbons 1995.) And the later, nineteenth-century economics remembered by the neoliberal revival is all marginalist calculation and mathematical equilibrium, rather than the ethical economics of John Stuart Mill or Alfred Marshall.

All neoliberal revivalists, however, even the almighty Friedman, pale in comparison with neoliberalism's guru, the early critic of Keynes and 'socio-philosopher of economics,' Friedrich von Hayek. Von Hayek trained at the Austrian School of Economics, where he was a protégé of Ludwig von Mises, a major critic of central planning,

who argued that, without markets, means of production could not be optimally combined. Von Hayek became a professor at the London School of Economics (1931–50), the University of Chicago (1950–61), and Freiburg University in West Germany (until his death in 1992). Von Hayek was also mentor to the Mont Pelerin Society, begun in 1947 at a hotel in Switzerland, attended annually by the leading lights of neoliberalism and dedicated to the 'exchange of ideas about the nature of a free society and … the ways and means of strengthening its intellectual support' (Leube 1984: xxiii). Essentially von Hayek's philosophy rested on two positions.

First, the growth of civilization comes from the freedom of its individual members to pursue their own ends in the context of private property rights. Social institutions, primarily the market, work best when derived from the voluntary and spontaneous collaboration of free men. Market competition generates an economic order (*cosmos*) that is the product 'of human action but not human design.'

Second, governments should therefore be democratic, with fixed limits on the sphere of their command, especially their powers of coercion. Planned economic orders (*taxis*) can handle only limited complexity. In particular, collectivist economic planning (even of the social democratic kind) leads inevitably to totalitarian tyranny (von Hayek 1984, 1988).

Von Hayek combined an ability to make broad, philosophical pronouncements like these, which seemed to derive from a deep knowledge of human history, with a more practical economic competence sufficient to oppose Keynes in terms that gained respect among professional, neoclassical economists – in the 1930s 'the new theories of Hayek were the principal rival of the new theories of Keynes' (Hicks 1967: 203). Or, putting it differently, von Hayek was one of a few 'dismal scientists' who could almost philosophize and get away with it. The efforts of von Hayek, Friedman and the Mont Pelerin Society to revive nineteenth-century liberal, classical and neoclassical principles, particularly in the discipline of economics, were reinforced by anarcho-capitalist notions developed in political science (that is, the idea that the free market can coordinate all functions of a society currently carried out by the state) and published in works written mainly by Austrian- or Chicago-connected political theorists, especially Murray Rothbard and David Friedman. The ensemble of economic and political ideas that made up neoliberalism moved rapidly from right-wing quackery to recognized convention in 1974 when von Hayek was awarded the Nobel Prize at a

time of widely supposed crisis in post-war Keynesianism (specifically, problems such as stagflation, which could not readily be solved using Keynesian fiscal and monetary policy).

In a landmark study that brings the work of Karl Polanyi up to date, Mark Blyth (2002) argues that what we, in this study, call neoliberalism was actually made up of four intersecting ideas: at base, a monetarist analysis of inflation developed by Friedman, which culminated in the position that markets were self-equilibriating in the long run and that intervention by the state was deleterious, if not perverse; the theory of rational expectations, which says that rational optimizing economic agents discount interventionist strategies pursued by governments, making state intervention 'at best a waste of time and money … [and] more likely downright dangerous … [indeed] governments *cause* recessions and depressions by their very actions' (ibid.: 144); supply-side economic theory, a resuscitaton of Say's law (supply creates its own demand) in the extreme form, proposed by Arthur Laffer, that tax cuts, especially for the rich, were self-financing (through an increase in production and, consequently, tax revenues); and public choice theory, in which politicians are analogs of market actors, maximizing votes by providing goods to constituents and therefore making democratic governments prone to generating inflation. The four theories combined in concluding that inflation, due to intervention by the state in an otherwise naturally self-equilibriating economy, was an all-encompassing social crisis treatable not by Keynesian policies (for these were the cause) but by neoliberal, market-oriented means.

American big business moved from reluctantly accepting Keynesian state regulation of the economy during much of the post-war period to actively supporting neoliberal deregulation in the mid-1970s: large US corporations and banks that had previously supported (twentieth-century) liberal research foundations, such as the Brookings Institution, switched allegiance and financial backing to right-wing think tanks, such as the Heritage Foundation, which became increasingly wealthy and influential (Kotz 2000). Blyth (2002: ch. 6) argues specifically that governmental policies put into place in the radical late 1960s and early 1970s persuaded American corporations that they must reinvigorate collective business institutions such as the National Association of Manufacturers, the American Chamber of Commerce (which quadrupled its membership during the 1970s) and the Business Roundtable, whose members controlled half the GNP of

the USA. Concluding that institutions responsible for the production of ideas, especially the media and universities, had become dominated by their critics, business not only re-established control of the political process, especially by financing political action committees, but went farther to produce ideas in support of free enterprise. The main means of doing so were the think tanks, such as the Heritage Foundation (bankrolled by the conservative Olin Foundation, headed by William Simon, secretary of the Treasury in the Nixon administration), the Hoover Institute and the American Enterprise Institute. Perhaps the single most important intellectual influence pushing policy to the right came from Martin S. Feldstein, a rightist economist who has long taught 'Ec10,' a 'decidedly anti-tax, free market-leaning introduction to economics' to thousands of students at Harvard University, many of whom have gone on to prestigious positions in the US Treasury Department (Leonhardt 2002), and who, as president of the National Bureau of Economic Research, provided a more serious rationale than Laffer for cutting taxes. The conservative business foundations, especially Scaife and Olin, also financed the diffusion of neoliberal ideas to the public through financing television documentaries and neoconservative journals, such as *Public Interest*, and by supporting right-thinking social scientists, writers and journalists. The *Wall Street Journal* acted as synthesizer and proselytizer for this disparate collection of ideas. In terms of global attitudes, US corporations, particularly those operating in emerging areas such as information technology, realized that they could compete in a neoliberal global space of free commodity movements and open capital markets liberated from 'miles of red tape.' Neoliberal economic policies were eagerly adopted by 'supply-siders' in the Reagan and Thatcher governments in the early 1980s. Following Milton Friedman's (1958) lead that 'millions of able, active and vigorous people exist in every underdeveloped country' and 'require only a favorable environment to transform the face of their countries,' neoliberal policies – aimed at creating 'more competitive markets with brave, more innovative entrepreneurs' – took over a previously liberal, interventionist development economics in the 'counter-revolution' of the 1970s and early 1980s (Straussman 1993; Toye 1987). By the mid-1980s, neoliberal economics had come to dominate a previously social democratic and Keynesian development discourse.

This domination extended to the global governance institutions. While the IMF and the World Bank have long used neoclassical

economics as the theoretical basis for policy formation, starting in the mid-1970s for the IMF and the late 1970s for the World Bank, the controlling faction of economic belief shifted to the right under the combined impetus of two growing tendencies. The first was a change in the discipline of economics away from Keynesianism and toward a neoclassicism influenced by the Austrian School's trust in markets, as opposed to state regulation, and by the monetarist theories of Milton Friedman, which likewise minimized state intervention in the economy. The second was a rightward shift in political opinion at the end of the 'long decade of the sixties' (that is, stretching well into the 1970s) marked by the elections of Margaret Thatcher and Ronald Reagan – Thatcher, for example, read von Hayek as an Oxford undergraduate and proclaimed that Hayekian ideas were what a right-wing Conservative Party should believe in (Yergin and Stanislaw 1999: 107) – and by the appointment to high posts in the US Treasury Department of dedicated right-wing ideologues who forced Hayekian principles on the Fund and the Bank on threat of withdrawal of US funding. As Reagan said to the annual meeting of the World Bank in 1983:

> The societies that achieved the most spectacular, broad-based economic progress in the shortest period of time have not been the biggest in size, nor the richest in resources and certainly not the most rigidly controlled. What has united them all was their belief in the magic of the marketplace. Millions of individuals making their own decisions in the marketplace will always allocate resources better than any centralized government planning process. (IBRD 1983: 2)

This is a statement drawing intellectual power directly from von Hayek, the Austrian School and Friedman. And this was a statement warning the Bank to move decisively against state-led development, or else! Under the control of neoliberal beliefs ever since, the global institutions governing the development of the world economy have consistently advocated a set of economic policies virtually identical to those of national governments.

The Washington Consensus

One account widely referred to in describing these policies has been advanced by John Williamson, senior fellow at the (Washington, DC) Institute for International Economics. Some time ago, Williamson (1990, 1997) coined the term 'Washington Consensus' to refer to

the set of policy reforms imposed when debtor countries in Latin America were called on to 'set their houses in order' and 'submit to strong conditionality.' By 'Washington' Williamson meant the political Washington of the US Congress and senior members of the administration, and the technocratic Washington of the international financial institutions, the economic agencies of the US government, the Federal Reserve Board and the think tanks, such as the one at which he himself works. And by 'policy' he meant policy instruments rather than more general objectives or eventual outcomes. The set of 'policy instruments' derived from the Washington Consensus and applied to borrowing countries by the World Bank and the IMF were said by Williamson to include:

Fiscal discipline. Large and sustained fiscal deficits are a main source of macroeconomic dislocation in the forms of inflation, balance of payments deficits and capital flight. These deficits result from lack of political courage in matching public expenditures to the resources available. An operational budget deficit in excess of 1–2 percent of GNP is evidence of policy failure.

Reducing public expenditures. When expenditures have to be reduced the view is that spending on defense, public administration and subsidies, particularly for state enterprises, should be cut, rather than primary education, primary healthcare and public infrastructure investment.

Tax reform. The tax base should be broad, tax administration improved, and marginal tax rates cut to improve incentives.

Interest rates. Financial deregulation should make these market-determined rather than state-determined, and real interest rates should be positive to discourage capital flight and increase savings.

Competitive exchange rates. Exchange rates should be sufficiently competitive to nurture rapid growth in non-traditional exports but should not be inflationary – the conviction behind this is that economies should be outward-oriented.

Trade liberalization. Quantitative restrictions on imports should be eliminated, followed by tariff reductions, until levels of 10–20 percent are reached – the free trade ideal, however, can be temporarily contradicted by the need for protecting infant industries.

Encouraging foreign direct investment. Investment brings needed capital, skills and know-how and can be encouraged through debt–equity swaps – exchanging debt held by foreign creditors for equity in local firms, such as privatized state enterprises.

A competitive economy. All enterprises should be subject to the discipline of competition – this means privatizing state enterprises in the belief that private industry is more efficient, and deregulating economic activity in the sense of reducing state controls over private enterprise.

Securing property rights. Making secure and well-defined property rights available to all at reasonable cost.

In brief, said Williamson (1990: 18), the economic position Washington concurred on in setting policy for the rest of the world (but did not necessarily follow itself) could be summarized as 'prudent macroeconomic policies, outward orientation, and free market capitalism.' This list of policies making up the Washington Consensus, he said, stemmed from classical mainstream economic theory, if Keynes can by now be counted as 'classical.' Essentially, by 'mainstream theory' Williamson meant neoclassical economics.

In a bit more detail, these policies favor an outward-oriented, export economy, organized through markets, with minimal state regulation, along with privatization, trade liberalization and limited (state) budget deficits. Economic policies stemming from the neoliberal perspective are promoted by global institutions regardless of national circumstance, such as cultural tradition or social structure, and regardless of previous tradition in the political economy of development. For their adherents, neoliberal policies produce a rapidly growing, market-oriented, profit-driven economy that generates sufficient jobs and taxes to rectify any social or environmental problems that might occur along the way. For their opponents, neoliberal policies ruin whatever ability Keynesian state intervention once had to produce capitalist economies complemented by social justice. Indeed, critics think that global capitalism is now in the midst of a series of interlinked financial, resource and environmental crises originating exactly in unregulated, pro-financier, neoliberal economic growth. We now have two polar opposite views on neoliberalism: what became the conventional wisdom, that neoliberal policy is the best economic science has to offer; and what has become the unconventional, dissident belief, that neoliberalism is a recipe for global economic, social and environmental disaster.

The institutional framework

In terms of the institutional formation of recent neoliberal economic policy the term Washington Consensus can be used to refer to an agreement among some of the main interest groups: the poli-

tical interests that brought right-wing 'progressive-reform' ideals to Washington in the mid-1970s and early 1980s, for instance; or the bureaucratic-technical interests whose professional training in neoclassical economics proved readily amenable to Hayekian and Friedmanesque persuasion. But interestingly Williamson downplays the academic component of policy formation, as with what I have called the Cambridge (Harvard–MIT) connection, and forgets almost entirely the economic interests, well represented in Washington, but headquartered elsewhere. The World Bank and the IMF operate primarily as bankers to the central banks of nation-states. Banks have power over policy formation because they control access to capital accumulations. And capital accumulations are institutionally controlled by commercial and investment banks. These banks are headquartered outside Washington in commercial cities such as New York, Boston, London, Zurich and Tokyo. Any conception of the formation of economic policy by global governance institutions has to take this broader connection with the banking world into account. Jagdish Bhagwati has called this connection the 'Wall Street–Treasury Complex' (in Wade and Veneroso 1998: 18), while Joseph Stiglitz (2002a: 230), no stranger to Washington policy circles, says that the IMF in his experience follows 'an ideology that was broadly consonant with the interests of the financial community.' Let us expand on these brief allusions by following some connections to the Wall Street financial community.

When we look at the actors crucial in setting up the neoliberal economic policies used for more than twenty years by the World Bank and the IMF, and when we glimpse beneath the surface of WTO policy-making (courtesy especially of leaked documents), we find evidence of a far broader circle of consent than that formed in Washington, DC. As our discussion has shown, neoliberal policy became evident in the mid-1970s when Washington was controlled by the Nixon and Ford Republican administrations, and was solidified (in the sense of being codified into the Washington Consensus) in the 1980s, under the Reagan and (first) Bush Republican administrations. Some of the key players making policy at the time were:

- William E. Simon, deputy secretary and later secretary of the Treasury in the Nixon and Ford administrations, US governor of the IMF and the World Bank, the Inter-American Development Bank and the Asian Development Bank. Simon had previously been

a partner at Salomon Brothers, a prominent Wall Street investment banking firm, and was active in the Investment Bankers Association of America.

- James A. Baker III, secretary of the Treasury in the Reagan administration between 1985 and 1988, previously with the Houston, Texas, law firm of Andrews and Kurth from 1957 to 1975 and, after public service, senior partner in the law firm of Baker and Botts and senior counselor to the Carlyle Group, a private global investment firm.
- Richard Darman, assistant secretary of commerce for policy in the Ford administration and deputy secretary of the Treasury (1985–87) in the Reagan administration. Darmon was a graduate of the Harvard Business School and had been a partner and managing director of the Carlyle Group and managing director of Shearson Lehman Brothers, a Wall Street investment banking firm. After public service he returned to the Harvard University Kennedy School of Government in 1998, where he had previously been a lecturer from 1977 to 1980.
- Nicholas F. Brady, appointed secretary of the Treasury by President Reagan in 1988, and continuing in office throughout the Bush administration, was former chairman of the New York investment banking firm Dillon, Read and Co.
- David Mulford, under-secretary for international affairs, and senior international economic policy official at the US Treasury under Secretaries Regan, Baker and Brady, was a lead actor in Republican administrations' international debt strategy and was formative in the development and implementation of the Baker and Brady Plans. He had been managing director and head of international finance at White, Weld & Co., an investment banking firm. After public service he became vice-chairman of Credit Suisse First Boston and a member of the executive board.

This pattern continued in the Clinton Democratic administration of 1992–2000, with the main players being:

- Robert E. Rubin, secretary of the Treasury for much of the Clinton administration and previously co-senior partner and co-chairman of Goldman Sachs and Company, a Wall Street investment banking firm. After public service Rubin became a director at Citigroup Inc., a New York commercial bank, and a member of the Citigroup Management Committee. Citigroup owns Citibank,

a commercial New York bank, and Salomon Smith Barney, an investment services company, together with insurance companies and many other financial service corporations.

- Lawrence H. Summers, who followed Rubin as secretary of the Treasury, had been president of development economics and chief economist of the World Bank. Previously he was professor of political economy at Harvard, to which he returned as controversial university president in 2001.

In terms of the backgrounds and private sector affiliations of the key players, in terms of the knowledge and expertise that they brought to bear and, more controversially, in terms of the interests they served, the 'Washington Consensus' might more accurately be described as the Washington–Wall Street Alliance, an institutional complex centered on the US Treasury Department, the IMF and the World Bank, with an intellectual offshoot to Harvard University and MIT, particularly the Harvard Business School, whose MBA, doctoral and executive education programs train the corporate and banking elites, but with the leading role being played by Wall Street bankers, especially investment bankers.

Investment banking is a specialized part of the US banking industry, created by the Bank Act of 1933, more commonly known as the Glass–Steagall Act. The Act was supposed to separate the banking and securities businesses and led to a division between commercial banking, taking deposits and issuing short-term loans, and investment banking, concerned with corporate finance (advice on raising capital by issuing stocks and bonds and marketing them on Wall Street), corporate mergers and acquisitions, arbitrage (buying and selling in world commodity and currency markets), underwriting and dealing in corporate and other securities – the most important part for our purposes is that the investment bankers deal in long-term loans. The largest investment banking concerns were: Salomon Smith Barney; Merrill Lynch, Goldman, Sachs; Morgan Stanley-Dean Witter; and Shearson Lehman Brothers. Since the repeal of Glass–Steagall in 1999, commercial banks, such as Chase Manhattan Corporation and Citibank, have developed, or acquired, investment banking facilities, as well as a range of insurance and stock brokerage services, to produce the largest financial conglomerates in the world – indeed, the most powerful corporate institutions in the world in terms of capital controlled. In the crisis of 2008 the investment banks folded, were absorbed

into commercial banks, or became commercial banks. Banking is an 'economic interest' combining two particular concerns: the banking interest directly, in terms of the practical necessity of conserving control over capital stocks placed with bankers to earn interest; and the corporate interest more generally as bankers advise and represent their corporate clients in return for fees of up to $100 million a year, with the banker-brokers rewarding corporate CEOs with IPOs (Initial Public Offerings of stocks) that are worth millions.

Adding the Wall Street connection, meaning the banking and securities businesses, to the Washington Consensus, meaning the political and bureaucratic apparatuses, enables a more revealing analysis of the power of policy practicality. For example, it enables us to understand why well-meaning presidents of the World Bank, like James Wolfensohn, persisted in practicing pernicious policies. Private financial interests, especially investment banking, acting most forcefully through the US Treasury Department, as well as through direct consultation, and deriving ideas and talent from the elite universities, have greatly influenced, even determined, the formation of policy in the IMF–World Bank–WTO governance complex. (For example, at the September 2002 meetings of the IMF and World Bank 'international bankers, investment executives and other financial specialists attended a gathering a few blocks away from the official meetings' at the Institute of International Finance, an encounter described by Klaus Friedrich, an advisor to Allianz-Gruppe/Dresdner Bank of Germany, as 'a lot of bankers with problems in their briefcases' – Blustein 2002c.) These financial interests prevent serious consideration of alternative policy directions through their control over expertise and their underlying command of capital. If we re-read the 'Washington Consensus' policies from the bankers' perspective, we can see that minimizing state spending, increasing competitiveness, securing property rights (including those of foreign companies), export-orienting economies to produce hard currency, all maximize the loan capacity of 'developing countries' and ensure, to the fullest extent possible, the ability of an economy to repay principal and interest. I am not, on the whole, suggesting some kind of cynical conspiracy by bankers and multinationals to create puppet economic regimes, despite the evidence that meetings recur among banking and governmental allies. And I recognize that once appointed to bureaucratic positions, bankers have considerable freedom to interpret what remains, however, the banking point of view. But an export-oriented, privately controlled, market economy *is* the

banker's conception of the good economy, even when considered in terms of the more general common good.

The problem is that this notion of a 'sound economy' does not sound too commonly good to those about to be made unemployed, cut off from public services, and paying exorbitant prices for water, electricity and other privatized services. And the notion that a 'sound economy' formed in this way will be good for everyone in the future is a matter of faith that shows every sign of rebounding, as financial capitalism comes into mounting crisis in 2007 and 2008. The Washington–Wall Street alliance has established, protected and reinforced a neoliberal policy regime that served to deregulate the world economy (in terms of national state intervention), freeing the way for global, and particularly US, corporations, the trading of industrial commodities without interference, and the movement of capital assets across national boundaries that have been reduced in significance. Rather than a 'sound' global system, the result is a wild economy of colliding interests, speculation and losses beyond the control of any particular interest or institution (see Chapter 6).

Here I must raise the most difficult question of all – what about 'The Market'? Saying that Wall Street is the most powerful actor in setting the policy model used by global governance to discipline countries the world over implies a more conscious collective actor than is actually the case. The central 'institutions' of Wall Street are the equity and bond markets, and these no one controls. While financial analysts may objectively 'study the numbers' in evaluating whether to invest client capital in bonds issued by a country or the corporations of a country, the decision is rendered into a subjective judgment by Keynes's uncertainty about the future, when the bonds will be repaid. George Soros, who knows more than most as head of the Quantum Fund, 'the best performing investment fund in history,' says of financial markets:

> Each market participant is faced with the task of putting a present value on a future course of events, but that course is contingent on the present values that all market participants taken together attribute to it. That is why market participants are obliged to rely on an element of judgment. The important feature of bias is that it is not purely passive: It affects the course of events that it is supposed to reflect. This active ingredient is missing from the concept of equilibrium employed by economic theory. (Soros 1998: 47)

The international financial market, then, is a meeting point where biases collide and where speculative subjectivities interact. The collision of uncertainties on the market determines the economic fate of nation-states and the global economy. As John Gray says: 'National governments find themselves in environments not merely of risk but of radical uncertainty … governments often cannot know whether the response of world markets to their policies will be merely to make them costly or to render them completely unworkable' (Gray 1998: 74–5). This is the model that the IMF wants to expand by further freeing capital markets from national controls? This is the best that 'economic science' has been able to imagine for determining the livelihoods of billions of people? This is the organizational matrix of the finest civilization ever known? No. This is the system that has plunged the global economy into financial crisis.

Hegemony and policy discourse

Professional economists subscribe with surprising frequency, in these days of social theoretic sophistication, to the view that policy prescriptions derive from a logically exact, mathematical economic science backed by quantifiable, truthful, empirical evidence. Even reworked as neoliberalism, neoclassicism is better than Keynesianism, because it has been proved to be the case. Yet there are many Keynesians with fine academic credentials, whose ideas are taken seriously even in conventional policy circles – Paul Krugman, columnist for the *New York Times*, for instance, or the Nobel Prize-winning Joseph Stiglitz, formerly chief economist at the World Bank. And the historical evidence, examined carefully, suggests that state intervention produces both economic growth and social development – see, for example, Robert Wade's (1990) 'governed market' theory of East Asian industrialization. Once the notion that policy derives from scientific truth has been treated with a healthy dose of skepticism, the need arises for a different approach to the analysis of economic policy formation, one emphasizing context, power and political interest. In this contrary view, economic theories are seen as symbolizing political interests and ideals, rather than deriving from the neutral findings of an exact social science. Even more, economic policies are seen as cultural and political statements that claim power by cross-dressing in the legitimizing garb of science. In brief, economic policy analysis is a cultural, political and social endeavor, rather than a study of the application of proven, scientific truth.

When big corporations pay millions of dollars to political parties in return for the promise of access to the president, they do so in the expectation that their donations will influence future governmental policy. Money buys influence, especially on policy. In this sense, any critical understanding of policy formation has to begin with the basic notion that policy serves economic and social interests. Here the most useful connection between interest and policy is the Marxian term 'ideology.' For Marxists, a dominant social power, conceptualized as a class, naturalizes and universalizes beliefs and values that are congenial to its interests. That is, statements are made by power interests in order to have politically legitimizing effects in the face of opposing interests (Eagleton 1991: ch. 1). But while the notion of interests begins an analysis, this crucial insight is insufficient. It has to be amended, by Antonio Gramsci's notions of civil society and hegemony. With Gramsci 'civil society' is a system of social and cultural institutions (family, Church, schools, and so on) outside, and parallel to, the state in a broad conception of 'civil and political superstructure.' Gramsci believed that ideological hegemony was established mainly by civil rather than state institutions. In this formulation, hegemony is a conception of reality, spread by civic institutions, that informs values, customs and spiritual ideals, inducing, in all strata of society, 'spontaneous' consent to the status quo. Hegemony is a world view, so thoroughly diffused that it becomes, when internalized, 'common sense.' Gramsci seems to include in this 'sense' the formation of economic behavior in civil society: 'Every social form has its homo economicus' (Gramsci 1971: 208). So Gramsci (ibid.: 412–13) saw economic rationality responding to material necessity by constituting a complex of convictions and beliefs, from which concrete goals were proposed to collective consciousness. This brief review of Gramsci moves the analysis from the ideological level – the socio-political production of *what* people think – to the hegemonic level – the sociocultural production of the *way* people think.

With my present concern about policy, however, I am interested in a particularly formalized system of producing good economic sense. This is an area of cultural-political production inhabited by highly trained, experienced individuals – 'experts' – and well-established, abundantly financed institutions – government departments, think tanks, banking associations, and the like. The entire social process of high-level institutionalized thinking, and the cultural process of producing insightful (but limited) ideas, employs a certain kind of

symbolic representation for which even the Gramscian term 'common' sense is insufficient. While thinking may begin at the common-sense level, and return to it when policies are explained by 'spokespersons' to the 'general public,' the intermediate stage of theorization and policy formation takes place at a different, theoretical order of symbolization – theories being experientially based, but highly rationalized, dense statements. On to a Marxian–Gramscian base we might therefore graft Michel Foucault's notion of 'discourse.' Foucault (1972, 1973) was particularly interested in the careful, rationalized, organized statements made by experts – what he called 'discourses.' In *The Archaeology of Knowledge* (1972) Foucault saw the human sciences as autonomous, rule-governed systems of discourse. Within these discourses, Foucault claimed to discover a previously unnoticed type of linguistic function, the 'serious speech act,' or statements with validation procedures made within communities of experts (Dreyfus and Rabinow 1983: 45–7). At the other end of the scale serious speech acts exhibited regularities in what Foucault called 'discursive formations.' Discursive formations had internal systems of rules determining what was said, about which things. Discourses had systematic structures that could be analyzed archaeologically (identifying their main elements and the relations that formed statements into wholes) and genealogically (how discourses were formed by institutions of power). We take from this the notion that discourses are carefully rationalized, organized systems of statements, backed by recognized validation procedures, bound into formations by communities of experts. Discourses assume, as one, particularly significant propositional form, the shape of economic policies suggested by experts to governing bodies. In other words, hegemony in the policy arena is theoretically backed, political and economic good sense produced by experts in the symbolic form of discourses.

Thinking in this Gramscian–Foucauldian way, economic policy does not come from science's ability to mirror social reality in a structure of truthful statements called exact theories. Instead, policy is socially produced by a community of experts who agree, more by convention or political persuasion than factual backing, to call a certain type of thinking and speaking 'rational.' Briefly returning to Foucault (1980), calling a certain proposal to organize an economy 'rational,' 'efficient,' 'optimal' or even 'sound' is a way of claiming power, and such terms place the reputation of science behind what is really just one, class-biased, opinionated way of thinking.

Furthermore, once a claim to rationality (or optimality, etc.) has been widely accepted, once a group of experts is deemed to speak the truth, further discussion is limited to a narrow range of economic topics (e.g. growth), thought with a prescribed set of theories (e.g. neoclassical economics), using a prescribed set of terms (e.g. equilibrium). Within this narrow thought system, formal analysis uses an intellectual code that specifies approved categories and terms. Simply using these terms restricts what can be thought, said and imagined. That is, the depth of hegemony resides in the ability of a discursive formation to specify the parameters of the practical, the realistic and the sensible among a group of theoreticians, political practitioners and policy-makers. A discourse operates negatively by producing and enforcing silences on disapproved topics, terms and approaches. I propose that positive reinforcement and negative compulsions of silence are concentrated in 'restrictive discursive spaces' – places where insider status is paramount, where only one discourse is effectively permitted, where critical discussion is limited to variants of a given discourse, where other positions are disciplined as irresponsible, and where using a different discursive terminology means that real critics are simply not heard. I regard these as places characterized by an arrogance of expert power.

The crucial part of this limitation on thought and expression is the institutional production of what might be called a 'practicality,' by which I mean a social sense of the content and boundaries of the pragmatic. That is, in the present case, the appropriate policy response to a given economic situation comes from a limited set of theories and range of alternatives that is socially, institutionally designated as 'practical.' This practical position, established by consensus among experts – who agree in general, while often disagreeing on particulars – draws on its extremes, inevitability and optimality, depending on the severity of the crisis that is faced. So a sense of 'inevitability' backs policy in the most politically contested situations – 'there is no alternative' or 'TINA' – while optimality backs practicality in less compelling circumstances – 'this is the best of all possible worlds.' A social sense of practicality precludes serious consideration of (theoretical and policy) alternatives by producing an ambiance of sober responsibility. 'Responsible spokespersons' operate only within its strictures using code words that, designating insider status, make other positions unrespectable – think of Henry Kissinger invoking 'the national interest' and you will get what I mean. In all

this, the trick lies in converting a politics, which represents a distinct class interest, and consists essentially of a set of opinions, into a practicality that appears to come from theory, and seems to express the common, rather than the partial, good. Phrasing this differently, if a little densely, the politics of hegemonic policy-making takes the form of the conquest of the common sense of practicality by a committed expertise.

There are, of course, competing tendencies within a hegemonic expertise, each responding to a somewhat different interest, with its own politics of interpretation, based on a variant of the dominant political belief. In terms of the formation of economic policy by the state, three groups of experts holding somewhat different versions of an overall prevailing view seem to be important:

1 conventional, talented theorists in the elite universities, especially those attended by future elites – the *ideological interest*;
2 key players outside the state apparatuses, but linked through exchanges of personnel, through frequent consultations, and other discursive mechanisms – in the main, the *economic interest*;
3 elected heads of state (president or prime minister) and the appointees controlling key state agencies, as with the Treasury or State Departments in the USA, together with the civil servants staffing government agencies, especially the upper echelons where policy is debated – I call this the *political interest*.

Competing tendencies among these interests create instabilities within the most established policy hegemony. Yet, at any time, a small number of leading political ideals expressed by key personalities establish the new styles that keep a policy discourse fresh. They employ persuasive new vocabularies, using innovative terms, even an archetypal aesthetic in the design and expression of the ideas they present, which come to permeate an entire hegemonic complex, with no small part of the motivational drive coming from interpersonal competition for reputation, power, status and consultancy fees. At the same time a power complex has its concentrated weak spot, often its institution of conscience, that serves to legitimize a hegemony by displaying sympathy, but can turn toward real conscience in times of crisis in a discursive formation.

Discourses with hegemonic depth originate in a few power centers where only a limited set of ideas are allowed 'responsible' presentation and elaboration. In analyzing these spaces, the clusters of economic

and political institutions that carry out the production and legitimization of theories, and the dissemination of policy prescriptions, are the crucial agents. Policy discourses are invested with power by the wealth and might of the geographical place of their intellectual origin and their most conspicuous application. In Western modernity the dominant centers of discourse production are embedded in the cultural region of the formation of scientific rationality (Peet 2000, 2007). Following a Weberian conception of the space of rationality, the centers of modern power are dominantly located in Protestant western Europe and North America, symbolized by the two Cambridges, in England and New England, home to the finest institutions of knowledge production in the anglicized world. The organized, systematized ideas behind an economic discourse often originate in theories or ideas 'floated' in the public arena by academics in the elite institutions embedded in this culture region – usually the elite universities, with large endowments stemming from long-established capital accumulations, collections of the world's finest intellects, whose very density lends 'truth effects' even to casual statements. Professionals from the academic world, especially the leading universities, and particularly the leading law departments, business schools, economics departments and the well-funded research institutes, carry policy discourses directly into the state when they are appointed to head government departments. The choice by an incoming administration of an academic to become part of the state – for example, serving a term as deputy secretary in the US Treasury Department – is partly determined by academic status and reputation. But the decision tends to be more directly motivated by political adherence tempered by ability – that is, the academic's ability to translate a political position into the technical terms of a policy document. Elite academia also trains the personnel staffing the upper reaches of political and economic bureaucracies. Thus academia serves as source of theory, domain of policy formation, provider of committed expertise and trainer of personnel.

The ideas behind a policy discourse also emerge more directly, however, and perhaps more forcefully, from economic activity as interpreted especially by business and financial elites. Here the discourse is more practical than theoretical, while power rests not so much on intellectual foundations as on control over wealth, capital accumulation, and technical expertise flowing from crucial positions in the economy – banking, for instance. Depending on the degree of

ideological sophistication, ideas flowing from highly committed interpretations of commercial practice are rephrased into universalistic value formats, by business associations, chambers of commerce and specialized institutes and similar elite economic organizations – there is a link here with the complex of elite law firms and specialized lobbyists representing business interests that cluster around centers of political power to 'mold the democratic process.' Increasingly, as market relations penetrate cultural production, economic discourses supporting business interests are conceived on contract by researchers working in 'think tanks' financed by grants from (often conservative) corporations. Indeed, wealth can produce its own 'science' by hiring consultants, sidelining studies that do not conform and widely publicizing those that do. Ideas and personnel continually move among business, academic, and quasi-academic institutions and the higher reaches of governmental bureaucracies, especially the treasuries and departments of finance, where real state economic power resides.

Some of the ideas propagated by academic and institutional agents, and processed into policies, are picked up by the information media – especially, in the economic case, the business sections of respectable, national and international newspapers, economic dailies or weeklies, popular magazines, news and commentary shows on television and radio (so powerful now that they form their own interest group with autonomy from the rest of the business world). For example, the nightly news carries brief sound bites from a small circle of 'responsible' think-tank experts that serve to anchor stories in 'the truth.' The media comment on policy from the perspective of their own economic interest as big corporations, but also help decide among competing policy directions by responding 'on behalf of' public opinion. Here we find the clearest links with commodification and the advertising revenues that underwrite the apparent neutrality of 'all the news that's fit to print' (or more cynically 'all the news that's fit to surround advertisements'), although my claim is that the entire discursive process, from ideological conceptualization to policy implementation, is structured by class, gender and ethnic power interests.

These ideas are formed into practical policy in political power centers, where government and governance institutions cluster, and high-powered experts endlessly 'circulate.' These centers of global power are exclusively cities in Western capitalist countries: either the capitals of leading national powers, overwhelmingly New York (for example, the United Nations) and Washington, DC (the International

Monetary Fund and the World Bank), or definitely Western, but officially neutral, political spaces, as with Geneva, Switzerland (the World Trade Organization and many UN agencies). So in terms of its geography, 'global' has come to mean the spatial expansion of the field of the exercise of power accompanied by the spatial concentration of control in a few Western cities. In the twin terms of class and space, a few thousand people, clustered in a small space, control the lives of billions of others, the world over.

The regulatory space, or hegemonic extent, of a dominant theoretical and policy discourse comes from its ability to persuade or coerce institutions of power across broad swathes of territory, where policy practices might otherwise be conditioned by narratives, discourses and theories deriving from greatly different interpretive traditions applied to diverse regional experiences and varying needs – for example, basic needs in developing countries as compared with wants and desires in developed countries. Discourses produced in these centers of power achieve hegemonic extent by exerting discipline (persuasion, coercion and the power of practicality) over spatial fields of influence – in this way they become 'globally hegemonic discourses.' The boundaries of a global hegemony are extended and reinforced by a series of formal-institutional mechanisms. Political/military interventions enforce adherence at times of crisis, when competing hegemonies collide in geopolitical space. Cultural/media systems are particularly adept at extending the boundaries of possibility for economic domination. Hegemonies are mostly policed by policy means, as when structural adjustment forces borrowing countries to adopt hegemonic models of economic growth. Hierarchies of centers of persuasion organize spatial flows of policy discourse that result in a series of articulations between universal and regional discursive formations. These diverse articulations, between the global and the local, can be described using a set of geopolitical terms that combine the political-discursive-rational dimension with the geographical-organizational-power dimension. So hegemony takes the following geopolitical forms: the dominant hegemony, produced in leading cultural-political-economic centers of symbolic production – I will argue that these are located in financial rather than political capitals; the sub-hegemonies yielded by processes of translation as dominant hegemonies are imposed in modified formats in relation to the contexts provided by local circumstances; the global hegemony produced through relatively stable correspondences among a hegemony and its various sub-hegemonies; and counter-

hegemonies that confront both global hegemony *in toto*, and its various sub-hegemonic forms (Peet 2002, 2007).

Counter-hegemony

Globally hegemonic discourses are confronted in the peripheries by alternative conceptions deriving more directly from the experiences of oppressed peoples. As the Marxist cultural theorist Raymond Williams insisted, 'the hegemonic' is neither total nor exclusive. Rather oppositional cultures continue to exist. For Williams (1977: 125), these alternatives may be 'residual' – based on experiences lived in the cultures of previous social formations; or 'emergent' – in the sense of the creation of new meanings and values, new significances and experiences, that are not fully incorporated into the dominant. Even with intensive globalization, different spaces exist in discontinuous time sequences, so that oppositional groups contend with the residues of dominations discarded elsewhere or, more realistically, long integrated into synthetic, new kinds of domination – contentions with feudal social formations, for instance. Continuing exclusion from material benefits is the main experiential base projecting residual resentments into emergent alternatives as fully fledged counter-hegemonies. Intellectuals marked by class, ethnic or gender difference often serve as spokespersons for what otherwise can amount to sullen resistance, or defiance phrased in narrative forms restricted to a local culture. These intellectuals have their own bases in alternative power complexes, situated around social movements or unions, and often represented locally and internationally by non-governmental organizations (NGOs), different in that they employ more informal media of thought, discussion and dissemination. Sometimes counter-hegemonic formations receive limited financial backing from liberal funding sources in the center. They have their own media outlets, both directly, as with committed, leftist publishers, or (more precariously) indirectly, as with conventional media that see profit potential in the residues of the real expressed by protest movements.

In the process of translation, as radical academics or liberal professionals translate emotion, anger, poems, songs, testimonies and assertions based in residual resentment into rationalized policy prescriptions, press releases, books and lots of scholarly articles that represent emergent counter-hegemonic discourses, some degree of disciplining is inevitable. The very process of translation from popular narrative into formal discourse is part of what might more

generally be termed 'colonization' – the tendency for the hegemonic to penetrate and control the counter-hegemonic. Translation nearly always involves reimagining local grievances, and ideas for solutions based in interpretations of local experience, in terms of outcomes already intellectualized in the various liberal, social democratic and socialist traditions that formed the oppositional counter-hegemonies in the established centers of Western critical thought. Important too is intellectual capturing, especially of the radical academic mind, by grants, institutional recognition, media coverage, Western championing and invitations to visit Harvard for a corrupting while. The uneasy articulations between sub- and counter-hegemonies yield ranges of contradictory locations, hybrids that result in sudden shifts of allegiance as contexts, opportunities and life choices change. Contestations between the hegemonic and the counter-hegemonic are, however, still punctuated by episodes of violence, with riots that leave bodies dead on the streets. This is because counter-hegemonic discourses more fundamentally derive their persuasive powers from the collective wills of oppressed peoples, from the experiences of the poor and downtrodden, from pangs of hunger and the cries of sick children, from the loss of respect in the death of a culture. It is on behalf of the dispossessed at the margins that acts of spectacular violence penetrate into the heart of hegemony.

The rest of the book

This book uses ideas of power, political interest, hegemony, discourse, responsibility and the power of practicality to examine critically three global governance institutions: the International Monetary Fund (IMF), the World Bank and the World Trade Organization (WTO). All three institutions play roles greatly different from those originally agreed under the charters that set them up. Indeed, we argue that a shifting stance with regard to governance is inevitable, because there lies at the heart of the present policy regime a contradiction that constantly threatens to rupture its hegemonic order. All three govern an economy that their neoliberal ideology insists is best left institutionally ungoverned. This contradictory position leaves global governance open to diverse but powerful criticisms. From the right, and largely within hegemony, more extreme versions of neoliberalism insist that economic problems are best left for self-adjusting, free markets to solve. From conservative allies comes the criticism that private associations can better solve economic problems. From

the nationalists they hear the refrain of global totalitarianism. From democrats they learn that no one elects them. From the counter-hegemonic left they are assaulted for the policies they impose on victim peoples. What's an institution to do? In what follows, we take a historical approach to critical understanding, believing that the policies presently followed by these three institutions derive from a considerable record of experiments, retreats, reassertions and yet the overall accumulation of power and influence. All three have achieved positions of seeming permanence by assuming a stance that combines institutional rigidity with procedural fluidity. Or, to put it more critically, and referring especially to recent years, all three have learned that a little spin and some confessions of partial failure ('we have a lot to learn') excuse many abuses in the exercise of power.

Chapter 2 looks at the political and economic conditions that made possible the Bretton Woods conference setting up the IMF and the World Bank. The chapter deals with two types of conditions: the conditions of political economic reality dominated by the decline of British geopolitical domination, the exigencies of the Great Depression and the rise to world power of the United States; and the conditions of economic theory, especially the breaking of the sanctity of the classical–neoclassical paradigm and the rise of the Keynesian amendment. These two great changes intersected in the formation of a kind of global Keynesian club, the Bretton Woods institutions, the international financial institutions (IFIs) designed to regulate international economic relations in such a way that the world would never again suffer the threat of total disruption. The institutional framework of the new global hegemony might seem to have come from consultation and discussion among equal-member nation-states. The historical reality is quite different. Of all the 'great powers' the USA had been most averse to being ruled by anything resembling an independent institution. So the chapter records, in some detail, how the USA came to dominate the post-war international economic agenda. The IMF and the World Bank, the chapter argues, were set up as US-dominated institutions, as collectivist fronts for US international economic policy – arms, some might say, of a new world order characterized by a more subtle, effective imperialism.

Chapter 3 reconstructs the history of the IMF, the more powerful of the two Bretton Woods institutions. The IMF was originally concerned with exchange rates and balance of payments loans, important but relatively uncontroversial aspects of international financial regulation.

IMF short-term loans were at first used mainly by the same circle of industrial economies that had dominated the institution's founding. The IMF shifted in the mid-1970s to a more interventionist stance in which loans were granted under conditions of greater austerity increasingly to Third World countries. Loan 'conditionality,' I suggest, was based on a particular, ideological conception of how countries achieve economic growth. This conception, in turn, was formulated by right-wing politicians and bureaucrats operating mainly through the US Treasury in a series of Republican administrations in the 1970s and 1980s. The results of neoliberal conditionality, together with other related policy moves, such as capital account liberalization, have been disastrous for working people. Discontent beginning as food riots has escalated into massive popular protests whenever the Fund tries to convene. In response, the IMF has superimposed a veneer of concern on its base of austerity, in the forms of debt relief, anti-poverty programs and public participation. Critical analyses suggest that these are more spin than substance. The chapter concludes by noting the significant decline in the power of the IMF in the years since its mishandling of the East Asian crisis.

Chapter 4 recounts the tragic loss of the potential inherent in what became a global development bank. The World Bank's early, limited role was as minor actor in the reconstruction of a war-torn Europe – as the International Bank for Reconstruction and Development. In the 1950s the institution's focus shifted toward project lending in the richer Third World countries. But in the 1960s and 1970s, with the formation of the International Development Association under Bank auspices, and at a time of social upheaval and transformative political possibilities, poverty alleviation and rural development under a basic-needs strategy became the Bank's main preoccupation. While this sounded better in developmental rhetoric than it resulted in policy practice, the real tragedy for the World Bank did not arrive until the later 1970s. Faced with a distinct rightward shift in political conditions, the Bank became involved in structural adjustment employing neoliberal policies, increasingly in concert with the IMF. The Bank also came under increasing criticism for the carelessness of its project lending and for the damage done too by its broader structural lending. So far the Bank's reaction, in terms of public participation and liberal reform of policy, has again been superficial. Yet the World Bank is the conscience of the international governance structure and also its weak spot, mistrusted by the right, lamented

by the left. It too has gone through crisis in recent years, although so far it has been saved by adding to the smily face of its conscience responsibility for adjudicating whether the Millennium Development Goals are being reached.

Chapter 5 presents a brief history of the political, economic and ideological conditions behind the initial formation of the GATT. It summarizes the various rounds of subsequent GATT meetings culminating in the Uruguay Round, signed at a ministerial meeting in Marrakesh in 1994, which greatly expanded the scope of trade agreements, and formed the WTO. The chapter examines the organizational structure of the WTO as administrator of what became a complex set of institutional procedures governing international trade. We then subject the WTO to sustained critical interrogation: its trade policy review mechanism is examined as an instrument of neoliberal discipline in a restrictive discursive space; its dispute settlement record is perused to see whether free trade is consistently preferred over environmental regulation; its attitudes toward labor are surveyed to detect class biases; and its TRIPs agreement is analyzed to see the potential cornering of ideas by multinational corporations. The chapter then looks at the various kinds of opposition to the WTO, with an emphasis on the eruption of protest in Seattle, 1999. It concludes with an overall, critical assessment of the WTO, also an institution in crisis to the degree that its main decision-making body, the Ministerial Conference, can scarcely meet anymore.

Chapter 6 places the current problems encountered by the three institutions in the context of the more general crisis of capitalism. The chapter argues that global finance capitalism is a new social formation replacing corporate industrial capitalism in the late twentieth century. It results from a massive redirection of income flows toward the rich that occurs under the presently prevailing neoliberal policy regime. The chapter provides what might be called a socio-psychology of contemporary finance, particularly its systemic drive toward risk-taking and speculation that led to the crisis of 2007/08. But even mad, speculative societies have a conscience, and this is expressed in a global anti-poverty discourse that forms a conspicuous part of the global financial system, including the international financial institutions that form the focus of this book. A corrupt economic system necessarily means, however, that expressions of benevolence turn into anti-poverty policies characterized more by 'bene*violence*.' Policies directed by the IFIs aimed apparently at forgiving Third World

debts and 'ending poverty now' result in the opposite – inclusion in a global economy riddled with impossible levels of debt and, if anything, higher levels of debt and increasing insecurity. We look at the destabilization of an unraveling ideological hegemony in times of rising crisis and counterpose some alternative principles that might guide a revitalized movement for global justice.

TWO

Bretton Woods: emergence of a global economic regime

While the world was still engaged in the Second World War, forty-four nations, led by the USA and the UK, met at Bretton Woods, New Hampshire, on 1–22 July 1944, to discuss economic plans for the post-war peace. Governing the international economy was an idea made possible by the anarchy of the inter-war period. In reaction, governments sought to secure world peace and prosperity through international economic cooperation. Such cooperation would be based on a world market, in which capital and goods might move freely, regulated by global institutions operating in the general interests of greater stability and predictability. Three regulatory institutions were envisaged: the IMF, the International Bank for Reconstruction and Development (IBRD, later known as the World Bank), and an International Trade Organization (ITO), which came into being only as the General Agreement on Tariffs and Trade (GATT), but much later became the WTO. The IMF and IBRD were formalized as organizations during the Bretton Woods conference, while the proposal for an ITO was part of a separate Havana Charter of 1947.

This chapter looks at three aspects of the emergence of the new global economic accord. First I look at the political and economic conditions prevailing in the West between the late nineteenth century and the middle of the twentieth, the idea being to contextualize expressions of collective concern about the capitalist economy that led to Bretton Woods. Second, I outline the economic perspectives dominant at the time, from the intersection of which Bretton Woods policies emerged as a governance system for a world in crisis. Third, I look at the political economy of the conference itself, and the Bretton Woods model that resulted. Needless to say, these three lines are intertwined. My approach is historical-interpretive and historical-constructive. For the most part I accept the universalistic discourse composed of statements of international accord that were used to justify the formation of the Bretton Woods regime. Only at the end of the chapter do I interpret these statements more critically, the aim

being not merely to show how the Bretton Woods institutions came into being but, more importantly (for that tale has been told before), how the geopolitical conditions of global hegemony changed, and how the discourses that responded to a capitalist world in crisis at the time 'constructed' the post-war international economic regime.

In describing the global system planned at the conference, several authors whose work I respect use the term 'regime,' as in the phrase 'Bretton Woods regime.' International regimes, in this conception, are the sets of rules and conventions governing relations among nations (Cooper 1975: 64). Or, in Ruggie's (1982: 380) view, regimes are 'social institutions around which actor expectations converge in a given area of international relations.' In this perspective, international regimes legitimize the policies and obligations of actor states with regard to a global order. They are concrete forms of the 'internationalization of political authority' – with 'authority' understood, in Max Weber's sense, as resting on a 'form of legitimacy' that derives from a 'community of interests' (ibid.). I prefer the term regime to 'system' or 'order,' two other terms often used, as the arrangements made were sometimes neither systematic nor orderly (Cooper 1975). I find the ideas of regime, communities of interest and forms of legitimacy compatible with our own terms 'hegemony' and 'discourse.'

Political-economic context

What we now call modern 'globalization' – an intense interchange of people, ideas, capital and technology across international space – came into existence during the Pax Britannica, roughly between 1875 and 1914. This was a period of relative peace in which liberal consciousness, with its faith in the natural progress of reason, rationality and the rule of law, combined with an assumption of racial superiority to justify European economic and political domination of large parts of the non-industrialized world. This world was tied together politically by imperialism and economically by trade, investment and flows of technology. In the fifty years preceding the First World War, global exports rose from $550 million to $19.8 billion; the value of world trade rose by an average of 34 percent per decade; and its volume rose by 36–37 percent each decade (Eckes 1975: 2). Most trade remained inter-European, with the colonies serving mainly as sources of raw materials.

International monetary exchanges at this time were based on the gold standard. The rules were simple: each national currency (the

amount of money in circulation) was backed by a quantity of gold held by the country's central bank. Currencies were, at least theoretically, freely convertible into gold, which was allowed to cross borders without restrictions. Under these conditions, in Eckes's (ibid.: 5) sparse words, 'trade-and-payments imbalances induced gold transfers, and gold flows automatically altered internal prices and incomes so as to restore payments equilibrium.' The economic system prior to the First World War was considered 'free' in the sense of being self-regulating, with 'natural' flows of money and capital. Britain was the dominant industrial and mercantile power. Its economy was completely intertwined with the world economy. Britain was the largest exporter of industrial products, financial capital and commercial and transport services, while forming the main market for agricultural goods. Britain sustained the international economy by paying for its surplus of imports from its 'invisible' financial and commercial services and overseas investments (Hobsbawm 1987). As the central importer, Britain provided other countries with a means of earning sterling (pounds – originally of silver) that served as the global currency.

On the eve of the First World War, Britain lost clear political and military superiority in relation to France, Germany and Russia. Contradictions surfaced between an increasingly hostile international political environment and an increasingly integrated international economy centered still on Britain. Meeting at Versailles after the First World War, the victorious Allies were mainly concerned with the political environment – issues such as national boundaries, colonies, security and indemnity. The economic environment, as with currency or trade issues, was hardly discussed. US President Woodrow Wilson said, on his way to Versailles, that he was 'not much interested in the economic questions' (Eckes 1975: 9). Faith was preserved in the classical economic liberalism of Adam Smith, in which the self-regulating market tended toward a socially acceptable equilibrium without explicit governmental intervention. The growing complexity of industrial society – characterized by organized labor, the beginnings of social welfare programs and intricate taxation systems – and the complications of the growing interrelations between national societies could only confound those faithful to classical economics beliefs.

Governments assumed that by reverting to the pre-war gold standard, business would simply continue as usual. Yet in the years immediately following the war, the capitalist world economy entered

a really difficult time. State treasuries were burdened by the cost of the war, which had far exceeded expectations. Moreover, Britain could no longer maintain a position at the center of the international economy. With laissez-faire economic policy, and the apparent detachment of politics from economics, came another dissociation, that of domestic economies from international economies. At times of crisis especially, countries sought to protect domestic production regardless of the effect on other countries ('beggar my neighbour' attitudes). Furthermore, during the war, the gold standard and currency convertibility, which regulated the price structures of independent markets, had been suspended. To mobilize domestic economies, governments printed inconvertible paper money, depreciating the values of national currencies. This resulted sporadically in massive inflation and unemployment.

Then, in October 1929, the prices of basic foodstuffs and materials lost between two-thirds and three-quarters of their value, undermining the already tenuous economies of every country linked with the liberal international regime. Between 1932 and 1933 unemployment in the USA reached 27 percent, and in Germany 44 percent (Hobsbawm 1994: 91–3). Unemployment and union activity were seen as internal threats with the potential for undermining social normality, stability, peace and what little economic prosperity remained. At the same time, and in contrast to the failing economic liberalism of the Western countries, the USSR was rapidly industrializing. Its state-planned economy seemed immune to the crises plaguing capitalist nations. Communism was seen by many working-class people as a viable alternative. Soon, fascism would present another alternative. By comparison the various capitalist countries reacted to international crisis nationalistically by devaluing their currencies, and thereby increasing their (cheaper) exports, in attempts to shunt the effects of depression elsewhere. Capitalist governments were therefore confronted with two difficult tasks. Something had to be done to lessen the effects of economic catastrophe. And the hegemony of the capitalist system had to be protected from the external threats presented by communism and fascism.

In response to these growing problems, the inter-war period saw the first signs of international economic collaboration among the developed, capitalist countries. Motivation came mainly from bankers rather than governments, which (following a liberal ethos) initially tried to avoid direct intervention in explicitly financial international

affairs. Far more aware of the effects of national interest rates, for example in attracting or repelling capital, bankers advocated some kind of international cooperation. Eventually, the quasi-autonomous central banks were more involved than official politicians in resolving international economic matters. For example, the German reparations payments, made under the Dawes Plan of 1924, were negotiated by the chairmen of the boards of the New York Federal Reserve Bank and the Bank of England. The League of Nations remained primarily a 'political' organization. But it did maintain an Economic and Financial Organization, and it sponsored a series of international conferences in various European cities between 1920 and 1933 (Heilperin 1947: 147; Eckes 1975: 11–12). In these we can see forming the beginnings of ideas about establishing some kind of global regulatory institution.

An international bank to aid post-war reconstruction was first proposed at a conference in Brussels in 1920. Another proposal, to restore the gold standard, stabilized via central bank cooperation but managed by an international convention, was discussed in Genoa in 1922. In the mid-1920s the League of Nations helped arrange loans to stabilize the economies of several European countries. An international economic conference, convened by the League at Geneva in 1927, and attended by several non-member countries such as the USA and the Soviet Union, came up with a series of resolutions dealing with trade, cartels and other issues that were thought to constitute an international code of behavior in policy matters. Discussion of a Bank for International Settlements took place in 1930 in The Hague. A World Economic Conference attended by sixty-six nations was held in London in 1933 in a desperate attempt at dealing with mounting problems – as with Britain abandoning the gold standard in 1931. The conference could not escape the classical principles that had guided economic policy in the past: it called for governments to balance their budgets, remove controls on the free movement of goods and capital and return to the gold standard. An appeal to the USA for help in restoring the gold standard was met by rejection – with President Franklin D. Roosevelt excoriating 'the fetishes of so-called international bankers' (Pauly 1997: 65). Eventually the conference dissolved in disarray. The usual explanation for the failure of these international agreements to establish a new global economic regime is that there was no world hegemonic power capable of occupying Britain's pre-war position – saddled by war debts, Britain was incapable, and the USA as yet unwilling. We might also add to the list

the depth of the crisis, the utter inadequacy of classical or neoclassical approaches to economic issues, the continuing divorce between economics and politics in the (nineteenth-century) liberal imagination, and the inherent tendency for international rivalry in (competitive) capitalist systems undergoing crisis.

What ended the inter-war economic crisis was neither conference nor global economic management, but the Second World War. Mass modern warfare requires mass modern production, carefully planned by the state, which was also the primary consumer of the machinery of warfare produced. Moreover, production was for readily apparent, immediate, political objectives, rather than market-oriented consumption. The war thus brought back together economics and politics which classical liberalism had long separated. The stage was set for Bretton Woods.

Discourses of economy

Even catastrophic events do not produce discourse directly. Discussions of policy need a language and a set of concepts, a discourse founded on economic theories. On the one side, the discourse of Bretton Woods can be traced back to classical political economic ideals (Hirschman 1945). Bretton Woods was a reaction to the (state) protectionism of the 1930s, just as classical political economy was formulated in reaction to the protectionist economy of mercantile capitalism. Adam Smith, it might be recalled, thought that the gain of one nation was not necessarily based on the loss of another. On the contrary, all nations benefited when they traded with each other in a free world market. Further, in the global division of labor, international trade brought about interdependence – that is, the dependence of each nation on the whole world system. Interdependence imbued each country with relative power. No one nation would have absolute power over the whole system. From trade, then, developed a uniform system of power balances. The relation between trade and peace, or economic exchange and political power, was present also in the thought of the British political economist J. S. Mill – commerce not only brought about peace, but also rendered war obsolete.

The classical notion that trade prevents war and brings about peace was present in the Bretton Woods project. Bretton Woods was conceived during a planetary war of unprecedented proportions. The fighting countries longed for peace. Practically, Bretton Woods, and the resulting institutions, were supposed to prevent further wars.

This classically based view, however, assumed mutual dependence, reciprocity and relative equality in economic and political-military capacity among nation-states. Such conditions were definitely not the case in the post-Second World War period. With political-economic inequality, international trade becomes an 'instrument' of national power (Hirschman 1945). That is, one nation-state uses the entire system to subordinate other nations that are weaker economically, for example through unequal trade, which makes less developed nations dependent on more developed ones.

In the post-war years, until the present, the latter kind of geo-political economic conditions have realistically obtained. As we mentioned earlier, dependence already characterized relations between North and South, whereas the communist East was becoming completely independent from the West. Under these circumstances, the equality of the classical liberal perspective could have applied only to the countries of western Europe and North America, perhaps only to the USA and the UK, and even there, as we shall soon see in greater detail, the term 'equality' is a subterfuge. We argue, therefore, that Bretton Woods was conceived in a world already characterized by relations of severe inequality, especially in terms of economic development. Nevertheless, in the Bretton Woods discourse, the world was publicly described in terms of the free market with sovereign autonomous states enjoying equal opportunity in an 'open international system' – that is, a politically neutral market (Blake and Walters 1987). Yet Bretton Woods also represents the aggressive desire of the capitalist market to expand globally beyond the boundaries of the developed industrial world. Owing to the influence of Keynes, however, such an expansion had to be regulated and controlled – the market should not be left to its own whims, and all nations should participate in regulating its forces. And these are only a few of the political-economic complexities of the times!

The idea of political intervention in the market had been present, to a limited degree, in classical political economy. Governments might intervene in cases of market failure, to provide public collective goods, or, according to Smith, in case of monopoly, which disturbs free competition. Liberal economists basically believed, however, that there were no necessary connections between economic growth (based on markets tending naturally to equilibrium) and political developments – in their view, economics was progressive, while politics was regressive (Gilpin 1987: 30). Moreover, national economic growth benefited

from international flows of goods and capital. The integration of a society into the world economy therefore enhanced national economic welfare. Liberal economic theory supposed an international division of labor and a market that arose spontaneously and harmoniously among states. Such a system presented problems to some liberal economists, especially in terms of a hegemonic economy governing the world economy, institutions to regulate it, or both. That is, for some, markets could not regulate themselves, and could reach neither equilibrium nor stability when left alone. Markets were intrinsically unstable.

Classically, liberal economists were also aware that the free market (conceived as free exchange among equals, unaffected by differences in power and political factors) did not benefit everyone and that not everyone gained equally (in the short run at least, before the market reached absolute equilibrium – ibid.: 180). The argument for free trade was instead based on maximizing global wealth and increasing efficiency, not on equity or equal distribution. The latter issues were not primary concerns for classically liberal economic theorists – equity issues were left to sociologists and other 'soft' social scientists. Notwithstanding this disregard for social justice, it was still argued that the liberal economic system was the ultimate model, and that its breakdown led to 'disharmony' and 'economic conflict.' In the liberal economic system not everyone gained, nor everyone gained equally, but without the system no one gained at all (ibid.: 45).

This brings us to the second side of the issue – state intervention in the economy. Interest in Keynesian policy, understood as the political management of domestic economies, developed as faith in the self-regulating market faded during the Depression of the 1930s. As we mentioned briefly in Chapter 1, John Maynard Keynes, in *The General Theory of Employment, Interest and Money* (1936), argued that the general level of employment was determined by the demand for goods and services in the entire economy. Assuming that the government had a neutral effect, two groups influenced aggregate demand: consumers buying consumption goods; and investors buying production equipment. Consumers increased spending as incomes rose, although by a smaller proportion (consumer credit was a potential yet to be fully realized by banks and governments): consumer spending was not, however, the key variable in explaining the overall level of employment, for consumption depended on income, which in turn depended on something else. In the Keynesian system, real

investment (new factories, tools, machines and greater inventories of goods) was the crucial variable: changes in real investment fed into other areas of an economy. And real investment resulted from decisions made by entrepreneurs under conditions of risk. Investment could be postponed. The decision to invest, Keynes said, depended on comparisons between expected profits and the prevailing interest rate. Here the key variable was 'expectation' or, more generally, the degree of investor confidence. The interest rate Keynes explained not in terms of savers postponing consumption, but in terms of speculation about future stock prices, which in turn determined interest rates, as savings moved from one investment fund to another. Productive investment again depended essentially on expectations about the future. Investors bought machines, providing income to machine-builders (companies and employees), who, in turn, spent money, further increasing national income, with the 'multiplier effect' (the degree of economic expansion induced by an investment) varying with the proportion of additional income that was spent rather than saved, and so on; a decrease in real investment had the reverse effects. The government might influence this dynamic by changing the interest rate, by deficit spending and other fiscal policies, shifting the economy from one equilibrium level to another, generally to higher employment levels. Depression could be countered by states maintaining low interest rates through central bank intervention, although Keynes doubted that this would be sufficient significantly to alter business confidence and thus investment. Additionally Keynes was for the redistribution of wealth through taxation, mainly with the purpose of increasing the propensity to consume, and the augmentation of private investment by government spending and deficit budgets ('pump priming'). Subsequently, the more conservative Keynesian economists have seen the manipulation of interest rates as a relatively non-bureaucratic, non-intrusive method by which the central bank of a country tries to influence national income and employment – an alternative being the ever-popular tax reduction. Liberal (New Deal-style) Keynesian economists see government deficit spending as a more effective measure: the 'liberal' aspect being that deficit spending can be aimed at improving social services. Keynes proved theoretically what depression had long shown in practice, that free markets did not spontaneously maximize human well-being. While Roosevelt first dismissed Keynes as a mathematician, rather than a political economist, Keynesian policy became the foundation for the

New Deal program in the USA in the late 1930s. Keynesian economists and administrators flooded into the governmental bureaucracies that ran the war effort in the early 1940s, while Keynesian influences were felt (through the influence particularly of economist Alvin Hansen) in several recommendations for social programs in the post-war period, including the US Employment Act of 1946 (Collins 1981).

The question was how to expand Keynesianism to the world scale. The belief grew that governments had to assume collective responsibility for managing the international economic system, and that one country, the USA as it turned out, had to assume the responsibility of global leadership. In reaction to the traumas of the Great Depression, Western democracies had to 'resolve the clash between domestic autonomy and international stability' (Gilpin 1987: 131; see also Cooper 1975: 85). With the post-war objectives of hegemony through economic growth and full employment on a national scale, governments had to commit to intervening in national economies and establishing welfare states. Yet also, in contrast to the inter-war period, governments were responsible for creating a stable international economic order and preventing a return to the destructive economic nationalism of the 1930s. As a result, the new international economic regime would differ from the laissez-faire regime of the nineteenth century and the protectionist regime of the 1930s. In contrast to the prevailing situation under the liberalism of the nineteenth century, the governments of nation-states would have a greater role in the economy, subject to international rules, in a compromise between domestic autonomy and international norms. Contrary to what happened in the 1930s, the new regime would appeal to the consent and cooperation of member nations, but would also commit them legally. And it would also recognize the mutual obligations of countries with balance of payment deficits and surpluses. In summary, there would be balance between national and international stability without subordinating one to the other, with institutions devised to manage and resolve international economic conflicts, and hence assume regulatory force in the international market. These institutions would assume the role of the state in a global market economy.

The USA: from isolation to global hegemony

Between the two world wars, the battered US economy was still in a better shape than the European economies. Moreover, the USA had a huge base of natural resources on which it could depend, and

a separate sphere of influence in the western hemisphere. These conditions had served initially as bases for the geopolitical and geo-economic isolation of the USA from Europe. Such conditions were strengthened further by the protection-mindedness of American businesspeople and farmers and the US Congress. As part of this, international economic policy was never left entirely to the American president. Rather, decisions had to be approved by Congress (Spero 1985). Isolationism at all levels left the USA with little political inclination for world leadership.

The US attitude toward European financial troubles immediately following the First World War exemplifies this. The US government had entered the war hesitantly, with general popular reluctance, and protest from leftist unions. Those favoring entering the war, the so-called internationalists, were often led by corporate affiliates, whose long-term goal was to erode the prestige of the London financiers. The internationalists, however, were not rewarded by new domestic policies after the war. The US Congress would not agree that the USA should enter the League of Nations (Block 1977: 17–19). Without the international experience of the European colonial powers, American politicians failed to recognize the specifically economic ramifications of their nation's strength after the First World War, when the European economy faltered. The US economy in the 1920s and 1930s consistently had an export surplus, with European products hardly intruding into the American market, which made it difficult for European countries to earn the necessary dollars to pay the interest on their war debts (ibid.: 21). US protectionist policy remained an obstacle to trade liberalization. Moreover, US actions, when they did occur, often had adverse effects. The US insistence that Britain and France repay war loans, in the context of limited access to US markets, forced the European nations to pressure Germany for reparations. Isolationism contributed to causing the Second World War.

The USA emerged from the Second World War, however, ready not only for participation, but also for international leadership (Scammell 1980). American post-war policy, and hence plans for a 'reordered world economy,' can be seen, partly at least, as a reaction to American isolationism of the inter-war period (Frieden and Lake 1991). For Spero (1985), the Europeans were haunted by the memory of the late entry of the USA into both world wars. The Europeans feared US isolation far more than its domination. For its part, the US had come to understand its previous isolation, and failure of leadership,

as a straight road to the collapse of the world economy and communist victory. Eventually, it was assigned, by the Europeans, and by its own fears, primary responsibility for establishing a stable international political and economic order. When the USA bound itself to international commitments, it did so from a pre-eminent position, and ensured that the commitments made conformed to American interests. As one authoritative study puts it: 'the United States has viewed all multilateral organizations, including the World Bank, as instruments of foreign policy to be used in support of specific US aims and objectives' (Gwin 1997: 195).

The conference held at Bretton Woods was made possible, according to Spero (1985), by three conditions. First, power was concentrated, with a small number of states, in North America and western Europe, making decisions for an entire world system. The communist eastern Europe states, with their centrally planned economies, maintained deliberate policies of isolation from the world economy, and eventually had their own 'international' regime. The dominant Euro-American states were also not challenged by countries in what came to be called the Third World, a great number of which were still emerging as independent states. Instead these countries were fully integrated into a world economy they neither managed nor controlled. And weakened by the war, Japan remained subordinate and external to management and decision-making. Concentration and exclusion facilitated the management of the system by confining the number of actors. Heilperin (1947) makes a similar claim, attributing the success of the Bretton Woods conference to the exclusion of most countries from planning and preparation. Accordingly, in successful conferences, key countries should reach prior 'substantial agreement' and then generalize the results to other countries, with slight amendments and improvements. Another author, Dunn (1992), goes farther and contends that the success of Bretton Woods in creating the IMF and the IBRD was due to the fact that countries other than the USA and Britain did not have a chance to include their 'different points of view' about the set-up of the resulting institutions.

The second condition making Bretton Woods possible resided in the common interests shared by the powerful states, mainly their beliefs in capitalism and, specifically, by the end of the Second World War, classical liberalism tempered by Keynesianism. States differed in their degree of preference for state intervention, with France advocating more governmental planning, and the USA preferring limited

planning, once the war was over. Nevertheless, the economies of all states relied fundamentally on market mechanisms, with private ownership and minimal barriers to the flow of private capital. They all agreed on a conception of the 'common good': the bringing of international peace through maximization of economic welfare, with political and military security being of primary importance.

The third condition was the new willingness, and ability, of the USA to assume leadership. After the Second World War, the American economy enjoyed a huge, growing market, particularly in consumer goods, great productive capabilities, and a strong currency. Combined with American military might, especially atomic weapons, this provided the advanced capitalist economies, and the world system they were planning, with a leading power. American hegemony and internationalist (capitalist) ideals became, for the USA, inseparable. The imposition of their vision, other than being based on economic and military strength, was complemented by older plans to 'break the British bloc' and turn the UK into a 'financial satellite,' while British weakness after the Second World War made it difficult to resist American plans presented at the Bretton Woods conference (Calleo and Rowland 1973). After all, at the end of the war, the USA owned three-quarters of the world's existing monetary gold, still the bedrock of currency stabilization. According to Eric Hobsbawm (1994), the institutions emerging from Bretton Woods were de facto subordinated to American foreign policy.

The conference

The United Nations Monetary and Financial Conference hosted by the US Treasury Department at Bretton Woods in 1944 brought together delegates from forty-four allied and associated nations and a neutral country, Argentina. Henry Morgenthau, secretary of the US Treasury, hoped to make Bretton Woods a high-level conference attended by finance ministers to add political weight to the final recommendations. But owing to war conditions, and other political concerns, only fifteen governments, including those of Belgium, Brazil, Canada, China and the French Committee of National Liberation, sent their finance ministers. Lord Keynes chaired the British delegation. M. S. Stepanov, deputy commissar of foreign trade, led the Soviet delegation. Senior diplomats from central banks chaired most of the remaining delegations. Alongside the leading economists of the time, however, were government delegates with few of the qualifications nec-

essary for a conference of that significance. Guatemala, for instance, sent Manuel Noriega Morales, a postgraduate student in economics at nearby Harvard University (Eckes 1975: 138). Some of the delegates were well acquainted with the complex documents to be discussed. Most learned of them only during the conference. Moreover, many delegates did not speak English, the official language of the conference, and the sophisticated issues discussed remained unintelligible to many. 'At Bretton Woods, representatives of forty-four delegations signed the agreements without having the time or opportunity to read them' (Van Dormael 1978: 226). Keynes described the conference in the following arrogant terms: 'twenty-one countries have been invited [to Bretton Woods] which clearly have nothing to contribute and will merely encumber the ground … The most monstrous monkey-house assembled for years' (Sanderson 1992: 30).

Even so, Bretton Woods merely formalized previous agreements between the British and the Americans. The conference followed two and a half years of negotiations between the treasuries of the USA and the UK. (The US Treasury Department was at the time assuming control over international economic policy, previously the domain of the more political State Department, particularly in the areas of international monetary, financial and taxation policy – Cohen, S. 1981: 47–58.) According to Raymond Mikesell (1994: 34), economist from 1942 to 1947 in the Division of Monetary Research, US Treasury Department: 'Bretton Woods was a drafting meeting, with the substance having been largely settled previously by the U.S. and U.K. delegations supported by the Canadians.' Even further, financial agreements between the USA and the UK were based on prior political agreements between President Franklin Delano Roosevelt and Prime Minister Winston Churchill. These arrangements constituted a hidden agenda for the Bretton Woods meetings. Through a succession of bilateral agreements, the USA and the UK worked together toward forming a 'world with expanding trade and easily convertible currencies' (Eckes 1975: 79–80), a world that matched their own economic interests as industrially dominant powers.

There were, however, some differences in what I previously called economic discourse. During the negotiations leading up to the conference, the vision of Harry Dexter White, director of the Division of Monetary Research, and deputy in charge of International Financial Problems, US Treasury Department, confronted that of Lord John Maynard Keynes, finance minister of the UK, and chief architect of

British economic policy. The USA pursued trade freed from imperial preferences ('free trade') which would effectively open markets to American exports. The UK wanted to maintain the sterling area as a sphere of privileged interests, but was concerned too about financing recovery in the post-war period. Negotiations between Roosevelt and Churchill, the Atlantic Charter (August 1941) and the Anglo-American Lend-Lease Agreement (February 1942), had already compromised the sterling area (see US Department of State 1985: 2–4). Gardner (1956: 51–68) concludes that the elimination of Imperial Preference was linked to the promise of an open-handed Lend-Lease settlement, by which the USA helped the UK survive during the Second World War and afterwards. As Roosevelt declared, in a communication to his secretary of state in September 1944: 'The real nub of the situation is to keep Britain from going into complete bankruptcy at the end of the war … I just cannot go along with the idea of seeing the British empire collapse financially, and Germany at the same time building up a potential re-armament machine to make another war possible in twenty years' (US Department of State 1945: 145). Alongside this, the USA wanted to replace Britain at the center of the global economy. For US Treasury Secretary Morgenthau the establishment of an 'International Stabilization Fund' (as the early version of the IMF was called) would be the outcome of years of struggle to move the financial center of the world from the City of London to Wall Street and, in so doing, 'create a new concept for international financial dealings' (Van Dormael 1978: 241).

Expecting victory in the Second World War, Germany had developed the first post-war monetary plan. Walther Funk, minister of economic affairs and president of the German Reichsbank, outlined a plan for the reconstruction and reorganization of the German and European economies after the war. Goebbels's propaganda machine trumpeted the 'New Order' as a kind of multilateralism that would bring unprecedented prosperity to Europe. In reaction to the German plan, in April 1941 Keynes set down his Proposals for an International Clearing Union (Cmd. 6437, London, 7 April 1943), which eventually became the basis for official British economic policy. He envisioned the sterling area at the center of a monetary system that other countries would gradually join, with the USA not playing much of a role (Van Dormael 1978: 5–11). In the USA, after the attack on Pearl Harbor in 1941, Morgenthau asked White to outline an Inter-Allied Stabilization Fund (Block 1977: 43; Van Dormael 1978: 40).

The antecedents for this can be traced to an Inter-American Bank proposal submitted by Roosevelt to Congress in 1940 that Morgenthau and White helped prepare (Mikesell 1994: 2). White drafted two plans in 1942: a Proposal for a United Nations Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations, both contained in the Preliminary Draft Outline of a Proposal for an International Stabilization Fund of the United and Associated Nations published in Washington, 10 July 1943. White's plans were eventually the blueprints for what later emerged as the IMF and the IBRD. Formal discussions began in spring 1943, after White's International Stabilization Fund draft had been sent to a number of countries for consideration. The proposal was discussed at an informal conference held in Washington in June 1943, attended by representatives of nineteen countries. The discussion concerned alternative plans, proposals and memoranda. The French published a memorandum on currency stabilization on 9 May 1943 (Beckhart 1944), while Canada published Tentative Draft Proposals of Canadian Experts for an International Exchange Union in Ottawa, 9 June 1943 (Knorr 1948). The more realistic, less intricate, French suggestions were given little consideration in working out the mechanisms of a new economic order. The Canadian plan resembled the White plan, but contained elements of Keynes's ideas. Once negotiations started in earnest White's plan became the real basis for discussions.

Informal discussions between American and British officials had begun in 1942. The Americans continued bilateral discussions with the British and representatives of other countries during the summer of 1943. At the meeting on 22–23 June 1943 between the British and American representatives, plans were made for negotiating a Joint Statement on an International Monetary Fund to be presented at an international conference. Representatives from the USA and the UK met nine times in Washington between 15 September and 9 October 1943. Complete agreement on a Joint Statement of Experts on the Establishment of an International Monetary Fund was reached in April 1944. While not covering all issues concerning the IMF, and not dealing at all with the IBRD, 'it did provide a framework to take to Bretton Woods, on which the American, British, and Canadian delegations agreed, and which they largely imposed on other countries' (Mikesell 1994: 25). Leon Frasier of the US First National City Bank would say later of the Bretton Woods agreements: 'in the conditions of the world as it was at the time of those negotiations,

these fellows said, "sure why not?" They had nothing whatever to lose. They looked to us for their military salvation and for their economic salvation, and any proposal within human reason put forward by representatives of the United States would in the nature of things be acceptable' (Block 1977: 51).

The statement was released on 21 April 1944, a few months prior to the Bretton Woods conference, where it was to be discussed in detail (Beckhart 1944: 493). The IBRD was first proposed in November 1943 and presented only in 'blueprint stage' at Bretton Woods (Heilperin 1947: 38). Although the US drafts were supposedly open to suggestions, alternatives of a fundamental nature were not encouraged – 'the American Delegation from the outset was committed to a particular course of action' (Beckhart 1944: 494). While there were differences between the US and UK versions – in general the USA wanted a large, political organization (the IMF) staffed by permanent officials, while Keynes wanted a small, part-time organization where an economic and financial intelligentsia would come together – the plans rested on common grounds, and both agreed that the monetary chaos of the inter-war period had yielded valuable lessons about a situation that all were determined to avoid in the future. Together they easily prevailed over plans developed by other member nations.

Morgenthau and White invited representatives from Australia, Belgium, Brazil, Canada, Chile, Cuba, Czechoslovakia, the French National Committee of Liberation, India, Mexico, the Netherlands and the Philippines to join the four 'great powers' – the USA, the UK, China and the Soviet Union – in a pre-conference drafting session at the Claridge Hotel in Atlantic City in June 1944 (Eckes 1975: 121). The 1944 meeting set the agenda for the Bretton Woods conference (Mikesell 1994: 33). White intended the Atlantic City meeting as an exploration 'to ascertain the differences of opinion, the major issues troubling the various delegates, so as to provide a basis for discussion and determine the position to take on the various points' (Van Dormael 1978: 169). It became evident from this meeting that the issue of quotas (deposits with a coordinating international agency) was of considerable importance. Since the discussions of 1943, delegates had been asking how quotas would be determined. The system of subscriptions and quotas as proposed by the USA would be a fixed pool of national currencies and gold subscribed by each member country. In mid-April 1943, White asked Mikesell, an economist in the Division of Monetary Research in the US Treasury Department, and

later member of the technical secretariat at Bretton Woods, to prepare a formula for stabilization fund quotas based on members' gold and dollar holdings, national incomes and foreign trade (that is, their economic might). Members were assigned quotas roughly reflecting their relative economic importance (Cohen, S. 2000). Although the delegates were later informed that quotas were based on a 'scientific formula,' Mikesell explained that White:

> gave no instructions on the weights to be used, but I was to give the United States a quota of approximately $2.9 billion; the United Kingdom (including its colonies) about half of the US quota; the Soviet Union, an amount just under that of the United Kingdom; and China, somewhat less. He also wanted the total of quotas to be about $10 billion … our military allies … should have the largest quotas, with a ranking on which the president and the secretary of state had agreed. (Mikesell 1994: 22)

By comparison, the quotas in the 1943 version of the Keynes plan were as follows: the UK $4.98 billion; the USA $4.04 billion; France $1.93 billion; Germany $3.13 billion; the USSR $0.41 billion (Block 1977: 234). Quotas were deemed of great importance because voting power at what eventually became the IMF would be based on them, as the American delegation proposed. White did not want to negotiate the issue. From the beginning it was tacitly agreed that votes on decisions made at the IMF (and later the IBRD) would be proportional to members' quotas, and not on the more democratic one-country-one-vote system. Clearly, this system did not meet all countries' expectations, and it remained problematic even for many who accepted it. White (see Van Dormael 1978: 170) explained the positions of the different countries: all countries wanted larger quotas; the more troublesome countries were China, insisting on having fourth place; France and India, both insisting on having fifth place; and all the smaller countries, especially those of the Third World, wanting larger quotas than assigned. The most troublesome country was Australia, which was seen to be 'participating to an extent far beyond the proper role of a country of her size and importance.' With one-third of all the quotas at the outset, the USA assured itself an effective veto power over future decision-making (Cohen, S. 2000). (See Table 2.1.)

Both the White and the Keynes plans proposed some kind of 'international agency' that would control exchange rates (Scammell

TABLE 2.1 Subscriptions to the IMF in the international accords (millions of dollars)

Country	Subscription	Country	Subscription
Australia	200	India	400
Belgium	225	Iran	25
Bolivia	10	Iraq	8
Brazil	150	Liberia	0.5
Canada	300	Luxembourg	10
Chile	50	Mexico	90
China	550	The Netherlands	275
Colombia	50	New Zealand	50
Costa Rica	5	Nicaragua	2
Cuba	50	Norway	50
Czechoslovakia	125	Panama	0.5
Denmark*		Paraguay	2
Dominican Republic	5	Peru	25
Ecuador	5	Philippines	15
Egypt	45	Poland	125
El Salvador	2.5	Union of South Africa	100
Ethiopia	6	United Kingdom	1,300
France	450	United States	2,750
Greece	40	Uruguay	15
Guatemala	5	USSR	1,200
Haiti	5	Venezuela	15
Honduras	2.5	Yugoslavia	60
Iceland	1		

Note: * The quota of Denmark to be determined by the Bank after Denmark accepts membership in accordance with the Articles of Agreement

Source: USA Department of State, 'International Monetary Fund Final Act Text', in *Proceedings and Documents of the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire. July 1–22, 1944*, vol. II, Washington, DC: US Government Printing Office, 1948, p. 1477

1980). Both plans reacted to two preceding extremes: the rigidity of exchange rates of the 1920s; and the floating rates of the free-for-all regime of the Depression years. For the Bretton Woods planners, the problem with the inter-war period had been lack of management and 'collective responsibility,' and the absence of a regulatory mechanism. Another important function to be performed by the international agency involved overseeing a 'code of action' and providing an 'institutional forum for cooperation and consultation,' with member governments formally committing themselves to collective respon-

sibility for the management of the international monetary order, unlike the divided responsibility and anarchy of the 1930s (Cohen, B. J. 1991). The international agency was conceived in this way so as to have 'supervisory power' concerning national actions threatening international equilibrium (Scammell 1980). In other words, the agency 'polices the responsibility of each nation to the community of nations' (Cooper 1975: 85). The policing function of the agency was greeted by Soviet hostility, and eventual refusal to ratify the agreements made at the conference – accepting the IMF would mean 'exacting investigations' of Soviet gold production, gold and foreign exchange holdings, spending of borrowed funds, and so on – all of which the USSR 'customarily kept secret' (Knorr 1948: 35). A 'code of action' was supposed to prevent the sort of economic warfare seen in the 1930s by providing a mechanism of multilateral clearing (Cohen, B. J. 1991; Scammell 1980) – by which was meant the supplementation of national stocks of currencies and gold, according to the system of quotas, to ensure an adequate reserve supply, with prearranged borrowing facilities (Cohen, B. J. 1991). According to Mikesell (1994: 12) both plans provided 'for international liquidity to enable countries to stabilize their currencies, eliminating exchange restrictions on current transactions, and outlawing bilateral payments arrangements and other forms of discrimination.' The several subsequent versions of White's plans were centered on reconstruction in the immediate post-war period, and balance-of-payments problems, while Keynes's Clearing Union, on the other hand, was concerned more with the multilateral clearing of national balances, and the debiting and crediting of net balances (ibid.: 5–13).

While the foreign delegations were getting acquainted with Bretton Woods, Morgenthau and White set to work. No matter what the intentions of the other governments were, the Americans had a clear idea of what they wanted to result from the conference. The US position was announced publicly in a press release on the first day of the event:

> The purpose of the Conference is … wholly within the American tradition, and completely outside political consideration. The United States wants, after this war, full utilization of its industries, its factories and its farms; full and steady employment for its citizens, particularly its ex-servicemen; and full prosperity and peace. It can have them only in a world with a vigorous trade. But it can have

> such trade only if currencies are stable, if money keeps its value, and if people can buy and sell with the certainty that the money they receive on the due date will have the value contracted for – hence the first proposal, the Stabilization Fund. With values secured and held stable, it is next desirable to promote world-wide reconstruction, revive normal trade, and make funds available for sound enterprises, all of which will in turn call for American products, hence the second proposal for the Bank for Reconstruction and Development. (US Department of State 1948: 1148)

As planned by White, the Bretton Woods conference was conducted through the means of three commissions: Commission I (International Monetary Fund), of which White was chairman; Commission II (Bank for Reconstruction and Development), chaired by Keynes; and Commission III (Other Means of International Financial Cooperation), chaired by Eduardo Suarez of Mexico. Each commission had several committees with non-US chairs and reporters. Washington usually had the support of the Latin American delegates. In return, the US representatives assured them that they would be able to select two directors, for the IBRD and the IMF. Britain counted on the backing of the Netherlands and Greece, as well as the Commonwealth countries, on most issues (Eckes 1975: 154). For more than two weeks committees and commissions met, sometimes twice a day, reviewing proposals put before them, making suggestions, recommending changes and putting forward new proposals. As it was an advanced technical conference, power resided in the hands of experts – economic and technical specialists and lawyers. Specialist opinion prevailed 'except on several sensitive political issues, which the technicians referred to senior cabinet officials for final approval' (ibid.: 138).

White neutralized Keynes, the only person seriously able to upset his plans, by appointing him chairman of the Commission on the IBRD. That kept the British so busy that they were unable to interfere with committee meetings regarding the IMF (Van Dormael 1978: 157). At the same time, Commission I – dealing with the IMF – was handled by White himself to prevent, as he said, discussion occurring, and agreements being made, on matters with which the Americans did not concur (ibid.: 174). All secretaries of the committees and their assistants were Americans. They would select and propose the subjects to be discussed, count the votes and, above all, write the minutes of the meetings and draft the final Act. The delegates were

told in a memorandum that 'secretaries like other officers at the Conference, are on this occasion international officials and for all practical purposes temporarily lose not only their national identity but their allegiance to the organizations, governmental or otherwise, with which they are affiliated' (US Department of State 1948: 1148). But in fact they were people White had trained at Atlantic City, and they formed a homogeneous and cohesive team that could understand the main issues and defend the US position. As one commentator put it:

> whether the delegates were aware of it or not, the important decisions were made behind closed doors, between the American delegation and the foreign delegation involved. While Harry White and his small group of 'technical advisers' kept absolute control over the text of the articles to be included in the agreement, the powerhouse of the conference was in Morgenthau's office, where some of the most difficult and troublesome issues had to be settled. (Van Dormael 1978: 179)

Additionally, White developed a further mechanism to ensure that the conference was under his control. Even though 'delegates from other countries made numerous proposals that conflicted with the basic pre-conference positions and agenda' (Mikesell 1994: 34), Morgenthau wrote in his diary that White had said: 'When there was some disagreement at some point, instead of referring back to the committees, or instead of discussing it at any length in the committees, we let a few people discuss it, and immediately referred it to the ad hoc committees, created especially for that purpose, to refer back to the Fund Commission, and not to the committees' (ibid.: 200).

After two weeks of deliberations the articles of agreements resembled, in general, the framework proposed in the Anglo-American joint statement (Eckes 1975: 149).

The Bretton Woods model

The Bretton Woods institutions were supposed to govern agreed-upon principles for the conduct of economic affairs decided at the conference – as stated in Article I of the Agreement, the IMF's purpose was 'to facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as

primary objectives of economic policy' (Scammell 1973: 119). These principles were as follows:

1 The experience of the competitive depreciation of currencies during the 1930s led to the principle of international control over exchange rates between national currencies. As the long-raging controversy between free and fixed exchange rates could not be resolved, a compromise was reached that can be termed 'managed flexibility.' Under this, the par values (see pp. 61, 76) of member-country currencies were defined in gold terms, but allowed to vary around these standards, with par values changed by more than this only under drastic conditions and by permission of the IMF.
2 A pool of gold and currencies to be drawn on in case of balance of payments difficulties was subscribed by member countries to the IMF according to a quota system adjusted every five years. The quota determined the country's drawing rights and also its vote in the institution. Countries could exchange specified amounts of their currencies for those of other counties under conditions supervised by the IMF.
3 To enable multilateral trade, after a five-year transition period, all member countries were to eliminate controls making currencies convertible into one another at the official rates without restrictions or discrimination unless approved by the IMF.
4 Various 'scarce currency' provisions were made to decrease instabilities resulting from shortages due to sustained surpluses in a country's balance of payments – the IMF was authorized to declare the scarcity, ration its remaining supply, require a country to sell currency to it, in exchange for gold, or use other measures.
5 The Bretton Woods Agreement established a permanent institution to promote international monetary cooperation and provide the machinery through which countries could consult and collaborate. The institution, called the IMF, a specialized agency of the UN, was part of an envisaged system that also included a bank dealing with long-term investments (IBRD), a trade organization (ITO), and actions to promote full employment under the UN Economic and Social Council. The IMF would have a board of governors, representing all member countries, which met annually, an executive board, of which five members would be from countries with the largest quotas, meeting continuously, and a managing director, who was not a board member. Voting on both boards was

to be according to quotas. Under the original quota system, the USA had 27.9 percent of the vote and the UK 13.3 percent (ibid.: ch. 5).

There was one issue, later to become highly controversial, which divided the Americans and the Europeans. The European view of the lending operations of the IMF was that resources would be provided to member countries more or less on request, as they were needed. In particular the British delegates to Bretton Woods thought that members should be free to pursue whatever domestic policies they desired, even if these affected exchange rates, a central concern of the conference. By contrast, the Americans thought that borrowing foreign currency (dollars, as it turned out) from the IMF was not an unqualified right. At the Atlantic City pre-conference the US delegation proposed that the language of the proposed Articles of Agreement (Article V) be changed from a 'member *shall be entitled* to buy another member's currency from the Fund' to a 'member *may* buy the currency of another member from the Fund' (emphasis added). The United Kingdom had the support of virtually all other countries in successfully opposing this change. While this indicates, however, that the USA did not entirely have its own way at Bretton Woods, subsequent practice at the IMF indicates otherwise. The US executive director on the IMF executive board, Frank Southard, insisted (in a memo) that use of Fund resources should be subject to close scrutiny to assure a country's adherence to its principles and purposes. Indeed, the US executive director challenged several requests to draw on IMF funds in the late 1940s on these grounds and, as a result, little use was made even of the gold that countries had deposited, until in 1950 the managing director specified that countries would have to lay out the specific steps they would take in overcoming balance of payments difficulties. Britain and France abstained in the subsequent vote on this issue, while other countries agreed to the American notion of 'conditionality' only because the USA was the main source of credit (Harmon 1997: 23–4).

Ratification

Following the conference, delegates were to explain the Bretton Woods agreements to their respective governments. In many cases, the delegates did not know exactly what they had signed, nor did their governments. Van Dormael (1978: 286) illustrates this point:

> Driven through the US Congress by what was described in the *New York Herald-Tribune* as 'the most high powered propaganda campaign in the history of the country,' and reluctantly agreed to by the British Parliament because they were tied to an indispensable loan, in most other member countries the Bretton Wood Agreements had been ratified without debate or opposition. Parliaments had hardly, or not at all, been involved in the negotiations, and did not know what they were all about. In most cases, it was a simple formality.

In the USA, opposition to ratifying the agreements came mainly from bankers, prominent newspapers and influential Republicans. Block (1977: 54) attributes 'the failure of the powerful international bankers to block outright Congressional approval' to two factors: first, the Fund would be a symbol of America's good intentions and a look forward to a rationally ordered international economy; second, a large economic quota guaranteed the USA effective veto power at the Fund. After Bretton Woods, Keynes wrote in a memorandum to the UK Chancellor of the Exchequer, 'We cannot be expected to sign an instrument which is either self contradictory or hopelessly obscure' (Van Dormael 1978: 226). In order to get the UK to ratify the agreements, on 13 November 1945 the new US Treasury secretary, Fred Vinson, whom President Harry S Truman had appointed to replace Morganthau after Roosevelt died, reiterated that the granting of a credit to the UK was dependent on its agreeing to the Bretton Woods accords. Vinson said that 'it had been made clear to the British that they would have to ratify Bretton Woods before the credit proposal was put up to Congress' (ibid.: 274). The Anglo-American Financial Agreement for a US$3,750 million loan was finally signed on 6 December 1945. 'Detailed terms of the loan were listed and one of the conditions was the ratification of Bretton Woods. In addition, Britain committed itself, unless the United States agreed to a temporary extension, to remove within a year all restrictions on the convertibility of sterling for current transactions' (ibid.: 275). After the agreements had been signed, and made public in London, Keynes became involved in a controversy over whether the Bretton Woods agreement was in the interests of the British Empire. The controversy over interpreting the agreement was not limited to economists and financial writers in the press. Within the UK Treasury, there was disagreement between Keynes and Professor Dennis Robertson over the meaning of certain provisions in the Final Act. Robertson was the

British delegate on Commission I, dealing with the IMF. At Bretton Woods, without consulting Keynes, Robertson had suggested that the words 'gold and gold-convertible currency' be replaced by 'net official holdings of gold and U.S. dollars.' White referred the matter to a special committee, not permitting further discussion. The special committee was the group of technicians headed by White. 'The change from "gold" to "gold and U.S. dollars" was lost in the ninety-six pages the chairmen and delegations signed a few days later' (ibid.: 170–71, 202). But it would legitimize the par value or dollar-pegged system that would come to characterize the Bretton Woods era.

In January 1946 the USA invited the thirty-four nations that had, by then, ratified the agreement to attend the inaugural meeting of the board of governors of the IMF and the IBRD in Savannah, Georgia. In Savannah it was decided that the offices of the IMF and IBRD were to be located in Washington, DC, because it would be easier to get economic information from the countries through their embassies. Keynes proposed New York, center of the capital market, as an alternative, to avoid excessive US political influence. The resulting decision, against Keynes, was possible owing to the US vote, combined with client regimes in Latin America and elsewhere. Keynes also wanted White to become first director of the IMF in order to ensure expansionist economic policies. But to ensure Wall Street confidence, he was left out (Block 1977: 74–5).

Political decolonization, economic recolonization

Post-war decolonization involved, in part, a movement for the redistribution of global economic power away from its exclusively Western, capitalist bases. In the 1950s and 1960s, Third World countries, motivated by structuralist theories of development (i.e. theories that looked to the specific socio-economic structures of Third World societies and to relations with First World countries for the causes of their underdevelopment), contended for power. Raul Prebisch, an Argentine economist based originally in the UN Economic Commission for Latin America (ECLA), but later the first secretary-general of UNCTAD (UN Conference on Trade and Development) after its founding in 1964, proposed a program of economic reform that would benefit Third World countries: this included commodity price stabilization, preferential tariffs and the expansion of foreign assistance. Gradually structuralist views came to prevail in many UN agencies and were the dominant view of the majority in the

UN General Assembly, where the principle of one-country-one-vote prevails, and where the world's people meet in the closest thing to a global democratic assembly that presently exists. The outcome was supposed to be a special UN Fund for Economic Development (SUNFED), in which the criteria for loans would be development need rather than banking rules. Opposed to this movement, First World governments resisted by backing the IMF and the World Bank, where voting is according to capital subscription. One such response was to set up the International Development Association attached to the Bank as its main 'soft loan window.' Along with creating a chronically underfunded UN agency (UNDP, the UN Development Program), this derailed the Third World governments' demand for a global development institution that they, representing most of the world's peoples, might control. Third World efforts at achieving economic reform continued in UNCTAD and through the call for a New International Economic Order. These efforts were increasingly resisted by the USA, with ideas particularly coming from the Heritage Foundation, a right-wing Washington think tank. The Reagan administration came to power with a mandate not only to roll back communism, but also, at the same opportune moment, to discipline the Third World, including the state-assisted capitalist countries of South-East Asia. This was accomplished through stabilization loans, structural adjustment and neoliberal reform programs pushed by the World Bank and the IMF in the 1980s and 1990s. The US response to the East Asian crisis of 1997 should be understood not as helping economic recovery, but as an attempt at resubordination. Additionally, the pro-Third World agency UNCTAD was effectively replaced by the WTO, founded in 1994. The world is now governed by Western-controlled institutions, by the G7 and G8, led by the USA, together with the IMF, the World Bank, WTO and OECD. The US position is that the existing global capitalist system is basically sound and that significant reform is unnecessary. And that position is backed by ferocious military, economic and cultural power. In effect, we might add after September 11, 2001, the world was made safe for Americans … by making the world American (Bello 2003).

Formalizing dominance

This chapter has presented my version of what transpired during those hot summer days in the now distant year of 1944. The chapter has conducted a detailed examination of the conditions, arguments,

preparations and maneuvers connected with the Bretton Woods Conference of 1944, which resulted in the establishment of the IMF and the IBRD. My position has been that Bretton Woods was an occasion for the formalization of US and UK dominance into an international monetary agreement, complete with enforcing institutions. In the period 1945–59, the IMF, the central institution formed at Bretton Woods, sat in abeyance awaiting the widespread establishment of the free convertibility of currencies and other conditions that it was designed to operate under. The Fund played only a minor role in establishing these conditions. In 1959 widespread currency convertibility enabled the IMF to begin to play the role White and Keynes had envisaged. And this role, especially from the 1970s onward, involved the IMF in surveillance of national economic policies and disciplinary controls over them. Yet, as I have shown, the IMF was not formed as a democratic institution in anything like the sense of inter-country equality. It was primarily an American invention, with British collaboration, consciously designed to foster one particular perspective on the development of global economic relations. It was located in Washington to place it within a policy-making system dominated by the US Treasury. The voting system was deliberately designed to enable the US will to prevail, and to prevent policies not in the US national interest from being adopted, or perhaps even discussed. From the beginning an expert-led discourse prevailed which ensured the domination of the Western economic intellect, to the point that many 'member countries' had little idea what they were accepting when they ratified the Bretton Woods Articles of Agreement. Although Bretton Woods resulted from American and British planning and cooperation, the USA dominated the conference and directed it according to its national interests. The USA emerged from Bretton Woods as an unchallenged hegemonic world power. A world economy centered on the USA came to dominate the quarter-century that followed (Hobsbawm 1994). The Bretton Woods regime became synonymous with a hegemonic monetary order centered on the dollar (Cohen, B. J. 1991: 243). Yet rather than being revealed for what it was, US domination could be clothed in the raiment of 'international consultation and collaboration' because of the apparently international nature of the conference. Thus the considerable abilities of the Bretton Woods institutions to direct and control the global economy that developed over the next half-century were, to a great degree, extensions of American political-economic power.

In all this, there is lots of evidence of conspiratorial collusion, tempered by occasional collision, particularly between the USA and the UK, but more generally among the 'great powers,' as they were too honestly called at the time. And there are many instances too of the interventionist abilities of 'great personalities,' again embraced in a dialectic of collision and collusion. Conspiratorial theories of why things happen are, however, fat with facts but thin on thoughts or, rather, rest on weak notions of power. They do not see that conspiring men represent interests by employing persuasive ideas, which sometimes they have helped to form, as with Keynes, but often they have merely updated to or specified a changed context. 'Great men' are effective agents in the construction of hegemony only when they marshal great ideas or, more skeptically, ideas that seem as though they might work to resolve crises. The system of concepts enables the statements they make to have logical order, explanatory depth and persuasive power. Suspecting this, I previously outlined the notion of discourse as a set of statements backed by validation procedures that lend them, in a scientifically modern world, the persuasive effect of the truth. And I accepted from the international relations literature the notion of regime as a system of social institutions that unify national behaviors and legitimize their policies as contributing to global order. Recalling these notions, I suggest that the Bretton Woods regime was constructed through the intersection of two economic discourses: the discourse of classical, liberal economics, modernized by mathematical neoclassical economics, and geopolitically extended in an age of world wars through a connection between trade and peace; and the discourse of twentieth-century, New Deal liberal or social democratic, Keynesian economics responding to 'market failure' by advocating state intervention. Further, I posit that classical liberalism was the primary discourse underlying an articulation with a secondary Keynesianism that was only reluctantly accepted in the USA and, as I suggested in Chapter 1, virtually abandoned for neoliberalism in the 1970s. That is, the international economy was seen as a regime best organized by competition, trade and markets in the classical and neoclassical economic senses, with regulatory intervention by an IMF and a World Bank kept under US control. Further, I suggest that this intersection of discourses resulted in a strange kind of cross-breed regime in which global governance institutions, invented to regulate the conditions of economic interchange, would call for deregulating economies. And finally, while I find the notions of discourse and regime insightful,

helping to organize a comprehension that has depth and cohesion, I also find both lacking in much the same area – the ideas that discourses convey and the concepts mobilized by institutional regimes. The underlying ideas, thought in the interest of power, give cohesion and appeal to discourse and regime.

THREE
The International Monetary Fund

As originally conceived at Bretton Woods, the IMF was to be a supranational body essentially doing two things: it would regulate the rates at which currencies were exchanged among member countries; and it would help ensure international stability by making loans at times of crisis in member countries' balances of payments. While its mission statement remains essentially the same, the IMF has subsequently undergone major changes, including several apparent reversals of fortune, that nevertheless resulted in an overall accumulation of power and influence – although recently that accumulative trend seems finally to have reversed. Today IMF policies directly affect the economies of 185 countries and influence, sometimes drastically and often disastrously, the lives of the vast majority of the world's people. Until recently the IMF was probably the single most powerful non-state (governance) institution in the world. Publicly, governments had to praise the IMF, while complaining privately about the policies imposed on them. By contrast, thousands of workers and students demonstrate against the IMF, in many cases losing their lives in the process because, they say, its economic policies produce poverty, hardship and starvation.

Why do large numbers of people protest the granting of IMF loans intended to stabilize economies in times of trouble? The IMF gives short-term loans to member countries experiencing balance of payments crises, essentially from previously deposited funds, but with the essential difference that the loans are made in 'harder' (more internationally acceptable) currencies than the deposits. Originally, under the Bretton Woods agreement, the conditions for IMF loans to member countries required simply 'an effective program for establishing or keeping the stability of the currency of the member country at a realistic exchange rate' (IMF 1958: 404). Over fifty years this limited 'conditionality' has grown into something far more. Loan conditionality, imposed on what are usually desperate governments, has become a way for the IMF to regulate the entire gamut of a country's economic policies. So it is not the actual deliverance of the loan but its

conditionality which is contested. Governments are required to adopt a set of economic policies and prescribed financial measures based on what the IMF thinks will promote economic stability, increasing the government's capacity to service loans – that is, make interest and loan repayments. By what theoretical means does the IMF establish these policies? The institution appeals to the best of neoclassical economic science backed now by fifty years of experience in the loan business. But a critical examination of that experience suggests instead that it extracts repayment at the expense of the economy, and especially on the backs of the poor people, of the borrowing country. And a critical look at its economics, especially after the mid-1970s, suggests that the IMF adheres to a neoliberal version of neoclassicism, one that so well knows what economies really need that it automatically generates the same policy package no matter what the context. The policies suggested by the IMF almost always require reducing tariff barriers on imports, and this eliminates jobs. They increase interest rates to cool the economy and reduce inflation, and this too reduces employment. At the same time, they impose austerity programs that cut back government services and remove state subsidies that have kept food prices low. So, critics argue, IMF policies create unemployment and poverty while reducing the national state's power to remedy the resulting social problems. Immediately, people who can least afford it are made to pay for loans to governments whose previous policies are deemed mistaken by IMF economists. More than this, the IMF imposes its own economic beliefs on countries that might wish to develop differently. IMF loans then become a point of tension at which social struggles within a society articulate with tensions between the society and the global system, with two main institutions – the national state and the IMF – at the center of the controversy. Most basically, then, the IMF extracts conditions that favor repayment at the expense of poor and working people. Whose interest, therefore, does the IMF economic discourse serve? I will try to provide an answer in this and the following chapter. But first we have to know the IMF inside out.

Structure of the IMF

Established in 1945, when twenty-nine governments signed articles of agreement resulting from the 1944 Bretton Woods conference, the IMF actually began operations in 1947. The IMF was supposed to be the primary supranational institution that regulated the financial

conditions deemed appropriate for the successful functioning of the world economy – especially, in its early days, conditions relating to currencies and exchange rates. These financial conditions were understood within a classically liberal capitalist view of how economies should function. Necessarily, Keynesian notions were added to this classical and neoclassical base – that some markets needed regulating by quasi-state institutions to ensure proper and fair functioning – 'necessarily' because the IMF itself is such a regulatory institution. As stated in Article I of the original Articles of Agreement (IMF 1990), the objectives of the IMF were:

1 To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
2 To facilitate the expansion and balanced growth of international trade, and to contribute thereby to high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
3 To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
4 To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
5 To give confidence to member governments by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive of national or international prosperity.
6 In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

Theoretically the IMF is situated within the United Nations system. It is the central institution of the international monetary system, the system of international payments and exchange rates among national currencies, which prevents crises in the payments system. It does so by monitoring the economic policies of member countries and acting as a reserve fund that can be used by members needing temporary financing to address balance of payments problems. The

IMF focuses mainly on the macroeconomic policies of governments, including: policies relating to the state budget, the management of money and credit, and the exchange rate; and the financial policies of governments, including the regulation and supervision of banks and other financial institutions. In addition, the IMF looks at the structural policies that affect macroeconomic performance (that is, the performance of economic aggregates such as national income, total national consumption, investment and the money supply). Under Article IV of the Articles of Agreement each member country commits itself to: directing its economic and financial policies toward orderly economic growth with reasonable price stability; promoting stability by fostering orderly underlying economic and financial conditions and a monetary system that does not produce erratic disruptions; avoiding manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and following exchange policies compatible with these undertakings.

The Board of Governors, with representatives appointed by all member countries (usually a country's minister of finance or the governor of its central bank), is the highest authority governing the IMF. The Board of Governors meets twice a year at the joint annual meetings of the IMF and the World Bank to make decisions on major policy issues.

The Board delegates immediate, day-to-day decision-making to an Executive Board of twenty-four executive directors, with a managing director as chairman. The IMF staff and management are accountable to the IMF's managing director, who is appointed by and accountable to the Executive Board. By 'gentleman's agreement,' the managing director is chosen by the IMF's European member governments, while the first deputy managing director is chosen by the US government. The Executive Board selects the managing director, who, besides serving as chairman of the Board, is chief of the IMF staff, and conducts the business of the IMF under the direction of the Executive Board. Appointed for a renewable five-year term, the managing director is assisted by a first deputy managing director and two other deputy managing directors.

The Executive Board usually meets three times a week at the IMF headquarters in Washington, DC. The IMF's five major shareholders – the USA, Japan, Germany, France and the UK – along with China, Russia and Saudi Arabia, have their own seats on the Board. The other

sixteen executive directors are elected for two-year terms by groups of countries called constituencies. Member votes and representation are skewed in favor of creditor nations. A new formula for calculating voting weights can be considered only during periodic reviews of the 'quotas' assigned to each country. Ten of the available twenty-four Board seats are currently occupied by developing countries, collectively holding 26 percent of the voting share. For developing countries to carry a decision in their favor they must build alliances with creditor members. There are currently forty-five sub-Saharan African member countries in the IMF, which hold a combined voting share of 4.4 percent.

Documents for the Board's deliberations are prepared by the IMF staff, sometimes in collaboration with the World Bank staff, and are presented to the Board with management approval; some documents are also presented by executive directors themselves. Most decisions are made by consensus. Optimally this is a unanimous decision by all executive directors. But there are important differences of view among the membership, for example between debtor and creditor interest. The IMF's regulations prescribe that 'the chair shall ordinarily ascertain the sense of the meeting, in lieu of a formal vote,' effectively seeking the broadest spectrum of support in terms of numbers of executive directors and voting share, provided that if put to a vote there would be the needed majority (depending on the decision being made, a majority of 51, 66 or 85 percent is required). The chair urges the Board to consider matters at least until a broad majority has emerged on the issue under discussion. Where no consensus can be reached a simple majority of the voting power can quickly be achieved by a collective agreement among the directors from the main creditor countries.

Until recently, the organization had some 2,800 employees recruited from 133 countries. These are international civil servants whose responsibility is to the IMF, and not to their national authorities. About two-thirds of the professional staff are economists. The IMF's twenty-two departments and offices are headed by directors, who report to the managing director. Most staff work in Washington, although some eighty resident representatives are posted in member countries, where they advise governments (through the central banks and the ministries of finance) on economic policy. The IMF also has offices in Paris and Tokyo for liaison with other international and regional institutions and in New York and Geneva, mainly for liaison with

other institutions in the UN system. Key policy issues relating to the international monetary system are considered twice yearly in a committee of governors called the International Monetary and Financial Committee, or IMFC (until 1999 known as the Interim Committee). A joint committee of the Boards of Governors of the IMF and World Bank called the Development Committee also reports to the governors on matters of concern to developing countries (IMF 1998a).

The IMF's financial resources come mainly from the capital subscriptions that countries pay when they join the organization or, following periodic reviews, when quotas are increased. Countries pay 25 percent of their quotas in 'hard' or readily convertible currencies, such as US dollars or Japanese yen (originally these payments were in gold), and the rest in their national currencies. Quotas determine a country's subscriptions, its voting power, and the amount of financing it can receive from the Fund. Quotas reflect the size of a country's economy and its volume of trade. The USA contributes most to the IMF and has 17 percent of the total votes; Japan and Germany both have about 6 percent of the votes; France and the United Kingdom each have 5 percent; Saudi Arabia, China and Russia have approximately 3 percent each. Since January 1999, IMF quotas have totaled $290 billion (or SDR212 billion – the SDR, or special drawing right, is an international reserve asset introduced by the IMF in 1969, whose value is based on a group of leading world currencies). The IMF can also borrow further under two sets of standing arrangements: the General Arrangements to Borrow (GAB), set up in 1962, with eleven participants (the governments or central banks of the Group of Ten industrialized countries and Switzerland); and the New Arrangements to Borrow (NAB), introduced in 1997, with twenty-five participating countries and their financial institutions. Under the two arrangements combined, the IMF has a further $46 billion (SDR 34 billion) available for emergencies (IMF 2002a).

Countries usually approach the IMF for financing when they are experiencing balance of payments problems – that is, not taking in enough foreign exchange (especially hard currency) from exports, or foreign investments, to pay for imports. This emergency situation, important because some imports are vital for economies or social services to function, is usually accompanied by other signs of economic crisis, as when the national currency is under attack in foreign exchange markets, the country's reserves of gold or hard currencies are heavily depleted, or the economy is suddenly depressed. Member

countries can immediately and unconditionally draw on the 25 percent of their quota (called a 'tranche' or portion) originally deposited in hard currency or gold. Should this be insufficient, they can then draw up to three times their original quotas (in hard currencies) as 'upper tranche' loans under conditions specified by the Executive Board of the IMF or, more exactly, by the IMF staff, as reported to the Executive Board. These conditions (or 'conditionalities') consist of policies that a government has to put into effect to convince the IMF that it will be able to repay the loan within a time span of one to five years. The Fund's power to impose conditionality originates from Article V ('Operations and Transactions of the Fund'), Section 3 of the Fund's Articles of Agreement, which broadly present the conditions governing use of the Fund's resources. Briefly, Section 3(a) states that the Fund: 'shall adopt policies on the use of its general resources […] and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.' This means that, prior to the release of any financial resources to its members, the Fund requires that certain constraints, widely known as 'conditionalities,' are imposed in the form of compliance with both Fund rules and Fund-suggested (practically mandated, in the case of poor countries) policy guidelines and adjustments. These 'monitoring techniques' provide the framework with which the Fund ensures solvency safeguards while targeting temporary balance of payments problems. There has been a significant increase in the number of conditionalities set for low-income countries eligible for its Poverty Reduction Growth Facility (PRGF) program. This increase in prescriptions has greatly expanded the IMF's remit to include public sector employment, privatization, public enterprise reforms, trade policy, pricing, social security systems and 'systemic' reforms, among others. This greatly enlarged scope of Fund conditionality advocates 'policies aiming more generally at improvements on the economy's underlying structure – its efficiency and flexibility – to foster growth, and facilitate adjustment to exogenous shocks.' This is where the Fund arrogates to itself the right to engage in much broader reforms including trade liberalization, pricing and marketing, labor market reorganization and generic institutional or regulatory changes. In a review of the legality of these extensions, Saner and Guilherme (2007) argue that

'it appears doubtful that lending arrangements with IMF member countries have complied with existing Fund rules.'

Details of the borrowing country's policy program are spelled out in a 'letter of intent' signed by a senior member of the government concerned and the managing director of the IMF. The IMF then monitors the government's performance to ensure compliance with the agreement specified in the letter of intent until the loan is repaid or renegotiated.

The IMF currently provides loans under a variety of 'arrangements' and 'facilities':

- *Stand-by Arrangements* assure member countries that they can draw up to a specified amount, usually over twelve to eighteen months, to deal with short-term balance of payments problems.
- *The Extended Fund Facility* provides assurance that member countries can draw up to a specified amount, usually over three to four years, to make structural economic changes that the IMF thinks will improve balance of payments.
- *The Poverty Reduction and Growth Facility* (replacing the Enhanced Structural Adjustment Facility in 1999) provides low-interest loans to the lowest-income member countries facing protracted balance of payments problems, with the cost to borrowers subsidized by funds raised through past sales of IMF-owned gold, together with loans and grants from richer member countries.
- *The Supplemental Reserve Facility* provides additional short-term loans at higher interest rates to member countries experiencing exceptional balance of payments difficulties because of sudden loss of market confidence reflected in capital outflows.
- *Contingent Credit Lines* provide precautionary IMF financing on a short-term basis when countries are faced by a sudden loss of market confidence because of contagion from difficulties in other countries.
- *Emergency Assistance* helps countries coping with balance of payments problems arising from sudden and unforeseeable natural disasters or, since 1995, emergency conditions stemming from military conflicts (IMF 2002b).

At present, all IMF borrowers are developing countries, transitional post-communist countries or 'emerging market' (middle-income) countries recovering from financial crises – although the middle-income countries have recently become extremely reluctant to borrow from

the Fund. Since the late 1970s, all the developed-country members have used private or other capital markets for loans, but in the first two decades of the IMF's existence over half the financing went to these countries. The IMF does not consider itself to be an aid agency or a development bank. It deals only with governments – the foreign exchange loaned by the IMF is deposited with the country's central bank to supplement its international reserves. And the IMF expects borrowers to give priority to repaying its loans on schedule, with the institution using various procedures to deter the build-up of arrears, or overdue repayments and interest charges. Countries that borrow from the IMF's regular, non-concessional lending facilities (that is, all but the low-income countries) pay market-related interest rates and service charges, plus a refundable commitment fee. In most cases, the IMF provides only a small portion of a country's external financing requirements. IMF approval signals to other financial institutions that a country's economic policies are on the 'right track,' reassuring investors and officials, and helping generate additional loans from these sources – the IMF, in other words, is the bankers' guide to creditworthiness. The IMF examines the economic policies of member countries through a process known as surveillance. Once a year, the IMF appraises members' exchange rate policies within the overall framework of their economic policies in what is known as an 'Article IV consultation.' (Article IV of the Articles of Agreement originally gave the IMF the power to oversee the international monetary system in order to ensure its effective operation, to oversee the compliance of each member with its obligations to the IMF, and the right to exercise surveillance over the exchange rate policies of members, including consultations, while respecting the domestic social and political policies of members, and paying due regard to the circumstances of members.) Surveillance is based on the IMF's conviction that certain approved domestic economic policies will lead to stable exchange rates and a growing and prosperous world economy (IMF 1998a).

IMF policy 1945–71

The IMF was formed mainly to address the economic needs of the European and North American nation-states in the immediate post-war period. These problems were thought to centre on exchange rates and balances of payments. To clarify: the term 'exchange rate' refers to the price of one currency in terms of others. In market

systems, exchange rates vary with fluctuations in the demand for and supply of a country's currency. These, in turn, depend basically on demand for and supply of the country's goods and services – although currency speculation also plays an increasingly important role. The term 'balance of payments' refers to the total financial transactions between the residents of one country and residents of the countries of the rest of the world. Balance of payments accounts are kept by governments and are divided into a current account – recording payments for goods and services – and a capital account – recording flows of capital assets such as cash, stock market securities and government and corporate bonds. Countries have to maintain reserves of gold and hard currencies acceptable in global trading relations to cover a sudden shortfall in export earnings or dramatic changes in the market value of their currency, otherwise they would not be able to pay for necessary imports. Such reserves normally cover at least several months' worth of imports. Reserves covering only a few weeks' worth of imports signal a balance of payments crisis. In such cases, to prevent disruptions in trade, or to forestall drastic measures such as debt repudiation, deficits in a country's balance of payments can be temporarily filled by international credits, such as drawing from previous deposits with the IMF, or short-term loans from foreign banks.

In the longer term, a country's exports, and thus its foreign exchange earnings, can be increased by devaluing the national currency in terms of other currencies. Devaluation immediately makes exports cheaper and more internationally competitive. But it also makes imports more expensive, and as these higher-priced goods feed through the national economy, inflation eventually results. A further round of devaluations may then be necessary. This is exactly the kind of devaluation cycle that the IMF is supposed to prevent. In international economics a stable currency regime (that is, small variations in the rate at which a currency exchanges with others) is deemed important for reasons of trade and investment security (that is, maintaining the value of capital investments). By joining the IMF in the post-war years individual countries surrendered some of their sovereign economic rights, especially over how they set their exchange rates, in return for collective conditions of 'exchange stability, orderly exchange arrangements, the avoidance of competitive exchange depreciation, and a liberal regime of international payments' (de Vries 1986: 15). Essentially the original conception behind the IMF, resulting from the

experience of the Depression of the 1930s, was that member countries would adhere to certain standards of behavior spelled out in a code that was administered by an international institution.

Through the IMF, member countries originally agreed to fix their exchange rates in a system of 'par values.' Each member country determined a value for its currency, measured in relation to gold, a commodity used to represent value in general, which was permanently valued at $35 an ounce. The country had to intervene (through its central bank buying and selling currency) if international market conditions changed exchange rates by more than 1 percent of the original, agreed-upon, par value. In the case of 'fundamental disequilibrium' in a country's balance of payments (that is, large and continuing deficits), the country could propose changes in the par value of its currency to the IMF, which could approve, deny use of its resources or, in extreme cases, require a country to withdraw from membership, all this being aimed primarily at competitive depreciation. Under Article VIII of the original Articles of Agreement, the IMF could (after a transitional period that ended up lasting until the late 1950s) exercise 'surveillance' over a country's exchange conditions, as with countries imposing restrictions on international payments, or preventing the free convertibility of its currency into others. National currency controls could, however, be imposed in cases of emergency, as with wholesale capital flight, with the approval of the IMF.

For the first twenty years, the most controversial issue confronting the IMF was the use of multiple exchange rates, particularly by Latin American countries, and later by other Third World nations. 'Multiple exchange rates' means the use (by a country's central bank) of several different exchange values, depending on the purpose of an international payment – for example, more favorable exchange rates granted to industries endorsed by a country's development policy. Following a 1947 'Letter on Multiple Currency Practices,' member countries had to submit multiple exchange rate proposals for the IMF to consider on a case-by-case basis. The IMF would agree to multiple exchange rates on a temporary basis provided that member countries dealt with what the institution saw as the underlying economic conditions – this was the beginning of 'conditionality.' Always opposed to multiple rates, in the late 1950s the IMF intensified efforts at simplifying and then eliminating them by the early 1960s. At the same time the IMF tried to get member countries to remove restrictions on the convertibility of their currencies into other currencies as a way of smoothing out

the financial conditions for international trade and investment. By the early 1960s fully convertible currency regimes existed in many European members of the IMF (de Vries 1986).

The other main function of the IMF was to act as a revolving fund, initially of $9 billion, whereby a country facing balance of payments problems could purchase foreign currency with its own, to correct temporary deficits in its balance of payments – the amount exchanged had to be repaid in gold or a currency acceptable to the IMF, usually within a year. Initially this function of the IMF was little used, mainly because the issue of the conditions placed on purchases had not been resolved (see Chapter 2). Only after 1950, with a reluctant general acceptance of the US position that purchases (often of US dollars deposited with the IMF) were conditional on a country's statement of the steps it would take to resolve its problems, did this part of the mandate of the IMF come into full use. In 1952 the IMF Executive Board agreed to a statement by the managing director that the policies proposed by a country to overcome balance of payments problems would, above all, determine the IMF's attitude toward its loan request (Horsefield et al. 1969: 3, 228–30).

The IMF began to distinguish among the various levels of borrowing, with low conditionality applied to borrowing from the 'gold tranche' (that is, the gold previously deposited by a country with the IMF) and higher degrees of conditionality applied to the 'upper credit tranches' (that is, the foreign currency, often US dollars, bought by a country). With this, loan conditionality became institutionalized in IMF dealings with member countries, especially as Third World countries began to regularly request drawings in the 1950s after the Korean War boom in raw materials prices collapsed, and balance of payments crises began. The IMF made stand-by arrangements conditional on the acceptance of policies such as eliminating exchange controls and the 'liberalization' of trade conditions – which meant withdrawing state intervention in foreign trade relations in favor of market control. Also the practice of 'phasing' drawings of funds was introduced with loans to Chile in 1956 and Haiti in 1958. Each phase was made conditional on satisfactory performance by the borrowing country as judged by the IMF – these conditions being laid out in letters of intent starting in 1958. Conditionality was essentially a US conception for the operation of the IMF that was opposed by other member countries, who still took the position of 'automaticity' that they believed to be the original intention of the Articles of Agreement

they had signed after Bretton Woods – that is, countries other than the USA thought they had an automatic right to withdraw their own deposits, albeit in dollars. The US executive director simply vetoed requests that did not comply with the American position, and the practice was for countries requesting drawings of large amounts of foreign currency to approach the USA directly for prior approval (Harmon 1997: 27).

In the 1960s the notion of fixed (par value) exchange rates came under increasing criticism as inadequate for dealing with rapid fluctuations in an increasingly global trading system. Arguments were made instead for fluctuating rates determined more by supply and demand in the international market for currencies. The IMF initially opposed this argument (essentially on Keynesian grounds, but also as a matter of institutional self-preservation), saying that the proper rate of exchange depended on a country's economic policies, and that fluctuations were often caused by speculative transfers of capital. Increasing attention was also paid to problems using gold and the US dollar as the main reserves backing international financial transactions. Some kind of internationally collective reserve unit (or CRU) was suggested in 1962. Then, by agreement among the finance ministers and central bank governors making up a 'Committee of Ten' (the leading economic powers of the time), and at the suggestion of the managing director of the IMF (Pierre-Paul Schweitzer), an amendment was passed to the original Articles of Agreement setting up a Special Drawing Account from which participating countries could exercise Special Drawing Rights (SDRs). This became a new kind of international reserve asset by 1970 just as the gold and oil crises drastically altered the international political economy and, with that, the role played by the IMF (de Vries 1986).

Crisis and transition 1971–79

The IMF traditionally used gold with a value pegged to the US dollar as the basis for international transactions. In the late 1960s, a major devaluation of British sterling caused fears of subsequent devaluations of the US dollar. Speculation drove the price of gold to unprecedented levels. At first a private, British financial group tried to stabilize the price of gold on the London market. But too much money was lost in the process. The market eventually forced the official price of gold to $38 an ounce, and then to $42.20, although there were separate official and private markets and a dual pricing system.

Even the increased official price could not compete with escalating market prices – no one wanted to sell 'official gold' because its price was set too low. Official transactions in gold came to a standstill. In 1971 the USA suspended convertibility of the dollars held by other governments into gold. An attempt was made to fix new exchange rates at a Smithsonian Institution (Washington, DC) meeting of the Committee of Ten, with the IMF Executive Board agreeing to a temporary regime of central exchange rates with wider margins of fluctuation. But even these could not be maintained. First the British pound, along with currencies tied to sterling, was 'floated' – that is, allowed to fluctuate according to demand and supply. Several other major currencies followed. The US dollar meanwhile was devalued twice within fourteen months. An enlarged Committee of Twenty tried in 1973 to come up with a reformed exchange rate system based on 'stable but adjustable' par values, but this was abandoned in 1974, and countries were allowed to determine their own exchange rate system. Eventually three kinds of exchange rate system emerged: 'free floats,' purely determined by currency markets; 'managed' or 'dirty floats,' involving central bank intervention to maintain minimum exchange rates; and currencies pegged to the dollar, or other major currencies such as sterling, and fluctuating with these. With two of its main bases undercut (the gold exchange standard and the par value system), the Bretton Woods system, as originally conceived, came to an end. It appeared that the ability of the IMF to regulate world financial conditions was at least greatly diminished, and perhaps finished (de Vries 1986).

The 1970s, however, saw the IMF re-emerge as an international lending organization on a different, and eventually more powerful, basis. How this came about is a complicated story. As we have seen, until the mid-1970s the IMF tried to make the international monetary system operate smoothly, restoring confidence in major currencies by making temporary loans at times of balance of payments crises. The IMF operated mainly in the interests of the industrial countries – as a kind of global Keynesian club, albeit under the direction of the USA. All this changed with a British application for an IMF standby loan in late 1976. Until the mid-1970s Britain maintained faint vestiges of its previously dominant position in the global economy. Sterling was a major reserve currency and means of international payment, while many countries, especially previous colonies, and countries in which Britain had played a dominant role, kept bank

accounts in the City of London, all this being a source of national income. Yet the manufacturing system that had made Britain 'workshop to the world' had long been in decline, while imports of food, raw materials, oil and industrial goods were increasing. Exactly this contradictory combination of international positions – vital to world financial stability, unstable in terms of trade – made a declining Britain the largest user of IMF funds for the first twenty-five years of the institution's operations. The UK drew $7.25 billion between 1947 and 1971, without much conditionality being attached to the loans (Britain being co-founder of the club) other than very general statements about policy, brief letters of intent, or (during a 1961 stand-by arrangement) an agreement to consult with the IMF in case of a major shift in policy. The Labour government led by Harold Wilson, however, which came to power in 1964, found that Britain was running a trade deficit of £750 million a year, and the Bank of England could not support the pound at an exchange rate of $2.80. The USA, under the presidency of Lyndon Johnson, offered to support the pound under a secret agreement that involved Britain maintaining its defense commitments 'East of Suez' and 'deflating the economy' – that is, restricting credit to reduce demand, cutting public spending and other similar policy measures (Ponting 1989). Then, in 1967, further heavy selling of the pound led the government to a reluctant devaluation (to $2.40) and an application to the IMF for a stand-by arrangement: this time the conditions included a visit to London by a negotiating team from the IMF staff, a detailed letter of intent specifying further deflationary policies, and quarterly inspections, these being interpreted by some members of the Labour cabinet as IMF control of the British economy.

While out of power, between 1970 and 1974, the Labour Party agreed to a 'Social Contract' with the British trade unions under which progressive social policies, including greater state direction of the economy, would create an appropriate climate for wage restraint. The prevailing view in a leftward-moving party was that (internal) growth and employment policies were more important than (external) exchange rate stability. Indeed, the Labour Party was re-elected in 1974 pledging, in its manifesto, to bring about 'a fundamental and irreversible shift in the balance of wealth and power in favour of working people and their families' (Harmon 1997: 4). Even during the 1974–75 recession, wages in Britain rose by 29 percent a year, while inflation ran at 20 percent. Britain's current account was heavily in

deficit, currency reserves fell, and the pound was considered to be still overvalued so that, as the phrase goes, 'confidence in sterling was low' (that is, oil states and private entrepreneurs threatened to move funds to more stable currencies that would hold their values). Even with (market-driven) exchange rates for the pound falling below $1.70 in 1976, and with unemployment rising, leftists in the Labour Party cabinet (Michael Foot, Tony Benn) wanted to reinflate the economy behind a barrier of import restrictions, rather than borrow from the IMF. Indeed, a multilateral international stand-by loan was arranged from the central banks of the USA, Japan and the west European countries, put together under the auspices of the Bank for International Settlements (BIS), with (informal) policy conditions coming from the US Treasury Department. Re-emergence of further pressures on the pound, together with an imminent need to repay the BIS loan, finally led a desperate British government to the IMF in late 1976. The resulting stand-by agreement, resulting from long and difficult negotiations, was made conditional on cuts in public expenditures, including many vital and popular social programs dear to the Labour Party's heart and crucial to its electoral success, together with the announcement of fiscal and monetary targets and a promise not to impose import controls, an anathema to free-trade-oriented organizations such as the IMF.

In an authoritative study, Mark Harmon sees the 1976–77 loan agreement between the IMF and Britain as a turning point in recent political-economic history. 'Economic policy retrenchment in Britain, involving repeated cut-backs in the Government's public expenditure plans and the move to publicly announced monetary targets, was largely the product of coercive external pressures exerted at multiple levels that served to constrict the policy autonomy of the governing authorities' (Harmon 1997: 229). Under the rubric 'coercive external pressures' Harmon includes a chronic lack of international confidence manifested in downward pressures on sterling – that is, the (currency) markets forcing policy changes on the British state. Harmon finds terms such as 'international cooperation,' often used to characterize global economic regimes, disguising a hierarchically organized political economy that includes the exertion of coercive instruments of power. He includes intergovernmental coercion under these 'external pressures,' in this case coercion applied by the governments of West Germany and the USA on Britain. Harmon says that the US government, under Republican Party control, exerted heavy pressure

on the British government, under Labour Party control, to change policy directions. (Indeed, Labour eventually emerged in the 1980s as a centrist rather than a leftist party.) These pressures could not be expressed too directly for reasons of state sovereignty. But pressure could be exerted via a supposedly neutral international organization, as with the IMF. Specifically, Harmon says, US Secretary of the Treasury William Simon believed deficit countries, such as Britain, to be in violation of an international 'code of behavior' that included, under 'responsible' behavior, the setting of 'realistic' goals for public policy, with realistic meaning a reordering of social objectives and a shift in resources toward private investment. The use of the IMF as the instrument for bringing about the desired changes in a sovereign nation's domestic economy, together with widespread publicity surrounding the British loan, 'fostered a belief that a conditional Fund stand-by was politically costly and something to be avoided if at all possible' (ibid.: 233). So the British loan contributed to the widespread view that the IMF was the last of the last places for states to look for external financing. Since 1977 the IMF's loan facilities have been used exclusively by Third World and post-communist governments. Harmon concludes from interviews he conducted that harsh IMF treatment of these desperate Third World applicants has only reinforced the reluctance of First World countries (as with a potential French application in 1983) to seek financing from the Fund. To summarize, after 1977 the role of the IMF effectively changed from being a means of collaboration on exchange rates and payments, mainly among industrial countries, to being a means of First World control over Third World economic policy. As we shall see in more detail, however, even the term 'First World control' is a misnomer that disguises a more narrow and concentrated domination.

The other significant change in the IMF's position occurred as a result of the oil crisis of the early to mid-1970s. In 1973, the Organization of Petroleum Exporting Countries (OPEC) raised the price of oil from $3.01 to $5.12 a barrel. Two months later it increased the price again, to four times the original. First World and Third World (non-oil-producing) countries suddenly incurred greatly increased energy costs, but each group reacted differently. On the whole, with exceptions that included Britain, First World countries had enough income and sufficient hard currency to pay the higher costs of importing oil, although not without significant inflation. Additionally, many First World countries were exporting technology and machinery

to the oil-producing countries so their balances of payments were not drastically disrupted. By contrast, most non-oil-producing Third World countries did not have high technological industry and were stranded without means of paying for oil imports, on which their economies had nevertheless become dependent. These conditions produced a massive shift in the geography of international payments. Oil-producing states accumulated huge surpluses in their balances of payments, while most non-oil-producing countries, especially in the Third World, went into equally serious deficits. Time, it seemed, for the IMF to ride to the rescue.

But the deficits faced by Third World countries were also an opportunity for private financial institutions, especially commercial and investment banks, to step in. Led by Citicorp, a US commercial bank based in New York, banks began extensive lending to the Third World in the late 1960s. The scale of this lending greatly increased in the mid-1970s, when the commercial banks began recycling 'petro-dollars,' deposited in New York and London banks, as loans to Third World governments. These private institutions were less concerned with the social and political responsibilities attending the loans, and were more concerned with the interest earned – on the whole, commercial bank lending was to middle-income, industrializing Third World countries, where it was thought that money could be made. The whole process of inflated lending on easy or non-existent terms resulted in even more debt, without much economic growth to service the loans, and with excess, unnecessary imports contributing even further to national deficits. Increasingly, Third World countries accrued new debt merely to repay interest on the old. Then financial institutions in the West suddenly realized that many debtors were not repaying their loans. The major banks panicked and refused to lend more. Third World countries could no longer borrow to cover their balance of payments deficits. So while the accumulating of indebtedness at first signaled a further potential decrease in the power of the IMF, and an increase in the direct powers of private banks, eventually the reverse happened, and the institution rose to new prominence, with new functions and greater powers of control over even more dependent countries.

Under Johannes Witteveen as managing director, the IMF quickly decided that it should play a leading role in managing the financial predicaments resulting from the oil crisis. In early 1974 the IMF set up a special temporary oil facility, financed by borrowing from member countries, mainly for Third World countries to draw from to pay the

higher oil prices. Also in 1974 the IMF introduced an extended fund facility to give medium-term assistance to Third World countries. And the IMF established a Trust Fund from sales of its gold holdings (no longer needed as SDRs supplanted bullion) to give low-interest, longer-term loans to low-income countries. The funds controlled by the IMF were greatly increased by increasing the quotas paid by national governments from 29 to 39 billion SDR, and establishing a supplementary financing facility based on additional borrowing from member countries. In 1972–78 the IMF approved more than a hundred stand-by arrangements, often for huge amounts, and for longer repayment times. Essentially the IMF survived and prospered by lending the funds for overcoming the world oil crisis and the multiple debt problems associated with it, especially the accumulating commercial bank debt (again the bankers' bank). Yet the IMF did not provide credit simply and unconditionally to countries in need. Instead the degree of conditionality increased markedly as the Fund's geographic emphasis shifted from First World to Third World loans, and as it introduced an Extended Funds Facility to 'give medium-term assistance to members with balance of payment problems resulting from structural economic changes' (IMF 1998a). This latter phrase meant that states could take longer to pay back loans if they promised to implement the very significant structural and economic changes that the IMF thought would ensure their capacity to repay.

As we have seen, elements of policy conditionality had long been attached to IMF financing. But the scope of conditionality expanded as crises occurred in several western European countries, and as more Third World countries joined the IMF in the 1960s. Conditionality is a point of tension between particular national governments and all governments that are members of the IMF, and centers on the Fund's powers of surveillance granted under Article IV. Increasingly in the late 1960s and the 1970s the IMF insisted on the adoption of 'stabilization programs' as prerequisites for stand-by and other financing arrangements. Cheryl Payer (1974: 33) outlined a model of the standard IMF stabilization program of the time as follows:

1 abolition or liberalization of foreign exchange and import controls;
2 exchange rate devaluation;
3 anti-inflationary domestic programs, including: (a) control of bank credit and higher interest rates; (b) lower state budget deficits

through curbs on government spending, increases in taxes, abolition of subsidies; (c) controls on wage increases; and (d) dismantling price controls;

4 greater hospitality for foreign private investment.

Under the guise of stabilizing the balance of payments situation in a country, the IMF engaged in the 'financial programming' of an applicant country's monetary, fiscal and other economic policies under the general term 'conditionality' and employing its powers of Article IV surveillance (indeed, one might add, stretching these powers, which originally dealt only with exchange rates). Following complaints from Third World countries about 'special treatment' being accorded to First World countries (although this treatment was severe enough in the case of Britain in the 1977 stand-by arrangement), the IMF's powers were more exactly specified in its *Guidelines on Conditionality* (IMF 1979). In return for using the IMF's general resources and stand-by arrangements, members were 'encouraged to adopt corrective measures … in accordance with the Fund's policies.' The IMF would discuss adjustment programs with members, including corrective measures, that would enable the Fund to approve a stand-by arrangement. It was agreed that 'in helping members to devise adjustment programs, the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems.' But the *Guidelines* also said that the managing director of the IMF would recommend approval only when he judged that the country's adjustment program was consistent with the Fund's provisions and policies, and when he thought that the program would actually be carried out. Indeed, countries might be expected to put the 'corrective measures' into effect before a stand-by arrangement was approved. Additionally, in the late 1970s, the IMF's annual 'consultations' with member governments were increased in scope following a Second Amendment to the original Articles of Agreement in 1978. Surveillance of exchange practices increased, while 'technical assistance' and training of officials in economic and financial management were expanded (ibid.).

To summarize, in the late 1970s the IMF assumed greater powers of control over longer-term economic policies (structural adjustment rather than short-term stabilization) while still supposedly paying 'due regard for the priorities, and circumstances of members.'

The debt crisis of the 1980s

After rising at a rate of 12 percent per year in the 1970s, commodity prices dropped sharply in the early 1980s, creating catastrophic circumstances for countries dependent on exporting raw materials. Countries partly compensated for the declining terms of trade with increased foreign borrowing. By 1982 the aggregate debt of non-oil-producing Third World countries had risen to $600 billion (de Vries 1986: 183). Debt crisis was triggered in August 1982 when Mexico announced that it could no longer make loan payments on time. Between 1977 and 1981 Mexico had economic growth rates of over 8 percent a year and greatly increased employment. The growth was precarious, however, with the country plagued by inflation and rapidly increasing debt, primarily in the public sector controlled by the PRI, the dominant political party. International interest rates were rising, and Mexico found it increasingly difficult to procure new loans. Investors began withdrawing funds from the country – between 1979 and 1982, US$55 billion in investment funds left (Grindle 1989: 192) – and Mexico's reserves were rapidly depleted. By mid-1982 capital inflows had virtually ceased. International finance responded with an 'emergency rescue operation' in which the central banks of ten developed countries provided short-term funding to Mexico, while a more permanent solution was being negotiated with the IMF. The IMF then approved a loan to Mexico conditional upon the acceptance of a structural adjustment program. The program included a reduction in public sector spending and state deficits that reduced government subsidies on basic consumer goods just as real wages fell precipitously (ibid.).

Brazil was the other large country involved in the debt crisis. Brazil had an import-substitution approach to development (that is, producing previously imported goods locally behind tariff barriers) that produced growth rates of 10 percent a year between 1968 and 1973 (Cardoso and Fishlow 1989: 82). But like many Third World countries, Brazil also borrowed heavily, particularly as the military government built large-scale projects in power, steel and transport infrastructure (Altvater and Hübner 1987: 140). This made Brazil increasingly dependent on the world economy and the financial markets. In the early 1980s international interest rates rose while the world (particularly the USA in 1980 and 1981/82) fell into recession. Brazil was unable to procure additional loans, while prices for its exports dropped significantly. Brazil announced a moratorium on

the repayment of foreign debts in 1982. The IMF imposed a policy regime similar to that required of Mexico. Brazil reluctantly turned from the growth path it had been pursuing and toward one that it was told could service debt. Currency depreciation, lower real wages, cuts in government subsidies and economic instability resulted. Brazil's economy stagnated. By the mid-1980s three-quarters of Latin American countries and two-thirds of African countries were under some kind of IMF–World Bank supervision.

The main players in the debt business were: the IMF, the Western commercial banks, and the First World governments on one corner of a triangular system; the governments of impoverished, oil-importing countries on another; and the people of the affected countries on the third. Concerned mainly with ensuring that loans were repaid, the IMF and the commercial banks developed an uneasy relationship of mutual support. The commercial banks needed the IMF to ensure loan repayment, and the IMF could do this with stabilization and structural adjustment measures imposed as conditions for loans ensured by the state. In return for playing this essential role, denied to private banking institutions, the IMF demanded that the commercial banks contribute even more money for international lending. This made the IMF a more powerful institution again, while increasing the profits of the commercial banks ($500 million profit in Mexico, $1 billion in Brazil), but left Third World countries even more heavily indebted (Chahoud 1987: 32). In the end, however, the people of the debtor countries paid the price in terms of unemployment, cuts in services and higher prices for basic necessities.

Another aspect of the changed conditions of the 1980s was a further rise in currency and other forms of financial speculation, which essentially turned Third World debt into a market opportunity. In an attempt to ensure partial repayment, commercial banks began selling the loans. In the 'used loan' market private capital interests bought the loans of Third World nation-states and, in exchange, received the loan value in the currency of the debtor country, which they then invested in that country. Private investors began speculating on the values of currencies and investing where they thought returns would be highest. Financial speculation brought on by the used loan market further destabilized non-Western economies that the IMF was supposedly stabilizing. At the same time, the IMF demanded that national governments (as part of loan conditionality) ensure economic stability by assuming greater responsibility for the loan-repayment

capabilities of the private sector of the economy as well, even taking over private loans where necessary. For example, if financial crisis struck the private banks of Ecuador, the Ecuadorean government was responsible for stabilizing the economy so that foreign investors did not lose money. In this way too the burden of debt was transferred from the banks of the First World to the banks of the Third World, to their governments, and eventually to their people (ibid.: 33).

The formula used by financial institutions to handle the debt crisis was called 'rescheduling.' During the first phase of the debt crisis, from 1982 to 1985, possible default by Third World countries was met by new loans organized by commercial banks, the IMF and other lenders. New lending under rescheduling was supposed to provide a respite enabling indebted countries to put their finances back in order, and resume repayment of their debts. The indebted countries had to follow IMF-sponsored adjustment measures that included raising taxes, raising tariffs, devaluing the currency and usually reducing government expenditure (more drastic structural adjustments were not yet seriously considered because the fundamental problem was thought to be temporary 'illiquidity,' that is lack of assets, such as cash, immediately available for settling financial obligations). Debt relief took the form of payment rescheduling, sometimes on concessional (low-interest) terms, sometimes coupled with new loans. Creditor governments formed a committee to deal with debt relief, in consultation with the IMF, which was hosted by the French Treasury and known as the 'Paris Club.' Repeated Paris Club rescheduling of debts led official lenders eventually to recognize that a new approach was needed for these countries.

Continuing efforts by the USA to find a position adequate for responding to a deteriorating debt situation culminated in a proposal made in October 1985 by James A. Baker III, secretary of the Treasury between 1985 and 1988 in the Reagan administration, in what came to be known as the 'Baker Plan.' To prepare for announcing the plan Treasury Secretary Baker summoned the chief executives of the largest US banks – Chase Manhattan, Citibank, Bank of America, along with Paul A. Volcker, chairman of the Federal Reserve Board – to a meeting (Rowe and Henderson 1985: A14). US Treasury and State Department officials, with Richard Darman, deputy secretary of the Treasury (1985–87) playing a main role, had been working on the plan for months, concerned that social and political pressures from the debt crisis could explode, particularly in Latin America.

The idea was that the IMF and the World Bank should join forces to increase the amount of loans available from both institutions and the commercial banks. But loans would be made conditional on 'policy improvements in the macroeconomic framework' under structural adjustment programs (SAPs) – the 'policy improvements' being in line with right-wing notions of the causes of growth (markets, privatization, deregulation of private enterprise, reducing state deficits, and so on). The new strategy for managing the debt crisis essentially read as follows:

1 The principal debtor countries, some fifteen middle-income Third World countries, owing a total of $437 billion, and paying interest rates of around 10 percent, would get an additional $29 billion in loans over three years, with $20 billion coming from commercial banks, the rest from international lending agencies, mainly the IMF and the World Bank.
2 To get these loans debtor countries would have to make 'structural changes' that were supposed to invigorate their economies, enabling them to 'grow their way out of debt' – these were more fundamental market-oriented reforms than previously, such as tax reduction, privatization of state-owned enterprises, reduction of trade barriers and investment liberalization (that is, allowing unrestricted access for foreign investors).
3 While the IMF would have a continuing, central role in enforcing these macroeconomic changes, the Fund was considered to be primarily a short-term lender and, believing that longer-term 'structural' solutions were necessary, the US Treasury and State Department wanted the World Bank to become more involved in 'modernizing' the economies of the debtor countries.

The Baker Plan was immediately accepted by the IMF. The commercial banks, however, proved wary about making new loans without guarantees from official sources. So commercial lending to debtor countries actually decreased following announcement of the Baker Plan, while official lending from the IMF and the World Bank, as well as the government of Japan, took its place: between the end of 1985 and late 1988, net lending from the public sector to the countries covered by the Baker Plan amounted to $15.7 billion, while new money from private banks amounted to $12.8 billion. Interest payments remained high – $30 billion a year continued to flow out of Latin America, for instance. Over the next three years the official

view became that the Baker Plan had failed, and that more extreme debt-reduction measures were necessary.

Throughout the 1980s debtor nations and commercial bank creditors had engaged in repeated rounds of rescheduling and restructuring sovereign-nation and private-sector debt. This led broad sectors even of financial and quasi-official opinion toward the recognition that some of the loans would never be repaid. For example, US Senator Bill Bradley (Democrat, New Jersey) argued that Latin American governments friendly to the USA would not be able to stay in power unless their debts were reduced or simply canceled, while new loans were of little good because they were used largely to pay off old interest charges. When the (Republican) Bush administration assumed office in 1989, the new secretary of the Treasury, Nicholas Brady, announced that the only way to address the debt crisis was to 'encourage' the banks to engage in 'voluntary' debt-reduction schemes – the plan resulted from previous work by David Mulford, Treasury under-secretary for international affairs (Rowen 1989). Under what became known as the Brady Plan, countries were to implement market-oriented structural adjustment, as with the Baker Plan, but this time in exchange for a reduction of commercial bank debt and, often, new loans from commercial banks and multilateral lending agencies (Blustein and Rowen 1989). For example, in the case of Mexico, an advisory committee, consisting of the Mexican government and representatives of some five hundred banks, negotiated a 'menu' of options that the banks could choose from to reduce (or increase) their debt exposure: existing loans could be swapped for thirty-year debt-reduction bonds that would provide a discount of 35 percent of the face value – that is, reducing Mexico's debt by this amount – with the bonds compensating the lender with an interest rate slightly above market rates; existing loans could be swapped for thirty-year par (face value) bonds with a below-market interest rate that would effectively reduce Mexico's debt service on those loans; and banks could also provide new loans of up to 25 percent of their 1989 exposure at market interest rates. In effect the banks, as creditors, would grant debt relief in exchange for greater assurance of the collectability of the rest in terms of principal and interest. In exchange for forgiving part of Mexico's debt, the principal and interest of the new bonds banks received were securitized (backed) by US Treasury bonds, which in turn were financed by the international financial institutions – the World Bank and the IMF would provide $12 billion

each, and the Japanese Import–Export Bank provided about $8 billion for securitization. Also what came to be called 'Brady bonds' could be bought and sold on financial markets, often at considerable discounts. The IMF Executive Board immediately adopted most of the Brady Plan linking debt reduction to structural adjustment, and US Treasury officials pressured initially skeptical creditor banks into making Brady deals. By May 1994, eighteen countries had agreed to 'Brady deals' forgiving $60 billion of debt and covering about $190 billion in bank claims. The typical Brady deal leads to 30 to 35 percent forgiveness of a country's debt (Vasquez 1996). Behind this flurry of debt rescheduling and relief activity, strong political pressure was exerted by national governments, especially the USA, usually operating in concert with the Paris Club and the IMF. The main concern of this group of actors was preserving the banking system in the face of the possibility of repudiations of hundreds of billions of dollars in unpayable debts.

Capital account liberalization

Looking again at the original Articles of Agreement forming the mandate for the IMF, we notice that: in Article I paragraph (iv) the institution was to establish 'a multilateral system of payments in respect of current transactions between members'; in Article VI member countries might exercise controls over capital transfers but not restrict payments for current transactions; and under Article XXX payments for current transactions, dealing with trade and other current business, including services and short-term banking and credit services, lie within the IMF's jurisdiction, while capital transactions, which are payments for the purpose of transferring capital, do not. In other words, the IMF was to regulate financial issues arising from trade in goods and services that appear in the current accounts of countries' balances of payments. Private capital movements to 'emerging markets' that were not directly related to trade, however, increased rapidly in the early 1990s. To facilitate these movements, the international banks and the US Treasury pushed governments into rapidly opening all parts of their financial markets to foreign entry. In September 1996, the Interim Committee of the IMF asked the Executive Board to investigate changing the IMF's Articles of Agreement so that it could address issues arising from the growth of international capital flows. In April 1997, the Interim Committee said that the Articles might be amended to enable the IMF to promote the 'orderly liberalization of

capital movements.' By this the Committee meant removing national (state) regulations on financial markets in member countries and removing all restraints on the free international movement of capital and all kinds of financial instruments and transactions – what the Fund called 'an open and liberal system of capital movements' (*IMF Survey*, 6 October 1997: 291). In line with this, the September 1997 joint meeting of the IMF and the World Bank in Hong Kong was supposed to give the Executive Board a mandate to complete work on amending the Articles of Agreement, so that the IMF would openly and actively promote capital account liberalization and extend its jurisdiction over global capital movements – a momentous extension of the Fund's original powers.

Then, on 2 July 1997, a speculative attack on the baht, the Thai currency, caused an overnight decline in value of 25 percent, followed by further waves of speculation aimed at the currencies of Korea, the Philippines and Indonesia, in what built into the East Asian crisis – failing banks, plummeting GDP, rising unemployment – which left the 'miracle economies' floundering for years. Even worse for the IMF's case, the 'financial liberalization' that had already occurred was widely seen as contributing to the massive flows of speculative capital into, and out of, many of the East Asian economies – Joseph Stiglitz (2002a: 89, 99), for example, calls capital account liberalization the single most important cause of the East Asian crisis, and the crisis itself the worst since the Great Depression. The IMF had been active in Thailand, urging the government to devalue the baht, cut it loose from its peg to the dollar and float it. The same day (2 July) that the government complied, the IMF praised its 'comprehensive strategy to ensure macroeconomic adjustment and financial stability' (the stock phrase for all such circumstances) while the baht was nosediving, followed by the currencies of most other East Asian countries after similar advice from the IMF – even the *Wall Street Journal* said of this: 'The IMF tripped this crisis by urging the Thais to devalue, then promoting contagion by urging everyone else to do likewise. Now Mr. Camdessus [managing director of the IMF] and Treasury secretary Robert Rubin want fresh billions to deal with the train wreck' (Wall Street Journal 1999: 120).

For the IMF, by comparison, the East Asian crisis stemmed from internal weaknesses in the financial and governance systems of the affected countries:

> A combination of inadequate financial sector supervision, poor assessment and management of financial risk, and the maintenance of relatively fixed exchange rates led banks and corporations to borrow large amounts of international capital, much of it short-term, denominated in foreign currency, and unhedged. As time went on, this inflow of foreign capital tended to be used to finance poorer-quality investments. Although private sector expenditure and financing decisions led to the crisis, it was made worse by governance issues, notably government involvement in the private sector and lack of transparency in corporate and fiscal accounting and the provision of financial and economic data. After the crisis erupted in Thailand with a series of speculative attacks on the baht, contagion spread rapidly to other economies in the region that seemed vulnerable to an erosion of competitiveness after the devaluation of the baht or were perceived by investors to have similar financial or macroeconomic problems. (IMF 1999)

The IMF claims to have then restored international confidence by 'helping' the three countries most affected by crisis – Indonesia, Korea and Thailand – to adopt programs of economic stabilization and reform in return for lending SDR 26 billion (US$35 billion) and arranging US$77 billion of additional loans from other sources. The IMF subsequently forced 'comprehensive reforms' that included increased foreign participation in domestic financial systems, increasing the power of free markets and breaking traditionally close links between business and governments. Exactly these links between government and business have, however, been main causal factors lying behind East Asian industrialization, while integration with international financial markets was thought by many to be the basic cause of the crisis. In this case, the IMF's policies in East Asia were criticized by Keynesian liberals and Friedmanesque neoliberals alike (see McQuillan and Montgomery 1999) and, as a result, the institution's reputation has never recovered, even in circles that the Fund values. Now the 'middle income' Third World countries of South-East Asia and Latin America follow the west European countries in also not going to the Fund in times of crises.

As a result of the East Asian crisis, the almost completed IMF capital account liberalization project faced a far more critical response. But the IMF continues to argue for it. So when Michel Camdessus (1998) was asked whether, with the still-deepening crisis in Asia,

capital account liberalization was such a good thing after all, and was the IMF the right institution to oversee countries' efforts to implement it, his answer was 'clearly yes.' It was right because the theory behind it was correct. That is, free capital movements help channel resources into their most productive uses, and thereby increase economic growth and welfare, nationally and internationally. The fact that the IMF had been called upon to finance balance of payments problems associated with capital accounts provided yet one more compelling reason why the Fund's jurisdiction should be extended to capital account issues. So in the managing director's view capital account liberalization must be 'bold in its vision, cautious in its implementation.' A different view of why the IMF persists in trying to open financial markets is provided by Jagdish Bhagwati, a prominent advocate of free trade. Bhagwati says that the Wall Street investment banks want to be completely free to put money into countries and take it out, while the Fund sees itself as lender of last resort and manager of the whole capital system: 'Morgan Stanley and all those gigantic firms want to be able to get into other markets and essentially see capital account convertibility as what will enable them to operate everywhere. Just like in the old days there was this "military–industrial complex," nowadays there is a Wall St.–Treasury complex' (interview, 1997, in Wade and Veneroso 1998: 18–19).

Hence capital account liberalization is still on the IMF's agenda. For critics, of course, this shows that when the IMF makes a mistake, as clearly (to almost everyone outside the institution) it did in East Asia, its response is to ask for new powers that would increase its capacity to make even more harmful mistakes in the future.

New debt crisis in Latin America

Latin American countries following free market policies have grown at a fraction of the rate they grew at in the 1970s and 1980s, when governments followed more interventionist and protectionist policies. In the late 1990s, and continuing in the early 2000s, many Latin American countries, following IMF-approved stabilization and restructuring programs, became economically depressed. The most serious case was Argentina, which had an exchange system that fixed the peso to the dollar, but also overpriced its exports and undercut its international competitiveness – the economy began a serious contraction in 1998. The country's accumulating debt burden ($128 billion), though not enormous relative to the size of its overall economy,

became unsustainable, as exports decreased. Fears of financial collapse led to the movement of assets out of the country. Argentina received $13.7 billion in IMF aid in the closing days of Bill Clinton's administration, but the incoming George W. Bush administration expressed reluctance to allow repeated bailouts of what it saw as failing economies. On the occasion of a new approach to the IMF in August 2001 for a further loan, the Bush administration tried to use Argentina's financial crisis to demonstrate its new, skeptical approach to financial bailouts, breaking 'an overly accommodating stance' by the Clinton administration. When Treasury Secretary Paul O'Neill and other Treasury officials met with the Argentine delegation to Washington the initial response was to decline to commit new aid. A description of the subsequent negotiations in the *New York Times* gives some idea of the power politics involved:

> It is not unusual for the United States, the largest single shareholder in the fund, to play an important role in shaping an emergency aid package to a large developing country. But several people involved in the talks said the administration's role was especially intricate in this case, with many late-night sessions held in Treasury offices rather than at I.M.F. headquarters nearby. Bush administration officials pressed a team led by Daniel Marx, Argentina's finance secretary, to come up with ways of reorganizing Argentina's finances and debt payments so that it could survive without fresh loans. (Kahn 2001a)

If there were to be new loans, the USA and the IMF wanted Argentina to demonstrate that the money would last beyond the usual terms of three years. Treasury Secretary Paul O'Neill said: 'We're working to find a way to create a sustainable Argentina, not just one that continues to consume the money of the plumbers and carpenters in the United States who make $50,000 a year and wonder what in the world we're doing with their money' – remarks that *La Nación*, a leading Buenos Aires newspaper, found 'outside all norms of respect and protocol.' After nearly two weeks of negotiations, the IMF announced $8 billion in emergency aid to Argentina to stabilize its economy, of which $5 billion would be lent immediately, and the other $3 billion delayed, awaiting a rescheduling of debt payments, a new and more forceful (even positive) approach. Other elements of the aid package included the usual IMF prescription of fiscal discipline and reduction of central and provincial government spending. The Argentine government then froze bank accounts and began raiding

pension funds to find hard currency to make debt payments. In 2002 the economy minister announced that Argentina would no longer use its diminishing foreign reserves to pay back IMF loans and that while Argentina hoped to reach a new agreement with the IMF, it was 'not going to sign just any old agreement … and would … not renounce its policy of social assistance' (Rohter 2002b). In September 2003, Argentina announced a temporary default to the IMF, until the Fund backed down. The result was rapid economic recovery.

An assessment by the IEO of the role of the IMF in handling the Argentine debt crisis during the decade 1991 to 2001 found that sizeable damage had been done to the Fund's reputation: associating it with inappropriate policies, creating a perception that it lacked even-handedness in dealing with member countries, and putting its role in signaling sound policy environments into question (BWP Update 42). This view is buttressed by a report from the US think tank Center for Economic and Policy Research. The Institute found that IMF projections of future economic growth were consistently wrong for Argentina, overestimating 'projections' of future growth when Argentina was following Fund prescriptions, and underestimating them when the country was in dispute with the Fund over debt renegotiation. The report concluded: 'The IMF's large and repeated errors in projecting GDP growth in Argentina since 1999 strongly suggest that these errors were politically driven' (Rosnick and Weisbrot 2007: 2). Widespread riots, the collapse of the government and continuing economic chaos had led to even more questions about the effectiveness of the IMF and the international financial policies of the USA, as with virtually all major financial agreements, including those in Mexico, Thailand, Indonesia, South Korea, Russia and Brazil.

Brazil had been the poster country of free market orthodoxy during the eight years of the presidency of former dependency theorist Fernando Henrique Cardoso. But following the advice of the IMF and the World Bank on restructuring the Brazilian economy resulted in only modest economic growth, of about 3 percent a year, and a public debt of $240 billion. In elections for a new president in 2002 the leftist candidate from the Workers' Party, Luiz Inacio Lula da Silva, promising relief for poor people, became the leading candidate. In the summer of 2002 a crisis in investor confidence, a plummeting currency (which lost 20 percent of its value in a month) and the prospect of a new government defaulting on the public debt led to a financial crisis, and an urgent request for an IMF loan of $30 billion.

The conditionality in this case was that most of the loan ($24 billion) would be delivered only if the new government, whichever one was elected, met certain budgetary targets over a period of three years, a stipulation seen as an intrusion into Brazil's sovereignty. Commenting on the situation in Latin America, the *New York Times* said: 'The standard advice of the Fund to clients facing crisis has been to insist on increased austerity, arguing that fiscal discipline is a necessary precondition to prosperity. But that translates into enormous suffering for millions of people, strengthens the appeal of left wing critics of free market economies and weakens governments that have made the changes Washington is urging' (Rohter 2002a: 3). All candidates in the Brazilian election, including 'Lula,' were forced by the financial emergency to agree with the IMF's conditions. The US Treasury tried to reassure investors that even if the Workers' Party won the election Brazil would get through the crisis. Wall Street, however, thought differently. 'When you look at the numbers, it's pretty tough to make them add up,' said Larry Kantor, chief of global currency strategy at J. P. Morgan Chase. 'The markets have to assume the worst,' said Rodrigo Azevedo, co-chief of Latin American research at Credit Suisse First Boston in São Paulo. 'The markets have clearly not been willing to give Brazil the benefit of the doubt' (Andrews 2002c: 6). The problem is that judgments such as these by 'financial analysts' determine the amount of capital flowing into Brazil and this (especially given the country's 'opening up' under IMF mandate) determines growth and employment. George Soros (himself no stranger to high finance) said that 'The system has broken down … It does not provide an adequate flow of capital to countries that need it and qualify for it' (in ibid.: 6). Or elsewhere, speaking about extensive IMF and international investor involvement in the Brazilian elections, Soros said: 'In ancient Rome, only the Romans voted. In modern global capitalism, only US financial agents vote, not Brazilians' (Semple 2002: A4). In particular, critics see IMF involvement as the subversion of democracy by an autocratic institution convinced that it knows best. But even this might be an optimistic appraisal – for the *New York Times* went on to say that the G. W. Bush administration 'continues to be baffled as to a long term solution' to the problem of the contraction of Latin American economies, and that asked why countries were 'increasingly rejecting the magic recipe of privatization, lower tariffs and increased foreign investment, [US] Treasury Secretary Paul H. O'Neill replied, "I have no idea"' (Rohter 2002a: 3). What O'Neill, Bush and the

others cannot reveal, and perhaps cannot realize, is that financial markets rule over political democracy rather than constituting it. In brief, the Argentina and Brazilian cases, together with imminent debt repudiation in Uruguay, and problems in Paraguay, Ecuador and Colombia, suggest systemic crisis in Latin America caused by a level of market failure that may well transcend the recuperative abilities of global governance.

The response to this crisis, discussed at the September 2002 IMF–World Bank meetings, and among the finance ministers of the Group of Seven industrial countries, was a new legal framework under which countries undergoing severe financial crisis would be able to enter something like a bankruptcy proceeding. The idea behind this had been 'floated' by several academics but 'not taken seriously' or 'never publicly embraced' (as the saying goes in inner circles) until, in November 2001, Anne Krueger, first deputy managing director of the IMF, and a former academic and member of the Hoover Institution, a conservative think tank in Palo Alto, California, raised it again with the name of Sovereign Debt Restructuring Mechanism (SDRM). The plan would fill what Krueger called a 'gaping hole' in the international financial system by establishing a formal bankruptcy process for nations undergoing severe financial difficulties, allowing them to stop paying debts while they negotiated with bankers and bondholders. The proposal was modeled on Britain's bankruptcy laws. A nation could apply to the Fund for the right to declare bankruptcy. Under the new approach, a country would approach the IMF and request a temporary standstill on the repayment of its debts, during which time it would negotiate a rescheduling or restructuring with creditors over a period of several months. If the request was agreed to by a majority of creditors could decide terms for the whole. The new approach was necessary because most private money lent to the richer developing countries recently has come from bond investors. When over-indebted countries, such as Peru, have sought to lower payments to their creditors, some bond-holders have filed lawsuits in their home-country courts, based on their contractual rights to receive full payment of interest and principal. Countries could also impose temporary foreign-exchange controls to prevent a rapid outflow of private funds. The arrangement would not legally extend the power of the IMF, but would override current US law, which allows any bondholder to sue for full payment in the event of a default. The plan faced severe opposition on Wall Street, where it was thought that it would

end 'emerging-market' debt finance: bankers and brokerage houses warned that investors would move their money out of developing countries rather than risk having funds impounded in an international bankruptcy proceeding. Charles H. Dallara, managing director of the Institute of International Finance (IIF), called it 'a nuclear-bomb solution that could really backfire.' The IMF, he said, wanted to cast itself as bankruptcy judge even though it was often the largest creditor and sought to protect its own loan portfolio. By comparison, the interests of private investors did not rank as high. The US government too was for a long time hostile to the SDRM. But financial collapse in Argentina gave renewed impetus and the new plan fitted into a change in the Bush administration's position after September 11, 2001, toward seeing the problems of developing countries not only as economic issues, but also as part of a national security strategy (Andrews 2002b). And the IMF staff, while at first antagonistic to the idea, came round to endorsing it as part of a reconsideration of position in response to the Latin American debt crisis. With support from political and bureaucratic sources, and in the context of economic and political crisis, the US Treasury Department and the finance ministers of the other industrial countries endorsed the plan in 2002, overriding Wall Street objections (Blustein 2001; Andrews 2002b).

Protesting the Fund

IMF policies have long drawn massive and violent protest from the millions of people adversely affected. Until the mid-1970s, when IMF conditionality took a turn for the austere, controversy over the Fund had taken the form mainly of intergovernmental arguments, between the USA and Britain, for instance, or between First and Third World members, and squabbles between governments and the institution – that is, between treasuries and ministries of finance on the one side, and the Executive Board, managing director and staff of the IMF on the other. But as conditionality came to be more drastically imposed on Third World countries, popular discontent quickly escalated. Protest often began as 'food riots' – people opposing sudden increases in the price of food – within overall 'austerity protests' – people objecting to broader aspects of a deteriorating situation, such as wage cuts and the elimination of government subsidies – all these being conditions imposed on national governments by the IMF in return for the granting of desperately needed loans.

For example, on 8 March 1976, workers in Cordoba went on strike

to protest about the Argentine government's freezing of wages for 180 days. National business organizations also protested against the government's decision. The government's intention was to meet the IMF's conditions for credits to offset increased costs of oil imports by lowering the rate of inflation, and increasing savings, in order to reduce Argentina's foreign debt (*New York Times*, 9 March 1976).

In January 1977, riots broke out in Egypt after the government decided to lift subsidies on staple foods (*New York Times*, 21 January 1977). Rescinding of the subsidies to reduce Egypt's balance of payment and budget deficits was encouraged by the IMF, the USA, Saudi Arabia and Kuwait. Twenty-four people were killed as the army put down the riots. Eventually, Saudi Arabia and Kuwait loaned Egypt $1 billion to cover balance of payments deficits and the Egyptian government restored many of the food subsidies (*New York Times*, 6 May 1981).

On 1 July 1981, a general strike was called by the Democratic Workers' Confederation in Casablanca to protest against the Moroccan government's decision to lift subsidies on staple foods at the IMF's insistence as a condition for a $1.2 billion loan for a balance of payments deficit and foreign debt restructuring. The removal of subsidies caused the price of butter to go up by 76 percent, wheat flour by 40 percent, sugar by 37 percent and cooking oil by 28 percent. The strike turned into rioting by thousands of youths from the shanty towns encircling the city. The army and police fired into the crowds, killing sixty-six people according to the government, and 637 people, mostly children and teenagers, according to the opposition Socialist Movement (*New York Times*, 4 July 1981).

On 24 April 1984, cities in the Dominican Republic erupted as business, labor, leftist organizations and youth struck and protested against government-imposed austerity measures. Under the conditions of an IMF loan, the government had lifted subsidies on imported goods, forcing the price of medicines to increase by 200 percent. The protest turned into a riot and the police and military overreacted: fifty people were killed and four thousand arrested. Officials in the Dominican Republic criticized the IMF for trying to impose policies without regard for the specific history, culture and social climate of the country (*New York Times*, 29 April 1984).

Nigerian protests began in April 1988 as a reaction to the lifting of subsidies on petroleum products, and continued over two decades. What began as labor strikes soon included a student uprising, with

several universities closed for long periods. IMF structural adjustment programs affected more than just petroleum prices – social services, such as healthcare, were adversely affected while many state subsidies, including those on food staples, were lifted – all of this coming with severe devaluation of the national currency.

In Venezuela, previously a bedrock of stability and democracy, protests were seen as direct responses to the destabilizing effects of structural adjustment programs. Venezuela was a relatively well-off, oil-exporting country, yet by the end of the Latin American debt crisis of the 1980s it had accumulated $33 billion in foreign debt. Protests in Venezuela centered on an increase in petroleum prices resulting from removal of government subsidies. Hundreds were killed in protests in 1989 as a reaction to increasing bus fares after petroleum prices were raised (*New York Times*, 28 February 1989). As with the Nigerian case, IMF-imposed austerity measures included cutbacks in the social sector, which fueled further protest. As the *New York Times* reported, 'Venezuela's president said dozens of people had been killed and hundreds wounded in rioting today … over economic measures imposed by the Government to satisfy its creditors' (*New York Times*, 1 March 1989). When the president announced that Venezuela might have to suspend payment on the country's debt to quell the violence, the USA granted 'emergency loans of $2 billion to get them through their trying times' (*New York Times*, 4 March 1989).

In spring 1998 massive unrest and violent riots in Indonesia directly resulted from IMF-mandated reductions in government subsidies. As with other protests of the time, opposition focused mainly on reductions in food and petroleum subsidies. Collapse of the national currency, the resulting international bailout, mass rioting and the eventual resignation of the president were all intricately connected with IMF intervention. The saga began in 1998 when the IMF gave the Indonesian government, under a clearly corrupt President Suharto, a $40 billion loan package. In return, Suharto had to agree to stringent austerity measures. A *New York Times* article summarized the situation: 'It is the IMF that will decide when the Indonesians have done enough to earn the next aid installment. But the United States holds a de facto veto over such decisions, and so the talks with Indonesia have been a delicate, three-way dance between Mr. Suharto, economists and top officials from the IMF and American officials in Jakarta and Washington' (*New York Times*, 25 March 1998). In May 1998, a 70 percent increase in the prices of fuel and electricity widened the

protests (*New York Times*, 6 May 1998, 16 May 1998). Businesses were burned, ethnic tensions grew as protesters targeted Chinese Indonesians, and by the time Suharto resigned later that month, some twelve thousand lives had been lost (*New York Times*, 6 July 1998). According to the *New York Times*, 'American and IMF officials have concluded … that they moved too hastily in insisting on breaking up food monopolies and ending subsidies on essentials like fuel. While the subsidies are expensive, they may be the only way to keep social unrest from seizing the country' (25 March 1998). Even so, as a later article concluded, 'Treasury officials today acknowledged that Indonesia has failed to meet some of the most important conditions that were imposed by the International Monetary Fund in return for a $40 billion bailout package. Nevertheless, they said, the United States expects to vote in favor of gradual resumption of aid' (*New York Times*, 1 May 1998).

In general, popular protests against the IMF and national governments tend to follow a similar path. Using the cases of 146 'austerity protests' in 39 countries in the period 1976–92, John Walton and David Seddon (1994) reach the following conclusions. They define 'austerity protests' as 'large-scale collective actions, including political demonstrations, general strikes, and riots, which are animated by grievances over state policies of economic liberalization implemented in response to the debt crisis and market reforms … devised and implemented by the International Monetary Fund' (ibid.: 39). Austerity protests, they say, tend to occur under these conditions: first, they almost always happen under circumstances of rapid urbanization and sudden increases in population size; second, they occur in places with recent histories of substantial political activism, organized and institutionalized through unions, community organizations, mosques, temples or churches; third, they do not occur in the areas of greatest hardship and suffering; fourth, and most significantly, they happen when people think that an injustice has been done – specifically that the 'social contract' between people and government has been broken (ibid.: 42–54). They explain that 'countries with large, poor urban populations experience protests when governments impose policies with repressive social class consequences in the interest of serving foreign debts' (ibid.: 887). The groups most drastically affected include the working poor, parts of the middle class, students and other urban dwellers. The elimination of governmental subsidies, mandated by the IMF, causes a rise in consumer prices. Together with currency

devaluation and wage cuts, this causes hardship for city dwellers that often results in protest.

In the Walton and Seddon explanation, to which we add some of our own ideas, many Third World states established implicit social contracts with citizens in the 1960s and 1970s. Many Third World countries, particularly in Latin America, pursued import substitution policies aimed at protecting local industry against foreign competition. Import substitution was pursued by a developmentalist alliance among commercial farmers, state bureaucrats, national industrial capitalists, urban merchants and urban middle and working classes. Rapid urbanization from 1950 onward forced governments to focus on satisfying the needs of city residents or risk constant political turmoil (Cardoso and Faletto 1977: 131). While the urban upper and middle classes profited directly from the protections afforded by import substitution policies, the rest of the urban populace, the working class and the poor, was incorporated into the developmentalist alliance via state subsidies on basic necessities. The social contract consisted of an unspoken agreement that urban dwellers would give their political allegiance to the government in exchange for these subsidies. But the bargain between the urban poor and the state came to rely increasingly on funds provided by foreign loans. With economic recession, and the rise in oil prices in the 1970s, foreign lending carried new neoliberal conditionalities. Lifting of subsidies on basic goods under IMF mandates provoked austerity riots not only because of the threat of starvation, but because the agreed-upon meaning, or the 'historicity' (Touraine 1988: 8), of what constituted social progress was broken, and a new historicity, originating with the IMF, came into force, one that prohibited the state from fulfilling its side of the social contract.

The state's legitimacy rested on the popular perception, seen mainly in terms of the prices of necessities, that it was committed to the social contract. When the price of food was no longer determined by the state, or even by public opinion, but was determined by the market under IMF mandate, then price no longer expressed an agreed social contract. Instead price represented collusion between what was now revealed to be an unjust, illegitimate, authoritarian government and a distant, international monetary institution. A new meaning came to define society's development: unregulated economic growth benefiting foreign capital and already rich people. The new meaning implied that money and profit had become more important than

the lives of the poor. Society's poor and weak were being sacrificed on the altar of profit. This new symbolic meaning provoked revolt against the symbols of wealth: treasuries, national banks, the legislature, presidential palaces, travel agencies, foreign automobiles, luxury hotels and international agencies symbolizing the national and international forces behind the lifting of subsidies have all been targets for protesters (Walton and Seddon 1994: 43). Let us add that many people have been killed during IMF austerity protests – at least tens of thousands, and perhaps a hundred thousand. The number of people who die as a result of the social and economic effects of IMF austerity programs, from the increased incidence of starvation and the concomitant reductions in health programs, has never been reliably estimated, although by one account 6 million African, Asian and Latin American children are said to die each year from the effects of structural adjustment (Budhoo 1994: 21–2).

Since the late 1980s, the mainly national demonstrations against IMF austerity programs have become international protests. The 1988 annual meetings of the IMF and the World Bank, the largest since Bretton Woods, held in West Berlin during the last week of September, and bringing together 13,000 bankers and financial officials, were met for the first time by massive protest, organized by First World Western opposition groups, and attended by tens of thousands of non-Third World citizens. Twenty thousand demonstrators drawn from a number of leftist causes marched through the city protesting 'against IMF policies towards developing nations' (*New York Times*, 26 September 1988). The Third World Congress, made up of representatives from impoverished Third World countries, issued a call for debt cancellation, while a broad range of people expressed concern about world hunger and poverty (*Guardian*, 26 September 1988). Taking place in western Europe, at the center of a major national member of the IMF, the protests were given considerable media attention. Small protest demonstrations met virtually all subsequent meetings until the Seattle demonstrations against the WTO in 1999, since when all meetings of the IMF, the World Bank, the G7 and G8 meetings among major Western economic powers, and virtually every other 'economic summit' have been met by massive protests.

NGOs

The recent demonstrations have been coordinated by a number of NGOs and protest groups, including some formed specifically to

oppose IMF and World Bank policies. Jubilee 2000 is a faith-based movement, with significant secular participation, which works to persuade governments to provide debt relief for the world's poorest nations. The coalition originated in the UK in the early 1990s, and currently has support groups in sixty-five counties. In scriptural terms (Leviticus 25:8–12), the concept of a jubilee means that every fifty years, land is restored to its original owners, slaves are released, and there is a general remission of debts. The year 2000 was considered an ideal time for a jubilee. In the Christian community the new millennium marked the 2,000th anniversary of the birth of Christ, while beyond religious circles the turn of the century was a major media and popular cultural event. Jubilee 2000 argues that the world's poorest countries spend more repaying foreign debt than they spend meeting human needs, such as healthcare, sanitation and education. The coalition claims that 7 million children die each year as a direct result of the burden of debt repayment. So they called for 'a one-off cancellation of the unpayable debts of the world's poorest countries by the end of the year 2000, under a fair and transparent process' (www.jubilee2000uk.org). Because of its biblical slant, the coalition was able to make debt forgiveness into a moral, rather than a political, issue, and this broadened the base of support: for example, the Pope is an ardent supporter. By 2000 promises of $100 billion in debt relief had been obtained. The USA, Britain, Canada, France, Japan, Germany and Italy all agreed to forgive 100 percent of the bilateral debt owed to them by the poorest countries. Much debt relief, however, is bound up in complex procedures and prior agreements. Countries have to spend the money saved on debt repayment for health and human services that were cut under structural adjustment programs. And, although debt forgiveness was promised by the year 2000, only twenty countries had received some debt relief at that time. Jubilee 2000 did not disappear at the end of the millennium but, rather, a new organization was formed – Jubilee South.

Jubilee South describes itself as an increasingly cohesive coalition of Jubilee 2000 organizations from the South. 'We come from Africa, Latin America, the Caribbean, Asia and the Pacific, and are united in our desire to strengthen and move beyond present Jubilee Debt campaigns through the presence and projection of a Jubilee South vision and voice' (www.jubileesouth). A series of summit meetings is being held in the global South. At one of these, in Johannesburg in 1999, representatives from forty Southern countries rejected the

debt relief initiative of the IMF and World Bank (HIPC – see the next section), on the grounds that the first initiative gave very little debt relief, while the second, begun in 1999, is insufficient. Jubilee South rejects the debt reduction initiatives for other, broader reasons: they legitimize a debt that Jubilee South does not accept; the initiatives are covers for 'creditor relief'; they provide Southern countries with an opportunity to access more credit and accumulate greater debt; and the initiatives are merely modified versions of previous structural adjustment programs (South–South Summit Declaration 1999: 6). Jubilee South calls for Southern governments to repudiate their debts because their citizens have already paid in full in the forms of colonialism and slavery. Finally, Jubilee South demands that the North pay reparations to the South for the pain and suffering historically inflicted.

The fiftieth anniversary of the Bretton Woods conference of 1944 saw a coalition of NGOs, led by the International River Alliance, form an alliance called '50 Years is Enough.' The organization has its roots in earlier movements. The Nicaraguan Network, working with other 'solidarity groups' in opposition to US military intervention in Central America in the 1980s, began to focus more on economic oppression. Religious organizations following principles of Catholic Social Teaching, as with missionary groups such as the Maryknollers and other groups of nuns and priests, began to criticize the new global economy, linking it with poverty in the global South. These groups were major resources for 50 Years is Enough and Jubilee 2000. At the 1994 Madrid meetings of the IMF and World Bank, 50 Years is Enough tried to counter what it expected would otherwise be a positive media response to the birthday celebration. And when we looked at international media reports for 1994, we found few descriptions of demonstrations that took place in Madrid. Instead the media's version of the critical reactions to the conference focused on the coalition and their message – according to our count of a hundred or so newspaper articles written in 1994 dealing with the anniversary of Bretton Woods, a quarter referred to 50 Years is Enough. While the original intent was for the alliance to last for eighteen months, an initially small campaign composed of thirty-six NGOs in 1994 is now 'a coalition of 205 grassroots, faith-based, policy, women's, social- and economic-justice, youth, solidarity, labor, and development organizations dedicated to the profound transformation of the World Bank and the International Monetary Fund' (www.50years.org). In

the late 1990s, 50 Years is Enough produced educational materials, organized conferences for activists from around the world, and set up small-scale house meetings where five or six people discuss IMF and Word Bank policies and projects. As a result demonstrators showed an increasingly sophisticated knowledge even of arcane aspects of IMF and World Bank policy, while increased public awareness of Third World poverty issues and the AIDS crisis increases pressure on First World governments, and their representatives at the IMF.

Debt relief and anti-poverty discourse

We have to understand the IMF's final policy turn in the context of this mounting criticism. Moral outrage in the developed countries tended to focus on the issue of debt relief for poor countries. And as we have seen, conventional, and even conservative, opinion had, by the late 1980s, reached the conclusion that debt levels were unsustainable, and that some kind of organized relief was necessary. While the debt crisis of the 1980s mainly concerned middle-income Third World countries, such as Mexico, Brazil and Argentina, in the 1990s the main emphasis of IMF debt management shifted toward the lowest-income Third World countries. Loans to these very poor countries had been made mainly from official sources, as with government-to-government loans, export credits, official development assistance and loans from the IMF, the World Bank and regional development banks (Birdsall and Williamson 2002: 13–21). Responding to widespread concern expressed by developed countries, and in concert with the World Bank, the IMF began its Heavily Indebted Poor Countries (HIPCs) facility in 1996. The HIPC initiative was intended to manage, and even 'resolve' in the IMF's optimistic language, the debt problems of the most heavily indebted poor countries (originally forty-one countries, mostly in Africa) with a total debt of about $200 billion. In these countries debt service obligations consumed large parts of countries' export earnings. Half of the 615 million people in the current HIPC countries live on less than $1 a day. The HIPC initiative, in the IMF's words, 'seeks a permanent solution to these countries' debt problems by combining substantial debt reduction with policy reforms to raise long-term growth and reduce poverty' (IMF 2000). By adopting policies judged 'sound by the international community,' debt relief to the eventual extent of $60 billion would be granted. The IMF describes the various stages of a highly controlled, adjustment debt relief process as follows:

> Once countries have demonstrated their commitment to reduce macroeconomic imbalances and sustain growth-oriented policies, normally over a three-year period, they reach the 'decision point.' At this stage, an assessment of the needed assistance is made and appropriate relief is committed, including reductions in the stock of debt. The full stock-of-debt reduction is implemented following a further period of sound economic policies, at what is then called 'the completion point.' (ibid.)

As a mere seven countries qualified for assistance in the first three years of the facility's operation, the HIPC initiative was 'enhanced' in 1999 to provide interim debt relief, between the decision and completion points, which immediately reduced debt service costs. The enhanced facility joined debt relief more obviously with poverty reduction. To qualify for assistance under the HIPC initiative, or to get concessional loans from the IMF or the World Bank, countries have to prepare poverty reduction strategies with the participation of members of civil society. This was a new approach for the IMF and its description is worth quoting at length:

> Nationally-owned poverty reduction strategies are at the heart of the new approach. Lending from the IMF (and IDA, the World Bank's concessional window) is being framed around a comprehensive Poverty Reduction Strategy Paper (PRSP) prepared by the borrowing country. The country and its people take the lead in preparing PRSPs. They are prepared by the government, based on a process involving the active participation of civil society, NGOs, donors, and international institutions. Locally-produced PRSPs are expected to generate fresh ideas about strategies and measures needed to reach shared growth and poverty reduction goals, and to help develop a sense of ownership and national commitment to reaching those objectives. The PRSP can then be endorsed by the Boards of the IMF and World Bank as the basis for the institutions' concessional loans and for relief under the enhanced HIPC Initiative. Donors, including the IMF and World Bank, provide advice and expertise. But the strategy and the policies should emerge out of national debates in which the voices of the poor, especially, are heard. Given the year or more needed to prepare full PRSPs, and with dozens of poor countries needing immediate concessional assistance from the IMF and World Bank, waiting for countries to complete PRSPs would have interrupted the flow of concessional loans. Consequently, countries

> are encouraged to prepare an Interim PRSP (IPRSP), drawing on existing data, plans, and policies, to guide their efforts during the PRSP preparation phase. (ibid.)

In the year after enhancement, $10 billion of debt relief was committed for ten countries, while by 2001, twenty-two countries, eighteen being in Africa, had qualified for debt relief under the HIPC initiative. This is supposed eventually to reduce these countries' foreign debt by two-thirds. Nevertheless, developing country debt (including that of middle-income countries) continued to rise from $500 billion in 1980 to $1 trillion in 1985 and around $2 trillion in 2000. What the IMF calls the forty-one 'HIPC countries' (the lowest-income countries) had an increase in total indebtedness from $60 billion in 1980, to $105 billion in 1985, $190 billion in 1990, and $205 billion in 2000 (ibid.).

As a result of mounting criticism, the IMF engaged in a series of internal evaluations of its operations and policies, and in 2001 set up a permanent Independent Evaluation Office (IEO) with the purpose of 'improving the IMF's effectiveness by enhancing the learning culture of the IMF and enabling it to better absorb lessons for improvements in its future work.' Even more remarkably, external evaluations of IMF procedures and policies were announced following an Executive Board meeting in 1996. In 1998 an external evaluation of the IMF's Enhanced Structural Adjustment Facility was conducted by four 'independent experts,' academic economists from the Harvard Institute for International Development, Oxford University and the Free University of Amsterdam. They used a case study method looking at IMF documents but also visiting eight countries in Africa, Asia and Latin America, where they talked with government officials, ministers and staff, NGOs, workers, trade union leaders and workers about the ownership, governance and social impacts of structural adjustment programs. The evaluators found a general recognition of the need for reforms of the kind proposed by the IMF, but concern that programs should be anchored in national consensus and ownership as a way of ensuring their sustainability, and concern too about loss of control over the setting of the policy agenda and the negotiation process. They recommended that Economic Management Teams be formed that would include not just the minister of finance in the country affected, but other cabinet members, together with the holding of national conferences where the aims, objectives and methods of the programs

would be openly debated among a large cross-section of people, including civil society organizations. In terms of social impacts, the evaluators found that adjustment typically involved huge changes in society, including massive changes in relative prices and redistributions of income, together with widespread suffering for poor people. What they called 'distributional impacts' could be identified before implementation of programs began. So they recommended explicit analysis of the distributional impacts of programs, something that had not occurred sufficiently, and the monitoring of income changes, using expertise from the World Bank in the absence of IMF proficiency in such matters. Finally, they thought that the structural adjustment facility should remain after countries had been stabilized as a signal that an economic environment now existed that investors could take seriously. The evaluators found a negative public perception of the IMF in many countries they visited which might deter governments from dealing with the Fund because of the political costs involved. They thought it important that the IMF should 'interact with people more and better in these countries so that they understand what the Fund does' (IMF 1998b). The IMF Executive Board said that it welcomed these proposals.

As a result of these and other pressures, in 1999 outgoing director Michel Camdessus issued a statement saying that member countries had endorsed 'a clear mandate for the Fund to integrate the objectives of poverty reduction and growth more fully into its operations.' The IMF changed the name of the Enhanced Structural Adjustment Facility (ESAF) to the Poverty Reduction and Growth Facility (PRGF). The change of name was intended to signal that IMF lending for poor countries would now be embedded in a broader development agenda: Poverty Reduction Strategies. This facility, available to eighty low-income countries, provides ten-year loans at an annual interest rate of 0.5 percent. The IMF says that the new version essentially does two things: it immerses poverty reduction into structural adjustment; and it aims at broader participation and greater country ownership of the economic programs that accompany loans. Under the PRGF conditionality is supposed to be more selective, with greater emphasis on the social impacts of policies and more emphasis on 'governance' – this includes accountability for public resource management, budgets that are more pro-poor and pro-growth, and increased flexibility for government budget targets. Uganda's Poverty Eradication Action Plan, begun in 1997 (IMF 1997), described by the IMF as transforming the

country into 'a modern economy in which people in all sectors can participate in economic growth,' is the model case.

Do we therefore have a new IMF, which has learned from its many critics and has changed its position from neoliberal structural adjustment to poverty reduction using policies suggested by civil society organizations during genuine national debates? The answer depends on whether and how the new model is realized in practice rather than in IMF press releases. The IMF finds in general that 'PRGF programs have had a promising beginning' (IMF 2002c). A dialog arranged by *Finance & Development*, the IMF in-house journal, asked five people involved in the preparation of Bolivia's poverty reduction strategy paper for their views on what worked and what did not. The minister and official most concerned, together with the IMF representative in Bolivia, thought the strategy had increased public participation in economic policy formation. But the one observer independent of governments or the IMF asked to comment by the journal, Juan Carlos Núñez from the Episcopal Pastoral Social Commission, said that the HIPC initiative provided a window of opportunity for dialog and debate by civil society, in which the main actors – the very poor – could make themselves heard and make proposals regarding the preparation of the PRSP. He added, however:

> It was based on three agendas: social, economic, and political. The poor were able to participate to some degree in the social agenda, but not in the other two, even though a real struggle against poverty must include certain changes in the political and economic structures. The methodology of the dialogue was controlled and closed, and did not allow for macroeconomic issues to be addressed. The players invited – especially in the municipal roundtables – were not the very poor; in fact, they belonged to the political system. The main political leadership did not attend and the announced political summit was not held. (IMF 2002d)

Hence there was a difference of opinion, even within IMF circles (you can almost hear the editors of *Finance & Development* saying 'oops!').

Outside the IMF, a number of studies critically examined the new initiatives. An extensive investigation by the (London-based) World Development Movement of four PRSPs and twelve interim documents, which drew as well on comments made by civil society groups from many developing countries, finds civil society groups unsatisfied with

the extent of public involvement in drawing up the strategy papers. The report says that the policy content of the new strategies does not constitute a major change from the past. Although the rhetoric may be poverty-focused, the actual policies do not have clear poverty-reducing consequences. The strategies still focus on economic growth without, for the most part, addressing how this growth is redistributed to the poor. Indeed, the core macroeconomic elements have changed little from the old structural adjustment programs, with continued adherence to privatization, liberalization and a reduced role for the state (Marshall with Woodroffe 2001).

Likewise, a detailed investigation of PRSPs in Cameroon, Honduras, Nicaragua and Mozambique (Knoke and Morazan 2002) finds them structured by the standard macroeconomic conditionality in which economic benefits are supposed to trickle down to the poor. Many of the structural adjustment conditionalities, as with privatization, liberalization of trade and fiscal (tax) policy, contradict the poverty-reducing aspects of the programs. Also the version of participation in constructing PRSPs laid out by the IMF does not consider the different conceptions of policy held by different power interests, some of which, the most powerful, have more opportunity to impose their views. Hence the PRSP has produced a process of consultation rather than real participation.

Civil society groups in Sri Lanka rejected that country's PRSP in 2003 because, as stated by the Alliance for the Protection of Natural Resources and Human Rights, the report was drafted without consultation with civil society and differed little from previous IMF recommendations. The Alliance consists of more than a hundred groups, including peasants and fisheries workers, trade unions, religious organizations and people threatened with displacement. The government unveiled its PRSP at a 'Development Forum,' saying it had been prepared after comprehensive consultation. Members of the Alliance tried to find out which groups had been consulted, with no success. Trade unions, for example, were not made aware of the PRSP until the ILO held a workshop about it. The Sri Lankan government attempted to pass a series of laws reflecting the priorities highlighted in the PRSP and aiming at securing new IMF and Bank loans but was resisted. As a report by Focus on the Global South argued: 'poverty is used as window-dressing to peddle more or less the same adjustment programs to low income countries that led them into a state of chronic economic crisis to begin with' (BWP

Update 33). Or as a staff report at the IMF and World Bank put it in optimistic Fundspeak: 'Low income countries are taking charge of their own future and recognizing that there can be no substitute for sound policies and their own efforts. The prospects for sustained, strong growth – which is indispensable for reducing poverty – requires investment, not least in human capital and infrastructure, as well as the right macroeconomic and structural policies, good governance, and healthy institutions. Countries therefore need to act to build an improved investment climate for private enterprise' (Staff of the World Bank and IMF 2002). That is, taking charge of one's own future through the PRSP process means improving the investment climate for private enterprise.

And a case study of Uganda, important because this country is regarded by the IMF as the leading, successful case of participatory governance, transparency and economic growth, finds that the actual policies on which loans were conditioned 'were determined by the IMF and World Bank representatives in consultation with small teams within the Ministry of Finance and the Central Bank [of Uganda]' (Nyamugasira and Rowden 2002: 5). The new programs have not learned from previous criticisms within the IMF and the World Bank of the failures of structural adjustment. The Ugandan case, the authors of the report say, supports growing criticism that the IMF and the World Bank have simply repackaged the structural adjustment policies of the past into the new poverty-reduction program.

Evaluating the IMF

The power of the IMF comes from the direct and indirect control it maintains over the granting of loans to governments experiencing crises in balances of payments and having difficulty making interest and principal payments on foreign debts. Power is exercised through the conditions specified in stabilization and adjustment programs that are imposed on the granting of desperately needed loans. At least since the mid-1970s, conditionality has been based on an understanding of economies based on a version of neoclassical economics that we refer to as neoliberal – that is, a revival of nineteenth-century liberalism that counters Keynesian interventionism by stressing privatization, deregulation and other anti-state policy areas. According to the official historian of the IMF, James M. Boughton (2002), the increasingly free-market nature of the conditionalities attached to loans is part of a 'silent revolution' in economic policy-making: a

subtle but ultimately dramatic drift toward policies that were 'more cooperative, outward oriented, and market friendly than before.' In this the official historian expands on remarks made about a 'silent revolution' by Michel Camdessus, managing director of the IMF. Speaking at the Annual Meetings of the Boards of Governors of the IMF and the World Bank in 1989, Camdessus (1989) said that countries were finally making the 'painful decision' to 'strengthen' their economic policies and implement growth-oriented adjustment programs with financial support from the IMF, after earlier resisting its advice, or changing their policies only as much as was necessary to qualify for financial assistance. These countries were now willingly embracing market- and export-oriented policies. Long-standing ideological divisions between those favoring private enterprise and those favoring a primary development role for state enterprise, and between those favoring open and unified market pricing and those insisting on widespread state controls, were gradually being resolved in favor of economic liberals in many parts of the world. In particular, he thought, economic philosophies and prevailing attitudes toward policy-making changed dramatically during the 1980s. In the new classical economics that came to dominate economic opinion in the 1980s, the government is expected to play only an indirect role in guiding the economy by creating the preconditions for sustainable growth, but not to assume direct responsibility for ensuring full employment or high rates of economic growth. Few governments would have adopted that position in the 1970s, but many did by the end of the 1980s. So – a 'silent revolution' in which the superiority of free enterprise, IMF style, was inevitably recognized as sound, good sense by governments all over the world.

On what is this 'recognition' based? And who does the 'recognizing'? In conventional economic reasoning arguments for the general acceptance of policies, together with their political-economic theoretical bases, are conventionally made on functional-realist grounds – that these policies work well in terms of producing results, usually high rates of economic growth, but also other macroeconomic variables, such as low inflation rates or surpluses in balances of payments. Any claim that policy-making merely follows the best of economic science as proved by empirical evidence is vulnerable to counter-interpretations of these data. So we might look at studies that have indeed investigated the effects of IMF policies on national economies.

Here we remain within conventional, and even conservative, investi-

gation, including some work from within the IMF itself. A survey by Mohsin Khan (1990), using sixteen studies of how IMF-supported programs affected the macroeconomic characteristics of countries subjected to conditionality, reached the following conclusion: seven out of sixteen studies showed positive effects on the balance of payments, four showed no effect, three showed a negative effect, and two drew no conclusions; five showed positive effects on the current account, five showed no effect, two showed negative effects, and four drew no conclusions; two drew positive effects on inflation, four showed no effects, and ten showed negative effects; four showed positive effects on growth, five showed no effects, and seven showed negative effects. In general, Khan's study shows that IMF conditionality may have a positive effect on balances of payments and current accounts, its immediate targets, but tends to have negative effects on inflation and growth, aspects of the economy having longer-term effects on populations. As Khan (ibid.: 222) said: 'On the basis of existing studies, one certainly cannot say whether the adoption of programs supported by the Fund led to improvement in inflation and growth performance. In fact it is often found that programs are associated with a rise in inflation and a fall in the growth rate.'

In an evaluation from the conservative Heritage Foundation, Johnson and Schaefer (1999: 54) concluded that 'Forty-eight of eighty-nine less-developed countries that received IMF money between 1965 and 1995 are no better off economically than they were before; thirty-two of these forty-eight are poorer than before; and fourteen of these thirty-two countries have economies that are at least 15 percent smaller than they were before their first IMF loan or purchase.' They find that lending by the IMF creates more long-term dependency (on more and more loans) than it gives short-term assistance, that it has failed to improve the economies of less developed countries, and that in many cases it has hurt them.

A major study by the United Nations Conference on Trade and Development (UNCTAD) of forty-eight least developed countries (LDCs) found that the IMF's Structural Adjustment Facility, begun in 1986, and extended in 1987 into the ESAF, has become the main new determinant of national economic policy in poor countries:

> The importance of ESAF loans stemmed less from the amount of resources provided than from the access which an IMF agreement provided to other official resources. Without an IMF ESAF

> agreement, it was impossible to have debt rescheduling through the Paris Club. Moreover, an ESAF program was often a precondition for grants and loans by bilateral donors, and financing from other international financial institutions in low income countries. ESAF-supported programs thus shaped policy change in LDCs, and also acted as the framework for obtaining concessional finance and debt relief in the 1990s. (UNCTAD 2000: 101)

As a result, developing countries go through repeated IMF structural adjustments that cause profound policy changes in terms of deregulation of prices and markets, liberalization of trade, and reform of foreign currency regimes and interest rates. What, then, are the results for the countries concerned? According to the UNCTAD study (ibid.: 108): 'The average real GDP per capita was declining by 1.4 [percent] per annum in the three years before the programs were initiated, was stagnant in the three years after, and then declined by 1.1 percent in the next three years.' At the same time, indebtedness grew to unsustainable levels. UNCTAD (ibid.: 110) concludes: 'the efficacy of the economic reforms, on which so many lives and livelihoods now hang is, and must remain, an act of faith.'

Questioning faith

For us this means that the IMF adheres to neoliberal economic thought in the production of policy prescriptions on grounds of faith, rather than the foundation of proven science. The main question becomes why and how a certain belief was adopted, and why it continues to be accepted as a matter of faith. And this question raises issues of power, interest, hegemony and discourse elaborated in Chapter 1. Our historical survey of the IMF indicates that the USA, working mainly through the Treasury Department, has always had a dominant, but not absolutely controlling, interest in the IMF – in terms of personnel and financing clearly, but also in terms of pressure on the formation of policy. In the mid-1970s, and again in the early to mid-1980s, the USA exerted its dominance with a particular intensity that included threats to withdraw financial support at times when the IMF was stretched thin. US dominance came to be expressed in a revised stance taken by a changing IMF. Loans and debt forgiveness were made conditional on a country's adoption of what quickly became a standard set of policies. These policies were based in a political view of how 'successful' economies function, especially (following

the Baker Plan) how economies grow. And this political-economic stance was vigorously propagated by a right-turning Republican Party, symbolized by the election of Ronald Reagan.

At the same time, economic conditions during the 1970s, especially the combination of stagnation (low growth rates and high unemployment) with inflation (a sustained increase in price levels that reduces the purchasing power of a country's currency), or, as it was called, 'stagflation,' was interpreted by many conventional (neoclassical) economists as a failure of Keynesian economic management. Economists who had long called for a return to the classical and neoclassical roots of economic thought as the truly scientific basis for policy-making were again taken seriously – within global economic governance institutions as well as in academia and state bureaucracies.

Thus a convergence of political economic perspectives took place linking external sources of rightist influence, coming particularly from the USA, and expressed well in Reagan's phrase 'the magic of the marketplace,' with the internal neoclassical 'scientific' economic culture of the IMF, which established the core position taken by the institution ever since – essentially one of neoliberalism. Yet the main tenet of neoliberal economics is the efficacy of the market – the *unregulated* market at the Hayekian–Friedmanist extreme of this style of thought. Following this dictate to the bitter end would entail the demise of the IMF, as indeed Milton Friedman (1999) advocated: 'We need government, both within the nations and internationally, to get out of the way and let the market work.' The IMF therefore had to synthesize aspects of Keynesian regulation with neoliberal demands for deregulation. The resolution of this contradiction was for global governance institutions to oversee the deregulation of national economies. This involved a shift upward in the locus of power to the global institutional level, within geo-economic power relations that maintained overall US control. Thus we would describe the IMF as an institution that believes, to the point of abiding faith, in a new kind of global neoliberalism, which preserves aspects of Keynesianism in terms of the need for institutional regulation of the world economy, as long as the IMF does it, but which also prescribes deregulation at the national level, especially in Third World countries, which become IMF dependencies. As we have seen, the policy positions that derive from this stance are prescribed regardless of the loss of thousands of lives in anti-austerity demonstrations and regardless of highly

informed criticism. So the IMF speaks in terms of 'sequencing and timing corrections' but never in terms of fundamental change in the way it conceptualizes model economies. When forced by public pressure to consider, at last, the opinions of those affected by its policies, it allocates bits of 'social programming' to selected, safe national actors as a front behind which it can carry on exactly as before. And it takes the desperate submission of Third World governments to its policy format as evidence that they at last recognize the truthful inevitability of the IMF position (the 'silent revolution'). The essence of hegemony is self-delusion!

The bankers' view of the world

Let us revisit some key events in the last two decades of governance practice from a particular, interested point of view – the notion of a 'banker's perspective' – which will become more apparent in the following chapters and is theorized in Chapter 6. In forming our conclusions, we looked at issues of a trade magazine, *The American Banker*, between 1980 and 2002, which represents the private banking perspective. We found that during the Latin American debt crisis of the 1980s, and later in the Asian crisis of the 1990s, bankers frequently claimed that the media were exaggerating a simple problem of liquidity into one of wholesale national solvency. Moreover, they thought, crises were more of a problem of regulatory structures – both in the countries undergoing crisis and in the home countries of the lending banks, especially the USA – than a problem of the basic structure of the global economy. Bankers were also convinced that solutions to financial crisis came from collective efforts by international agencies, governments and central banks but, most importantly, from the concerted efforts of the 'financial community.' Their collective capability for dealing with crises was maintained by banking associations and institutions, together with 'think tanks' that represented banking interests and provided the banking community with insights into future investment. Of those, the institutions that were most active during the 1980s include the Institute of International Finance, a 'global association of financial institutions' established in 1983 in Washington, DC; the American Bankers' Association; the Bankers' Association for Foreign Trade, now the Bankers' Association for Finance and Trade; the Institute of International Bankers; the Group of Thirty, a New York-based think tank established in 1978; the Institute of International Monetary Affairs, a Tokyo-based think

tank; and the Institute for International Economics, Washington, DC. These institutions, usually composed of banking and other financial organizations, engage in lobbying legislators, regulators and policy-makers, and play important advocacy roles in the interests of the banking community. They also organize periodic conferences, and they provide members of the financial services industry with information on markets and on financial technologies. These research institutions, well funded by private sources, organize forums and establish study groups and committees to present the banking industry with information on international economic and financial issues that provide the financial industry with a 'sounder basis' for policy-making advocacy and their own financial decisions. Most of these institutions are based in Washington, DC, and New York. Many have branches in other major financial centers.

A case in point is the Institute of International Finance (IIF), established in 1983, in the midst of the Latin American debt crisis. This institute had the sole purpose of gathering and improving information on the economic circumstances of borrowing countries that would enable bankers to make sound investments based on proper country risk assessment. Based in Washington, the IIF includes prominent members from the financial community, the biggest banks, securities firms and insurance companies that invest heavily in foreign markets, and is chaired by senior members of major Wall Street banking institutions. The IIF organizes meetings and conferences where bankers negotiate among themselves, and with governments and international agencies, about solutions to investment problems. The IIF represents banks with foreign loans to the US government and to the global governance institutions.

Bankers tend to represent their interests as a group. Senior members of the bigger banks take the lead and do the intermediary work for what can sometimes amount to amalgamations of hundreds of banks. The solution to the debt crisis of the 1980s was seen by bankers, among others, as residing in the re-establishment of the creditworthiness of debtor countries. The crisis itself was seen as a liquidity problem, not a solvency problem, meaning a short-term shortage of money to pay off debts, rather than a lack of capability to service this debt in the long run. Hence, the solution to the debt crisis rested on re-establishing creditworthiness – that is, improving the 'investment climate' in debtor countries, by means of adjustment and restructuring programs implemented under the auspices of the

IMF. This was important for future lending. Instead of forgiving loans and easing interest rates on debts, bankers believed that the solution to the debt crisis resided in creating more debt. Bankers recognized the irony of such a solution, of 'throwing good money after bad,' in their words, to solve the debt crisis. They thought, however, that only by rejuvenating capital flows into debtor countries could these countries grow so that they could service their debts. They also thought that the real growth of developing countries was dependent on growth in the developed countries, for the latter provide markets necessary for the Third World exports needed to increase their 'hard currency' reserves and hence service their debts.

For the bankers, the IMF plays a crucial role in at least three ways. First, the main function ascribed to the Fund is to maintain 'reasonable flows of liquidity.' For bankers, the IMF should not play the role of long-term lender. The Fund's financial services were seen more, in the words of Jacques de Larosiere, IMF managing director at the time, as a 'catalyst to unlock access to private capital markets.' IMF resources should not be frozen in long-term loans, but should be used as stand-by emergency funds, to maintain the flow of private capital into Third World countries. The Fund's austerity measures were directly related to this flow, as adjustment programs were seen as the necessary factor in establishing the creditworthiness of debtor countries. Bankers tended, however, to be critical of these austerity measures when they became too severe, for they then inhibited the development of indebted countries.

Second, bankers see the IMF as a main source of systematic and centralized information. As an international governance institution, the IMF has a more 'state-like relationship' with member countries than private banks can possibly have, and can get higher-quality information from them. Bankers complain that the IMF does not release all the information it has. The IMF usually responds to such criticism by saying that it publicly releases most of the information it gathers.

Third, bankers think that the IMF can play the role of central coordinator of international financial policies and stabilizing agent in international financial markets. Yet bankers also take a strong position against regulations and regulators, or any other kind of state or quasi-state intermediary, for that matter. Often they would prefer to do away altogether with the IMF and negotiate directly with Third World governments, as well as finance and monitor debt through

direct agreements with states. Bankers are often critical of the IMF for being inefficient, and are sometimes critical of their governments' intervention in foreign lending as being counterproductive. Their main criticism is directed against the rigidity of state regulations dealing with accounting and conditions for foreign lending. This view is shared by American and European bankers alike. The main point they contest is the requirement for maintaining reserves against foreign loans. They also contest the rating of debtor countries that the US government uses in determining reserve funds.

Bankers see any regulation that restricts capital flows as an obstacle to their business. Their ultimate aim is to keep capital flowing as much as possible. This is why they are not as concerned with the immediate repayment of debts as much as with potential repayment in the future. They welcome any suggestion for an increase in their lending as long as there is some guarantee that part of their loans will be repaid in the future. This makes them more interested in the long-term creditworthiness of debtor countries than in their immediate ability to pay off debt. From this perspective, the rescheduling of debts can be seen as a transformation of short-term debt into long-term bonds. Some analysts see rescheduling as 'near default' or 'default by attrition' – that is, default in everything but name. A good investment banker, however, knows that the transformation of short-term into long-term debt is a transformation of commercial loans into investment loans, and of a commercial client into a chronic borrower. Bankers would be more willing to extend additional loans to pay interest on original loans than to ease debt conditions or forgive certain loans – but, as we have seen, they finally acquiesced to debt forgiveness as a concession to the hard facts of overextension. They regard debt forgiveness as a cause of further problems, however, more than as a solution to current problems.

Banks are willing to trade loans among themselves and with Third World debtor countries, or to swap loans with those countries for equity shares in state-owned firms or natural resource industries. Loans are traded in 'secondary markets' for a fraction of their real value. Bankers trade loans to increase the geographic diversity of their investments – that is, to decrease the national concentration of their loans. This is in line with an attempt to diversify risks and a preference for dealing with loans on a case-by-case basis. They do not see regional solutions as viable. Instead, each case should be dealt with differently, according to the capacities of the country in question.

Therefore, another criticism directed against the IMF is that austerity measures cannot work in the long run, nor can they work on the scale of whole regions, such as Latin America. This is in line with their view that the IMF is not a long-term lender, nor a development agency. Nevertheless, in the mid-1980s the case-by-case approach was seen to be ineffective, and the Baker Plan proposed putting an end to Third World debt crisis in a way that deviated from previous strategies, but nevertheless invited private banks to extend more loans. The plan was first met by criticisms from bankers as being 'purely conceptual,' offering no guarantees on future loans, and lacking detailed procedures. It took two meetings between the banking community and James Baker 'behind closed doors,' and a final meeting of bankers, all under the auspices of the IIF, before they announced strong support for the Baker Plan. The Baker Plan also marked a general shift in policy, from austerity measures to development programs. This meant more involvement, and a stronger role, for the World Bank in the debt crisis. This was also accompanied by a new rhetoric on development targets, strategies for alleviating poverty and inducing growth in Third World economies. For bankers, this meant a new form of partnership with the World Bank – a joint loan project was proposed in the mid-1980s in which the Bank guaranteed repayments to commercial banks, and in which the Bank participated directly in the commercial part of a co-financed loan. On the assumption that no country has ever defaulted on a World Bank loan, an increase in Bank lending was seen as a catalyst for private bank lending.

These rapid shifts in emphasis bring a few general issues to the center of our concerns. These are the relation between the financial system and economic development, and the role of global institutions and private banks in encouraging economic development. It is quite evident from bankers' emphasis on financial reform in debtor countries, and their belief that real economic growth is the only way debtor countries can service their debts and repay their loans, that they think the financial structure and the quality of financial services play a decisive role in making real growth possible, and that, reciprocally and mutually, investment in production and in long-term development projects is crucial to a country's financial status, its creditworthiness with regard to banks and, by extrapolation, to the international financial system and its stability. The IMF and the World Bank were established in 1944 to play this dual role of stabilizing the global financial structure and encouraging economic development.

The question remains, however, how to bring financial stability, how to instigate economic development, what kind of development, and toward what ends? From our investigation of the financial crises of the 1980s, 1990s and 2000s, banks, bankers and their associations were more than financial intermediaries between capital accumulations in developed countries and the global governance institutions lending to central banks in developing countries. Investment banks in particular provided the expertise, contacts and conditions of trust necessary for transferring money among institutions and among countries. Necessarily they carry a conservative attitude toward moneylending – 'necessarily' because originally banks lent old money from rich, conservative people, and 'necessarily' because, in terms of practicality, they want to ensure that eventually the money they lend will be paid back with interest. We find the connections between investment banks and governance institutions frequently alluded to in a cynical way by those in the loop, particularly in the *Wall Street Journal*. How these connections operate, and how they might be theorized, are issues we will try to illuminate further in the coming chapters … for this gets to the crux of the matter.

Decline and fall of the IMF?

As this chapter has shown, the IMF has been subjected to high and increasing levels of well-founded criticism. Third World countries have long said that they resent being told what to do with their economies by the IMF. During the East Asian crisis in 1997, the IMF laid down conditions that governments had to meet in order to access $120 billion in foreign funds. As financial contagion spread to Russia and Brazil, the IMF followed, with multibillion-dollar loans. But those days are over. After their experience with the Fund in 1997/98, the Asian countries began accumulating huge international foreign exchange reserves, in part so they would not have to rely on the IMF again. The case of Argentina in 2003 showed that a country under dire stress could stand up to the IMF, and not only live to tell the tale, but even launch an economic recovery. The IMF is still influential in poorer regions (for example, sub-Saharan Africa) where countries seek debt relief, and help in paying higher food and fuel prices with the global inflation of 2007 onward. But its influence in middle-income countries has plummeted. The Fund is a 'shadow of its former self' (Weisbrot 2005).

The most outspoken critics of the IMF are Latin American governments and social movements. In 2007 Venezuela's president, Hugo

Chavez, called the IMF and the World Bank ' tools of the empire … [that] serve the interests of the North,' and severed ties with both institutions to pursue radical political reform and an economic 'third way.' Ecuador completed an early repayment of the country's IMF debt, stating: 'We don't want to hear anything more from that international bureaucracy.' Ecuador then ejected the IMF's resident representative out of the offices of the central bank, and the Fund withdrew its representative from Ecuador entirely. Nicaragua's president, Daniel Ortega, requested a new PRGF arrangement with the Fund, but added that involvement with the international institutions was unpopular, saying: 'It is a blessing to be free of the Fund, and for the Fund it will be a relief to rid itself of a government that defends the interests of the poor.' He stated that he planned to end Nicaragua's borrowing from the Fund within five years. Russian president Vladimir Putin said that global institutions like the IMF and the WTO should play a much lesser role and proposed a 'new architecture of international economic relations based on trust and mutually beneficial integration.' China has rejected the IMF's advice on its exchange rate policy. Indonesia, recently the second-largest debtor to the Fund, with nearly $8 billion outstanding, repaid its debt early despite a devastating earthquake hitting the country fifteen months after a tsunami struck at the end of 2004. Macedonia, Bulgaria and the Philippines also tried to repay loans earlier than necessary. The Fund's $10 billion loan agreement with Turkey, often termed 'the IMF's last major customer,' expired in 2008. This left the Fund with less than $20 billion in outstanding credits, its lowest in twenty years, and down from $100 billion three years previously (BWP Update 56). Richard Webb and Devesh Kapur (2006: 2) find: 'The de facto exit of its clientele, driven by the combination of high political costs associated with Fund borrowing and growing availability of alternatives, now poses an unprecedented challenge for the Fund, in particular on its income.'

As poor countries cleared their debts, the IMF suggested in 2005 that they might still require 'ongoing IMF advice, monitoring and endorsement of their economic policies – what is called policy support and signaling.' This 'signaling' refers to information the Fund provides about countries' economic performance and prospects that is used by private creditors including: banks and bond-holders, interested in the repayment prospects of loans; official donors and creditors interested in reassurance about the countries they are supporting; and the public at large. In low-income countries, such signals previously have been

sent mainly in the context of the IMF's Poverty Reduction and Growth Facility and the related Poverty Reduction Strategy process. Now a new facility, the Policy Support Instrument (PSI), has been initiated, in the IMF's words to: (i) promote a close policy dialog between the IMF and a member country; (ii) provide more frequent Fund assessments of a member's economic and financial policies than is available through the regular consultation process, known as 'surveillance'; and (iii) deliver clear signals on the strength of these policies. According to the IMF, the PSI is voluntary, demand-driven, and intended to be supported by strong country ownership. Therefore, it will be available only upon the request of a member (IMF 2007). Only five countries have so far agreed to the new surveillance, which amounts to the IMF acting as a kind of international credit rating agency, telling other investors whether or not to lend. Simply put: IMF advice is not worth the price of continued surveillance.

Buttressing these rejections of the current institutional framework, there are several attempts under way at building regional alternatives. In 2007 the economic ministers of Argentina, Venezuela, Bolivia, Ecuador, Paraguay and Brazil agreed to set up a Bank of the South. Venezuela's President Chavez had mentioned this in early 2006, as part of a set of financial institutions that would provide an alternative to the World Bank and IMF – Venezuela will move 10 percent of its reserves into the new bank. The Bank of the South maintains equal voting rights for each of its member states. And at a Kyoto meeting of the ten members of the Association of Southeast Asian Nations (ASEAN) with nearby South Korea, China and Japan (ASEAN+3), the countries of the region agreed to an $80 billion regional currency swap arrangement as a step toward an eventual Asian Monetary Fund. The 'Chiang Mai initiative' began as a response to the 1997/98 Asian financial crisis. Under the initiative, central banks from the countries swap foreign exchange reserves to combat speculative attacks on their currencies.

From a position of dominance in the pre-Asian-crisis global economy, the power of the IMF has been reduced by failed crisis management, the rejection of major policy initiatives, countries paying up as quickly as possible and distancing themselves, its credibility and legitimacy being questioned, and other symptoms of decline. The financial crisis of 2007/08 might seem like the perfect time for the IMF to 'rise like a Phoenix,' but the Fund played a minor role. This was due to widespread criticism of its earlier performance during

the East Asian crisis. Indeed, even conventional critics are basically saying the IMF is useless in just *predicting* crises. For example, a report by the US Government Accounting Office (GAO) on the IMF's new 'vulnerability framework,' constructed after the Asian crisis, comments that one of its key parts (the World Economic Outlook) has a 'poor track record in forecasting recessions, including those directly associated with a financial crisis. From 1991–2001, out of 134 recessions that occurred in developing countries, the WEO correctly forecast only 15, while actually predicting an increase in GDP in the other 119 recessions, including major ones leading to the Mexican and Asian crises' (BWP Update 35). As its lending activities shrank, the IMF lost income and faced $100 million in cuts from its previous $900 million budget. The Fund tried to sell some of its 103 million ounces of gold bullion reserves to set up an investment fund to generate revenue, but has to get US and congressional approval for selling the gold, with many other member countries resisting sales because they regard the gold as belonging to them. Under pressure from its membership the IMF's incoming (2007) managing director, Dominique Strauss-Kahn, was forced to cut the IMF's budget. So the IMF itself went through structural adjustment, beginning as usual with firing workers or inducing them to leave. In this case, voluntary retirement packages were enough to convince 590 Fund staff members, including six department directors, to leave – the IMF had planned to reduce staff levels only by 380. The IMF responds to this new crisis as usual, through 'streamlining' and 'thorough-going internal reform.' This includes reform of the voting structure. At the 2006 Annual Meetings in Singapore, ad hoc increases in quotas were agreed for China, Korea, Mexico and Turkey. The IMF says that further reforms will eventually increase the voting shares of two-thirds of the 185 member countries, and enhance the voice and participation of low-income countries through a tripling of basic votes. But the total increase for developing countries is only 1.6 percentage points, meaning that rich countries, representing about 15 percent of the membership of the IMF, will continue to wield nearly 60 percent of the voting rights. The idea is to 'Refocus the IMF' on current global problems, such as rising food and fuel prices and the financial market crisis of 2007/08. Thus far, however, beyond 'monitoring' and 'advising,' the IMF has not been able to reassert itself. The question is, will it survive as a main actor in a changing global governance structure?

FOUR
The World Bank

At Bretton Woods, discussion of the formation of international organizations dwelt almost exclusively on the IMF. The IBRD was a mere afterthought. What little exchange there was concerning the IBRD centered on its possible role in the post-war reconstruction of Europe. On the few occasions that poor countries were – briefly – mentioned, issues such as poverty never came up. Indeed, such were the preoccupations of the Europeans and Americans at the time that labels such as 'poor countries,' or the more critical term 'underdeveloped counties,' did not exist as functional geographical categories – countries outside Europe and North America were referred to as 'the colonies.' Now, however, the World Bank operates as a development agency with a mission statement that says 'our dream is a world without poverty.' For this the World Bank group, as the conglomerate calls itself, lends US$17 billion a year to client countries. What is more, it sets the conditions under which further billions, in loans and grants, flow to Third World and post-communist countries. Taken together, these two interventions – direct loans and the setting of policy conditions – make the World Bank the most important development institution in the world. 'The World Bank,' as one commentator wittily puts it, 'is to economic development theology what the papacy is to Catholicism, complete with yearly encyclicals' (Holland 1998: 5 – 'yearly encyclicals' refers to the annual *World Development Report*s). Between afterthought and dream lies a long and contorted history that saw the Bank grow from very little to a mighty institution.

Structure and purpose

The World Bank group actually consists of five specialized institutions:

1 The International Bank for Reconstruction and Development (IBRD) makes development loans, guarantees loans and offers analytical and advisory services. The IBRD borrows at low

interest rates by selling bonds in private capital markets in First World countries and makes near-market interest loans to 'creditworthy countries' in the Third World and elsewhere. It has made about $360 billion in loans over its lifetime and currently lends $10.5 billion a year for some ninety new operations in thirty-six countries.

2 The International Development Association (IDA) gives loans to countries that are 'usually not creditworthy' in international financial markets. IDA loans carry no interest, but a 0.75 percent administrative charge is made annually. The IDA, averaging $6 billion a year in lending to the poorest countries, is funded from member governments' national budgets.

3 The International Finance Corporation (IFC) is the largest multilateral source of loan and equity financing for private sector projects in the developing world.

4 The Multilateral Investment Guarantee Agency (MIGA) provides investment insurance.

5 The International Center for Settlement of Investment Disputes (ICSID) facilitates the settlement of investment disputes between governments and foreign investors (World Bank website).

The terms 'World Bank' and 'the Bank' refer properly only to the IBRD and the IDA, and we will basically restrict our attention to these. The president of the World Bank at the moment is Robert B. Zoellick, former US Trade Representative. Its headquarters is in Washington, DC, and it has the same membership as the IMF – 185 countries. Its staff numbers 8,000 employees in Washington and 2,000 in the field. The World Bank is owned by its member countries represented by a Board of Governors, which meets once a year, and a Washington-based Board of Directors, which conducts day-to-day business.

The purposes of the World Bank, as stated in Article 1 of the original (Bretton Woods) Articles of Agreement, are:

1 To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs and the encouragement of the development of productive facilities and resources in less developed countries.

2 To promote private foreign investment by means of guarantees

or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.

3 To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and conditions of labor in their territories.

4 To arrange the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, will be dealt with first.

5 To conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate postwar years, to assist in bringing about a smooth transition from a wartime to a peacetime economy. (World Bank 1989)

The World Bank has a capital stock subscribed by its member countries and divided into shares.

Early years

The World Bank was very much a US creation. Americans made up much of its early leadership and staff and provided most of its capital. The result was 'a strong and enduring American imprint on all aspects of the Bank, including its structure, general policy direction, and forms of lending' (Gwin 1997: 197). The World Bank, in its early form of the IBRD, was largely dependent on selling bonds to raise the bulk of its loan capital. The rest of the available funds came from the subscriptions of member countries – the original capital subscription was $9.1 billion, of which $3.2 billion or 34.9 percent was from the USA (in 1946, when the Bank formally began operations, its initial authorized capital had risen to $12 billion). For the first ten years the US part of this subscription, around one-third of the total, provided the only fully usable component, because the deposit was in dollars, the main currency used in post-war international transactions. Additionally 85 percent of the Bank's bonds were denominated in US dollars and sold on Wall Street. Banks and

insurance companies, the main market for bonds in the post-war period, at first regarded the World Bank with suspicion, seeing it as a 'do-good institution.' So, in its early years, as a supplier of loans to western European governments for reconstruction in the late 1940s, and later as attention shifted toward the richer Third World countries in the 1950s, the World Bank's main mission was to gain the confidence of private investors, especially those on Wall Street. The Bank maintained a Marketing Department (until 1963) on the Street, and employed a syndicate led by First Boston Bank and Morgan Stanley, an investment bank, to sell its bonds. The first president of the Bank (for a mere six months), Eugene Meyer, had been a Wall Street investment banker and government official. The second president, John J. McCloy, a New York lawyer, was seen by Wall Street as its representative, and was charged with taking control of the World Bank away from the New Deal crowd (ibid.: 199). And Eugene Black, president between 1949 and 1962, had been at Chase Bank and was very much Wall Street's man. Indeed, all presidents of the Bank, except two, have been commercial bankers, investment bankers, or lawyers with extensive New York banking connections.

The Bank garnered Wall Street's confidence by insisting on 'fiscal and monetary discipline' on the part of borrowing countries, and by engaging in 'sound banking practices,' such as confining its activity to project lending for the construction of easily defined, public utilities (electric power, transportation and other economic infrastructure), with strict end-use supervision, including close control over disbursements from loans.

This restricted version of project lending was, however, also in line with what little economic theory at the time dealt with developmental issues. The idea of early development economics was to remove blockages to, or set the preconditions for, economic growth by making capital investments (project lending) that would raise productivity. Money spent on program lending (that is, broader social programs dealing with education and health as well as more directly economic projects) was regarded as a waste of scarce resources. So the World Bank essentially loaned money for infrastructure projects that could be shown to be viable in terms of prospective interest and principal repayments. (Indeed, this has remained its basic function until the present day, bearing in mind that 'project lending' has at last been broadened to include education, health and similar 'social' areas.) The Bank did have to show, however, that borrowing countries were

'creditworthy' in general, as well as in terms of the particular project. Thus, from the very beginning of lending to Third World countries (a loan to Chile made in 1948 was conditional upon repayment of pre-war bonds), some degree of Bank assessment of overall economic policies has occurred. In this the Bank was at first more conservative than most of its member governments, for most of which a mixed economy, incorporating elements of capitalism and socialism, was considered conventional economic wisdom, at least until the late 1960s. By comparison, the Bank 'always was pro-market' (Kapur et al. 1997, vol. 1: 481).

During the 1950s the World Bank, along with other conventional institutions, evidenced a rising interest in broader issues of income distribution and poverty. This was partly because Bank presidents actually went to Third World countries and saw for themselves the conditions prevailing there, along with the usual Bank missions and official staff visits. To quote the Bank's Report in 1955:

> Experience has shown again and again that monumental projects are not necessarily useful projects. But the unspectacular – the care of equipment, the teaching of skills, the careful nurturing of land – is often of inestimable value … [Economic development] has to be an awakening in the minds of millions of people, in all walks and conditions of life – an awakening that will move people to work more effectively for tomorrow's rewards … The Bank starts its tenth year with a sense of much learned and much done, but with a full realization that there is much more yet to learn and much more yet to do. (World Bank 1955: 38–9)

The main reason, however, why the World Bank, along with many other First World institutions, suddenly expressed concern for the masses of poor people in the world stemmed from cold war engagement between the USA and the USSR, with the Third World as its hot spots and ideological battlegrounds. As US Secretary of State John Foster Dulles said, in overcoming conservative congressional objections to making soft loans to Third World countries: 'It might be good banking to put South America through the wringer, but it will come out red' (La Feber 1993: 177). The Eisenhower administration finally moved in the direction of increasing aid to Third World countries in the late 1950s, arguing that such aid was 'an investment for peace.' The World Bank, with what had by that time become a conservative, reliable, 'sound' banking image, symbolized by an AAA bond rating

awarded in 1959 and maintained ever since, proved to be a plausible vehicle. In its initial form as the IBRD, however, the Bank (with an additional agency, the IFC, augmenting Bank lending in the private sector after 1956) was not necessarily the best lending mechanism, since it charged near-market interest rates. Something that looked more like an 'aid' institution had to be added (Kapur et al. 1997).

Thus the late 1950s saw a number of changes. Within the Bank, lending was directed toward the poorer countries, rather than Europe, or the richer non-European countries, while 'development' was coming to mean poverty alleviation, rather than transportation and electrical power projects. The sectoral coverage of lending was widened from industrial infrastructure investment toward the agricultural sector, where most of the people in poor countries worked. Outside the Bank a geopolitical strategy of containment, which had focused US military, diplomatic and economic interest on the 'rim countries' surrounding the USSR and China, was extended to include a broader swath of countries said to be 'just entering world society.' There was a flood of intellectual interest in questions of 'underdevelopment,' as in sociological modernization theory and development economics, while area studies departments were opened all over the campus map. In particular the incoming Kennedy administration, acting out of a mix of humanitarianism and security concerns, was active in strengthening US foreign assistance. US policy toward the Bank in the late 1950s and early 1960s seems to have been motivated by three concerns: building a strong organization to promote a 'free and open world economy'; leveraging funds from the private market and other countries to ease the burden on the USA; and supporting countries deemed important to US interests (Gwin 1997: 209). All this led to a second wave of institution formation in the period 1958–62, including the formation of the IDA within the World Bank.

The idea of adding an IDA to the Bank's lending structure had first been mentioned in 1951 as a way of achieving the objectives of (US) President Truman's Point Four program, announced in his 1949 inaugural address – that is, making the benefits of scientific-industrial progress available to underdeveloped countries as part of the cold war. The concrete proposal that actually established the IDA was made in 1959 by the US Treasury headed by Secretary Robert B. Anderson. A year earlier a Special United Nations Fund for Economic Development had been formed. The USA wanted to pre-empt that organization and keep development funding within the Bank (see

Chapter 2). The purposes of the IDA as stated in Article I of the Articles of Agreement were:

> to promote economic development, increase productivity and thus raise standards of living in the less-developed areas of the world included within the Association's membership, in particular by providing finance to meet their important developmental requirements on terms which are more flexible and bear less heavily on the balance of payments than those of conventional loans, thereby furthering the developmental objectives of the International Bank for Reconstruction and Development … and supplementing its activities. (IDA 1960)

The IDA would offer 'soft loans' ('soft' meaning over long periods of time and at very low rates of interest) from revenues derived from 'Part I' donor counties, for purposes that were not necessarily revenue-producing, or directly productive in the usual economic sense, in what were called 'Part II' recipient countries. Most of the money would come from capital subscriptions from donor countries, rather than from bond sales. Under Article V of the Articles of Agreement, the use of IDA resources and the conditions of its financing were outlined as follows:

1 The Association shall provide financing to further development in the less-developed areas of the world included within the Association's membership.
2 Financing provided by the Association shall be for purposes which in the opinion of the Association are of high developmental priority in the light of the needs of the area or areas concerned and, except in special circumstances, shall be for specific projects.
3 The Association shall not provide financing if in its opinion such financing is available from private sources on terms which are reasonable for the recipient or could be provided by a loan of the type made by the Bank.
4 The Association shall not provide financing except upon the recommendation of a competent committee, made after a careful study of the merits of the proposal. Each such committee shall be appointed by the Association and shall include a nominee of the Governor or Governors representing the member or members in whose territories the project under consideration is located and one or more members of the technical staff of the Association. (ibid.)

Again, the IDA was originally a US-inspired institution. As Robert Anderson said, on recommending the IDA for congressional approval, 'it showed the rich countries' commitment' to helping the poor countries 'advance their economic life under free institutions' (Sanford 1982: 46). The USA provided 42 percent of the initial contribution (limited originally to $1 billion) and mobilized support from other developed countries. Originally the IDA funded projects in much the same manner as the IBRD, and indeed worked closely with it, but the concept of 'project' was widened in the IDA to include 'social' projects dealing with health and education, while eligibility for IDA loans was restricted to poor countries. In the end the IDA opened the Bank to a broader perspective on development lending that made possible its emphasis on poverty and basic needs in the 1960s and 1970s.

Poverty and basic needs

The appointment of George Woods as president of the World Bank in 1963 proved momentous. While Woods had a banking background, as chairman of First Boston Bank, he had worked in investment rather than bond sales, the bailiwick of the previous president, Eugene Black. At that time, the IBRD faced a combination of high earnings from past investments, but diminishing investment opportunities in the infrastructures of its traditional client countries. The solution lay in a new and more risky lending policy with longer repayment schedules, more technical and other kinds of direct assistance, and loans primarily in agriculture – including potential involvement in the politically contentious area of land redistribution. For the Bank's new policy to be effective, the limited funds originally paid into the IDA had to be replenished from increased subscriptions from donor countries, and from IBRD profits, something that proved difficult and contentious. And there was a frustrated move away from economic growth as the central focus of the Bank's lending policies and toward issues of poverty alleviation which was picked up later when Robert S. McNamara replaced Woods as Bank president. As a result of this new 'crusading energy' the Bank's lending doubled during the 1960s, the size of its staff tripled (with growth especially in professional economists), the number of member countries increased, especially in Africa, and lending escalated for projects in new areas such as water supply, sanitation, education and agriculture, areas that led to greater cooperation with UN agencies such as the FAO and UNESCO. The World Bank, and especially its IDA component, but also increasingly

the IBRD, began to use income per capita as a criterion for lending, rather than the traditional creditworthiness or performance, with its clientele becoming poor rather than middle-income countries – India and Pakistan received 70 percent of IDA allotments in the 1960s. Even so, Woods finally resigned, disillusioned with the lack of support for his attempted transformation of the institution from a bank to a development agency.

The presidency of McNamara (1968–81) is often regarded, at least by (New Deal-style) liberals, as the Bank's halcyon days. Previously employed at the Ford Motor Company and in the Kennedy and Johnson administrations (as secretary of defense), and renowned for his advocacy of scientific management, Robert McNamara nevertheless came with a fierce determination to redefine the Bank into a development agency dealing with poverty issues. The motives behind this seem to have combined genuine, compassionate generosity with the realization, intensified by the Vietnam disaster, that US national security was incompatible with a world of poverty – as McNamara put it during a 1966 speech: 'without development there can be no security' (Kapur et al. 1997, vol. 1: 219). By 'development' McNamara meant more than the Bank's long-lasting fixation on economic growth. The notion that economic growth produced beneficial effects that trickled down to the poor (with the implication that governments should trust in an eventual equity of benefits produced by the market) had come under extensive criticism in academic and bureaucratic-institutional circles. As a social engineer, McNamara translated this changing theoretical perspective into the position that poverty could be eradicated through direct policy intervention, as in Lyndon Johnson's 'War on Poverty' within the USA. Under the McNamara presidency, the Bank continued to believe fundamentally in the efficacy of free markets, but took a more equivocal view of ownership, believing that managerial competence was more important than private entrepreneurship, so that loans could be made under public ownership systems within an overall conception of greater governmental intervention in the development process – it should be added that this political position was not shared by many of the Bank's staff, or by some donor governments.

The main problem was defining a poverty alleviation policy that would suit the Bank's existing lending practices based in project lending, which would appeal to its principal shareholders and could be sold to borrowing countries. The period 1968–73 saw a number

of temporary enthusiasms – population control, various employment policies, nutrition, health, water supply – all culminating in the later 1970s with a 'basic needs approach' to lending – that is, giving greater attention to need rather than output in the allocation of resources. For example, the Bank's Urban Development Department, formed in 1972, engaged in a series of 'sites and services' projects – that is, providing new house sites and public services to an area – and then housing upgrading in slum areas, the main problem being the recovery of costs from low-income homeowners. But none of these proved sufficient. Finally, during a 1973 Nairobi speech, McNamara came up with a theme for the rest of the decade: the Bank would carry out large rural development schemes focused on small farmers as its main vehicle for direct poverty alleviation. Even so, this proved difficult to translate into 'bankable projects.' Eventually the final form was called 'integrated rural development projects.' Bank loans and technical assistance were given for key agricultural inputs (fertilizer, seeds) and infrastructure (water, electricity, roads) aimed at small farmers in a specific geographical area (hence a 'project') which would increase productivity, providing surpluses that could be sold in markets, which in turn would raise (money) incomes. Such projects, however, proved to be easier to outline on paper in Washington than to carry out in the field: it turned out that little was known about rain-fed tropical agriculture in Africa, the prime regional target of Bank lending, and that attitudes and institutions were more difficult to change than technology. Even more, major land tenure reforms were a prerequisite of any agricultural development aimed at the poor. Otherwise loans went mainly to middle-income and richer farmers, increasing income inequalities. As a result of all this, even the World Bank's own Operations Evaluation Department called most such projects 'failures.' Well before the end of McNamara's presidency, the ardor had gone from the poverty initiative that, at its height, had amounted to no more than a third of Bank lending, with the rest going to the traditional areas of infrastructure investment. Debt and balance of payments in Third World countries became leading issues, with 'structural adjustment' as the solution (Kapur et al. 1997, vol. 1: chs 5, 6).

Structural adjustment

Dissatisfied with ad hoc project lending, and with countries needing foreign exchange to pay for oil imports and meet interest payments, McNamara said in 1979 that the Bank should use program loans to

induce 'reforms' in recipient, mainly middle-income, countries. By this time, within an overall policy regime shift from Keynesianism to neoliberalism, the meaning of the term 'reform' was being changed to mean structural adjustment lending to promote export orientation and trade liberalization. The World Bank would follow the lead of its more senior partner, the IMF, under a division of labor that allocated 'stabilization programs' (short-term adjustment lending) to the Fund and longer-term 'structural adjustment lending' (SAL), aimed at correcting deeper 'structural' problems, to the Bank. In 1980 the Bank laid out the general conditions under which structural adjustment loans (SALs) would be made available. The argument was that the new conditions faced by Third World countries – deteriorating terms of trade and growing current account deficits – forced them to reconsider how they might 'adjust' their development patterns and economic structures. The Bank's new lending program would provide loans that were policy-based (rather than project-based), extending over several years, and would provide direct support for specific policy reforms decided upon during 'dialog' with the borrowing country. The specific 'reforms' were not yet decided upon exactly, although they would continue the trend toward 'liberalization' mentioned previously.

Indications of the direction in which things were going were, however, provided by a 1981 report on development in sub-Saharan Africa prepared by the Bank's African Strategy Review Group coordinated by Eliot Berg, a market-oriented economist from the University of Michigan (World Bank 1981). This combined remnants of McNamara's small-farmer strategy with a strong advocacy of the market and a critique of state intervention. The report found that the basic problems of the sub-Saharan region – slow economic growth, sluggish agricultural performance, rapid rates of population increase, balance of payments and fiscal crisis – stemmed from a combination of internal and external factors exacerbated by 'domestic policy inadequacies.' The list of inadequacies went something like this: trade and exchange rate policies overprotected industry, held back agriculture and absorbed administrative capacity; there were too many administrative constraints and the public sector was overextended, especially in the direction of hopelessly corrupt and inefficient parastatals (government-owned corporations); there was a bias against agriculture in price, tax and exchange rate policies. These areas of the macroeconomy had to be changed, the group concluded,

if production was to be given a higher priority. While (supposedly) reticent about advising specific policy measures, the report found existing state controls over trade to be ineffective, and recommended that private sector activity should be enlarged, that agricultural resources should be concentrated on small capitalist farmers, and that countries should follow an export-oriented development strategy. The report was received with widespread, bitter criticism from the governments of the countries it was supposed to help, and with whom 'dialog' had presumably taken place.

This turn to a more policy-interventionist stance, evident in the late McNamara years, was reinforced in 1981, with a change in the Bank's presidency to A. W. Clausen, formerly head of the Bank of America. Under the Clausen presidency, poverty took a back seat to the new driving forces of macroeconomic policy, stabilization and balance of payments adjustments, all understood within a more right-wing doctrine of the strict limits of governmental intervention and the virtues of 'flexible, self-adjusting free markets.' The Clausen presidency also brought new personnel with different political-economic beliefs into the Bank. As head of the Bank's crucial economics department, McNamara had favored Albert Fishlow, an economic historian then teaching at Yale University. But after an editorial in the *Wall Street Journal* attacked Fishlow's supposed (state) interventionist (Keynesian) tendencies, and derided his interest in 'things like income distribution in Brazil,' Anne Krueger, an energetic, market-oriented neoliberal, was made chief economist of the Bank (Kapur et al. 1997, vol. 1: 339). More fundamentally, the shift from McNamara to Clausen corresponded with a distinct move to the right in key donor countries – Margaret Thatcher became prime minister in Britain in 1979, Ronald Reagan was elected president of the United States in 1980, and Helmut Kohl was elected chancellor of West Germany in 1982. A shift in US attitudes toward the World Bank had already been signaled during the Ford administration, when William Simon, secretary of the Treasury, said at the 1976 annual meeting of the World Bank's Board of Governors: 'The role of the private sector is critical. There is no substitute for a vigorous private sector mobilizing the resources and energies of the people of the developing countries' (Gwin 1997: 217).

Thus the Reagan administration came into power in 1981 with antagonistic views of the World Bank and other multilateral institutions and favoring reduced US support for them. David Stockman,

director of the Office of Management and Budget in the Reagan administration, believed that 'the organs of international aid and so-called Third World development … were infested with socialist error' (Stockman 1986: 116). Likewise, the new US under-secretary of the Treasury in the Reagan administration, Beryl Sprinkel, a protégée of Milton Friedman, immediately commissioned a study to see whether the World Bank had 'socialistic tendencies' (in Kapur et al. 1997, vol. 1: 338). The message from the Treasury in a report on US participation in multilateral development banks was that such institutions should foster greater adherence to open markets and the private sector, that loan allocations should be conditional on policy reforms in recipient countries, and in any case that the USA should reduce its expenditures on the banks (US Department of the Treasury 1982). Reagan followed this up with a speech to the 1983 annual meeting of the World Bank Board of Governors saying that countries achieving the most broad-based economic progress had all believed in the 'magic of the marketplace.' As he put it: 'Millions of individuals making their own decisions in the marketplace will always allocate resources better than any centralized government planning process' (Gwin 1997: 231) – a statement that followed Milton Friedman's views almost exactly (see Chapter 1). Against objections from the State Department, the Treasury Department, with support from President Reagan, cut the US contribution to replenishing the IDA by 25 percent, with the clear implication that future participation was conditional on a drastic change in Bank policy away from any notion of state-directed development (Kapur et al. 1997, vol. 1: 338).

Structural adjustment became the main means of carrying these political beliefs into economic practice. At first, these reforms were directly connected with a country's balance of payments, under a 'strict constructionist view' of the Bank's arena of intervention. But eventually this limitation was discarded, and the entirety of a country's macroeconomic structure became subject to change. In the *World Development Report* for 1987 the Bank laid out its role in structural adjustment lending. The Bank said that it had increasingly been recognized that it was virtually impossible to have an investment project that produced a high rate of return in a bad policy environment. Therefore the Bank had introduced new instruments in support of developing countries' programs and policies of structural reform: structural adjustment loans focused on macroeconomic policies and institutional change at the country level; and sector adjustment

loans promoting sectoral policies. These were medium-term lending programs (over several years) that facilitated the reforms through which countries adjusted their policy frameworks so that they could 'achieve sustainable growth' and obtain 'external financing.' The Bank explained that structural adjustment required firm commitments on the part of governments to sustain reform over time. Reform programs needed to be flexible and the Bank supported modifications in policy packages in the light of domestic and international developments. Where policy reforms toward desirable structural change had transitional costs that affected the poor, the Bank worked with governments to develop appropriate programs (World Bank 1987: 34).

The same report also discussed the kinds of policy needed for achieving faster growth in developing countries. First, trade policies to increase international competitiveness: maintaining realistic exchange rates and replacing quantitative restrictions with tariffs reduced countries' 'bias against exports' and moved them toward an outward-oriented trade strategy that improved trade performance and helped them achieve higher rates of growth. Second, policies aimed at macroeconomic stability: lower fiscal deficits through reducing public expenditures were essential for increasing savings and improving resource allocation. Third, complementary policies improved resource allocation, as in fewer price controls, investment regulations and labor market regulations (such as high minimum wages). Speaking of the highly indebted countries, the report urged that the momentum of reform must not be allowed to slacken, even in the face of political difficulties, if the orderly servicing of debt were to be maintained. Interruptions in debt servicing could damage the financial system and make the resumption of normal levels of borrowing from the private capital market difficult (ibid.: 29–35).

We can follow the Bank's new line of thinking, displayed in this account of structural adjustment, through the various *World Development Report*s published during the 1980s. The 1983 *World Development Report* (World Bank 1983: 29) said that foreign trade enabled developing countries to specialize, exploit economies of scale and increase foreign exchange earnings. The 1984 report (World Bank 1984: ch. 3) used 'growth scenarios' to argue that developing countries would improve their positions by changing their economic policies: avoiding overvalued exchange rates, reducing public spending commitments, having an 'open trading and payments regime' that encouraged optimal use of investment resources. The case examples

were the 'outward-oriented' (but not state interventionist!) East Asian countries. In the following year (World Bank 1985: 145) the Bank warned that a 'retreat from liberalization' would slow economic growth. The 1987 *World Development Report* asked what the ultimate objectives of development were. Generally, the answer was 'faster growth of national income, alleviation of poverty, and reduction of income inequalities' (World Bank 1987: 1). The Bank stressed 'efficient industrialization' as the key economic policy. It drew directly on Adam Smith's argument that industrialization and the division of labor, keys to increased productivity, would be retarded by a low ability to trade widely – for small countries this meant that progress depended on the ability to trade freely with the rest of the world. It also drew on Ricardo in arguing that trade allowed a more efficient employment of the productive forces of the world, and on Mill in saying that consumers ultimately benefited through lower prices and being tempted by things they had not previously thought attainable – the latter could revolutionize a country whose resources were undeveloped for want of energy and ambition in the people. State protection of industry in the past, the report said, had led to inefficient industries and poor-quality, expensive goods. So the idea was to reduce trade barriers, switch the economy's focus to exports, and compete vigorously in world markets. By the end of the 1980s a set of structural adjustment policies based in a rightist interpretation of neoclassicism was firmly in place.

Debt relief

While the Reagan administration's ideological predilection may have been for a reduced US commitment to the Bank, the realities of the debt crisis of the 1980s soon overwhelmed political preference. At first, as we saw in Chapter 3, an assumed short-term liquidity crisis in middle-income Third World countries was addressed by IMF stabilization programs. But by the mid-1980s, it had become clear that many countries could not service even their 'rescheduled' debts. The USA, along with other donor countries, was forced to reconsider the role of the multilateral banks, including the previously suspect World Bank, in far more drastic solutions. The Reagan administration was convinced that the Bank had changed in response to US pressure, and that the new kind of structural adjustment lending could respond to the debt crisis by advancing market liberalization. Thus, in a speech to the joint World Bank–IMF meetings in the autumn of 1985, US

Secretary of the Treasury James Baker called for a new and more interventionist role for the Bank in coordinating increased loans from private and multilateral bank sources and ensuring policy changes in debtor countries. Similarly, when the first Bush administration recognized what the commercial banks had been forced into realizing – that Third World debt levels were unsustainable – the Brady proposal of 1989 made debt reduction contingent on 'policy reforms' supervised increasingly by the Bank rather than the Fund. In the Baker and Brady Plans, the US Treasury and the Federal Reserve Board, under the chairmanship of Paul Volcker, were active participants in negotiations with debtor countries – according to Volcker they 'directed the lending of the Bank' (Gwin 1997: 236). And within these conditions, the USA supported increased funding for the IDA in 1987 and a doubling of Bank capital in 1988, with the stipulation that US vetoing power would be maintained even though its proportion of subscriptions fell to 20 percent.

With its new emphasis on structural adjustment, the World Bank caught up in the 1980s with the critique of state interventionism and renewal of neoclassicism that had occurred in 'professional economics' in the 1970s. In line with this renewal, 'structural adjustment' came to mean a process of change in the international financial system, and in the economic positions of individual countries, that was necessitated by the oil price increases of 1973–74 and 1979–80. Most basically, structural adjustment meant a 'combination of supply- and demand-side policies … directed towards the transformation of the structure of an economy in response to serious disequilibria, aiming both to restore macroeconomic equilibrium and to improve microeconomic efficiency' (Stern with Ferreira 1997: 540). Initially this meant using capital accumulating in surplus countries, as in the oil-exporting members of OPEC, to sectorally transform borrowing countries toward export orientation. Subsequently it meant establishing macroeconomic policies that might produce stable prices, full employment and a positive current account balance, all intended to 'restore internal and external balance' to an economy. It also meant microeconomic policies aimed at increasing the efficiency of the supply side of an economy, as in privatization, increasing tax incentives to producers, changing trade policy, and so on (a fuller list is given in a discussion of the 'Washington Consensus' in Chapter 1, p. 14). So in general the structural part of adjustment entailed two broad movements: changing the structure of incentives toward profit orientation, increasing the role

of markets as compared with states and augmenting private property rights; and restructuring the sectoral composition of an economy toward tradable (and especially exportable) goods. Under the Bank's structural adjustment program, accounting for about a quarter of its total lending, sums of money large enough to draw the interest of borrowing countries' senior policy-makers are made available in quickly disbursed loans in exchange for broad commitments to change the economy in general (SALs), or a main sector of the economy in particular (SECALS). In the late 1980s and early 1990s, the heyday of structural adjustment, the Bank was making loans averaging about $100 million each to fifty countries a year, predominantly in Africa and Latin America (Kapur et al. 1997, vol. 1: 520). In this sense, conditionality is the link between the Bank's version of neoclassical economic beliefs, turned in the right direction through an injection of neoliberalism during the Reagan and Bush administrations in the USA, and the commitments made by borrowing countries to follow specific conditions stipulated by the lending institution as the basis for making a loan or allowing subsequent drawings of previously committed loan money. While IMF conditionality specifies ten or fewer policy measures that can be monitored by the institution, with further drawings made contingent on a country's satisfying perhaps a quarter of these performance criteria, the Bank's conditionality is far broader, amounting often to fifty or more measures, many of which cannot be monitored through statistical indicators, leaving subsequent drawings to be judged qualitatively by the Bank or negotiated with the country concerned. Increasingly the demarcation lines between the IMF and the World Bank – short-term for the Fund and long-term for the Bank – have tended to fade, while agreement has tended to cohere on the direction of policy prescription (Polack 1997).

Under the structural adjustment policy of the late 1980s, the Bank came to specify changes in dozens of areas of macroeconomic policy – so many that neither the World Bank nor even the government concerned could ensure that policy conditions were being enforced. Out of sheer practical necessity the Bank was forced in the direction of borrower 'ownership' of the reforms supposedly emerging from lender–borrower dialog. Along with this, from the mid-1980s onward, the Bank began to stress issues of 'good governance' understood as efficient, orderly and accountable public administration. Also, after accepting the renewed emphasis on growth stressed in the Baker Plan of 1985, the Bank (as had earlier the IMF) came to be more heavily

criticized for the austerity of the structural adjustment programs it was sponsoring. A UNICEF report called *Adjustment with a Human Face* pointed to the deteriorating health and education conditions, the worsening employment situations and the falling incomes in countries undergoing structural adjustment (Cornia et al. 1987).

The replacement of Clausen with Barber Conable, a former Republican congressman, in 1986 and the resignation of Krueger in 1987 brought a renewed emphasis on poverty issues. Deserted by the very administration officials who had persuaded him to accept the presidency of the Bank, when the US Treasury Department led other major shareholders into vetoing the proposed World Bank budget for 1986–87, and faced by continuing hostility led by David Mulford, assistant secretary for international affairs at the US Treasury, Conable felt free to reorient Bank policy in the direction of social issues, while four years later, with Lewis Preston as president, poverty reduction became the Bank's 'overarching objective.' Subsequently the Bank tried to reinvent itself McNamara-style as a development agency fighting poverty.

In line with this, the Executive Board in 1989 approved use of the World Bank's resources in debt or debt-service reduction for heavily indebted countries, essentially following the Brady Plan (see Chapter 3). The Bank used several financial devices, including new money, buybacks and discount bonds, to provide official support for countries deemed to have 'strong adjustment programmes' (Kapur et al. 1997, vol. 1: 656). The Bank was heavily involved in Mexico, but played a minor role in the more general Latin American debt crisis of the 1980s. Its main role, along with the IMF, has been more recent, in the Heavily Indebted Poor Country (HIPC) initiative begun in 1996. This is an attempt at reducing the external debt of the world's poorest countries – those eligible for highly concessional assistance from the IDA, and which also face an unsustainable debt situation even after the application of traditional debt relief mechanisms (such as under the Paris Club agreement). To get the assistance, countries have to implement 'integrated poverty reduction and economic reform programs.' The World Bank uses a Trust Fund to forgive 50 percent of the annual debt service due on existing IDA debt.

This new attitude on the part of the Bank responded to an environment of increasing criticism, including substantial amounts from within the institution. The Wapenhans Report, named after a Bank vice-president and entitled 'Effective implementation: key

to development impact,' found that 'at least twenty percent of the 1800-odd projects in 113 countries contained in the Bank's $140 billion loan portfolio presented major problems' (World Bank 1992a). The Bank's Operations Evaluation Department published a report, entitled *World Bank Structural and Sectoral Adjustment Operations*, in June 1992, which critically reviewed the SAL and SECAL programs: 'In the 18 Sub-Saharan African countries reviewed, no less than 14 had experienced a fall in investment rates during adjustment.' Less than 20 percent of adjustment-related technical assistance loans were substantially effective, and 15 percent had only negligible impact. The report said that decreased social expenditures as part of structural adjustment lending had led to 'unsatisfactory results' in terms of poverty; income inequality had increased in some countries and landless farm workers had borne the greatest burden of higher food prices (World Bank 1992b).

Revisions

So it is that some commentators find that the World Bank shifted at the end of the 1980s and in the early 1990s to a revised neoliberal model stressing 'market-friendly' state intervention and good governance (political pluralism, accountability and the rule of law) with a renewed emphasis on social issues such as poverty and education and a dedication to debt reduction (Kiely 1998; World Bank 1991: 1–2). Thus, in the 1990s, the various *World Bank Development Report*s outlined a new 'holistic approach' to development involving social safety nets, poverty, health, education, environment, rural areas and gender considerations, in concert with conventionally neoliberal areas, such as increased property rights, trade liberalization and privatization. In 1997 James D. Wolfensohn, who became president of the Bank in 1995, called for closer relations with other institutions and civil society actors to increase the effectiveness of the developmental effort. In 1998 the Bank carried out a series of consultations with government representatives, bilateral donor agencies, multilateral financial institutions, academics, NGOs and other civil society organizations, together with the private sector. Also in 1998 Wolfensohn suggested an integrated approach to development based on a framework articulated and 'owned' by the country itself, aimed at poverty reduction and sustainable development, known as the Comprehensive Development Framework (CDF). In many respects, this is the Bank's policy answer to criticisms that structural adjustment does little to alleviate poverty.

As the president of the Bank said, the CDF was necessary 'since too many in the developing world were not being helped sufficiently by the development process, and [the World Bank was] in danger of losing the war against poverty' (World Bank 2000a: 5). The CDF attempts to balance the institution's concern for macroeconomic policies stressing economic growth with the social and human aspects of development, and especially poverty alleviation. Outlined in the 1999/2000 *World Development Report*, the CDF has two complementary parts: a stable macroeconomy shaped by 'prudent fiscal and monetary policies'; and the CDF itself, stressing honest governments, strong property and personal rights, supported by an efficient legal and judicial system, human development, as in education and health, physical infrastructure, and sectoral elements such as integrated rural development strategies and urban management (World Bank 1999a). The CDF is based on four principles designed to guide implementation of future development strategies in specific countries. First, the framework emphasizes the need for a long-term, holistic vision of development that considers structural and social issues simultaneously, as well as acknowledging the interlinkages between all economic sectors. Second, the country receiving assistance or loans needs to be in control, taking ownership of the process. This entails the respective governments building consensus domestically and consulting with as many different civil society and private sector actors as possible. The necessary prerequisite to country ownership is an emphasis on partnership between the 'stakeholders' in the development process, again incorporating government, civil society and the private sector of the country concerned, and the main external actors, such as the World Bank, donor countries and bilateral aid organizations. Finally, the CDF calls for regular assessments of actual development outcomes to ensure accountability toward meeting the goals set out in each country's long-term vision (World Bank 1999a, 2000a, 2000b).

The CDF was part of a larger effort by the Bank to produce what it termed a new consensus in the international development community, comprised of various donor organizations and bilateral and multilateral agencies such as the UN and the OECD, on the ingredients for successful development policies. Several UN conferences have also led to the production of a document entitled 'On common ground' (OECD 2000), which retains central elements of the CDF proposal. Obviously, the Bank is trying to reposition itself within a much larger group of international organizations that emphasize a dedication to

alleviating poverty and providing development assistance (see Chapter 2). Emphasizing agreement on the fundamentals of development policies with other institutions of the UN, which historically have been much better received by the Third World and NGOs, the World Bank is signaling a shift in approach to its many critics. The Bank's leadership is acutely aware of its public relations problems: 'much suspicion still exists on the part of certain well-organized members of civil society. This must be overcome' (World Bank 2000a: 9). Likewise, in a 1999 meeting the Development Committee, a joint effort of the Board of Governors of the World Bank and the IMF, proposed that Poverty Reduction Strategy Papers be prepared by national authorities, in close collaboration with Bank and Fund staff, in all low-income countries receiving support from the Bank's IDA and the IMF's ESAF. Again, the emphasis was on strategies that were country-driven, developed transparently with broad and even popular participation. Yet the strategies were also supposed to be clearly linked with the development goals and principles of the CDF. Some fifty countries have subsequently implemented the CDF principles. The World Bank now says that participation, including poor or marginalized groups and the private sector, is crucial to building country ownership of national development strategies.

The 2000 *World Development Report: Attacking Poverty* (World Bank 2000c) also reflects this struggle over image and substance outside and within the Bank. As with the CDF, the report indicates a shift in World Bank thinking toward situating the social and cultural dimensions of poverty alleviation at least on a par with structural adjustment. At the beginning of the report, Wolfensohn says that the Bank 'now also recognize[s] the need for much more emphasis on laying the institutional and social foundations for the development process and on managing vulnerability and encouraging participation to ensure inclusive growth.' Yet he insists too that macroeconomic stability and market-friendly reforms remain equally essential for reducing poverty (ibid.: vi). The report is subsequently organized around three central themes of opportunity, empowerment and security. The theme of material opportunities for poverty reduction still refers to the necessity for economic growth, but also includes the quality and pattern of growth and the importance of the equality of distribution, themes that are novel to Bank thinking. Further, the report stresses the need for empowering the poor by establishing, and strengthening, state and social institutions receptive to their needs

and which offer poor people a chance to shape decisions that affect their lives. The eradication of various forms of discrimination also figures prominently. Finally, the report says that providing security for the poor means reducing their vulnerability to economic shocks, natural disasters and personal misfortunes through various social instruments, such as accessible insurance mechanisms for health or disability. A sizable part of the report draws on interviews with 40,000 poor people, emphasizing individual experiences of powerlessness, vulnerability and denial of access to essential services, such as education or healthcare (Narayan 2000). Chapter 3 of the report sets out a case for the importance of redistribution in favor of the poor by noting that poverty is inextricably tied to income inequality, rather than being a result of a lack of economic growth. Chapter 4 argues that markets and pro-market reforms are simply beneficial to the poor despite contrary evidence from a number of countries mentioned elsewhere in other parts of the report. Again, the evidence points to tension between competing convictions embedded in the Bank's overall position.

Consequently, commentary from the media, civil society and NGOs to the Bank's poverty report ranged widely. The *New York Times* saw the report throwing 'stones at the orthodox temple development economics' and reading 'like something written by … the "Berkeley Mafia",' and suggested that James Wolfensohn was 'proving hard to outflank on the left' (Kahn 2000). Oxfam, the British development NGO, found that the report was a 'flagship document that the World Bank can be proud of' and called for implementing its appeal for a fight against inequality (Oxfam 2000). Oxfam lamented, however, the 'neo-liberal hangover' still apparent in the chapter dealing with the benefits of market-friendly reforms for poor people. The (British) Institute of Development Studies (IDS 2000) said that ideas such as the empowerment of poor people were treated as decorations, and that the report offered nothing beyond cosmetic and semantic changes. Certain events surrounding the preparation of the report added ammunition to this last, more critical perception. Originally, the writing team was led by Ravi Kanbur, an academic economist from Cornell University. But Kanbur resigned in May 2000, citing undue outside pressure over changing the emphasis on policies of redistribution and social spending (Denny 2000). According to news accounts, Kanbur's reaction was a result of direct intervention by the US Treasury Department and its then secretary, Lawrence Summers,

in rewriting the report (Global Policy Forum 2000). While the Bank subsequently denied this kind of censorship, saying the final version remained true to its earlier drafts, Kanbur's resignation nevertheless provides more evidence for the struggle over influence on the course of World Bank policy taking place within the institution and among powerful interests outside. The *Economist* called the resulting 'chaos' a 'Washington Dissensus' (Economist 2000).

Let us note a couple of the results of this 'dissensus' within the Bank. In two stunning research papers, one published in the World Bank's Working Paper series, the second as yet unpublished, Branko Milanovic, of the World Bank's Research Department, criticizes some of the crucial positions taken by the Bank, the IMF and the WTO. Milanovic says that conventional international trade theory implies that increased trade and foreign investment should make income distribution more equal in poor countries and less equal in rich countries, but that finding these effects in reality has proved difficult. Using data from household budget surveys, and looking at the impact of openness and direct foreign investment on relative income shares, he finds some evidence that, at very low average income levels, the rich benefit from openness. As income levels rise, that is at around the income level of Colombia, Chile or the Czech Republic, the situation changes, and the relative incomes of the poor and the middle class rise, compared with the rich. Thus it seems that openness makes income distribution worse before making it better – or that the effect of openness on income distribution depends on a country's initial income level (Milanovic 2002a).

In a second research paper, Milanovic (2002b) argues that the current view of globalization as an automatically benign force is seriously flawed. It focuses on one, positive face of globalization, while entirely neglecting a malignant one. Two key historical episodes in globalization are misinterpreted: the period 1870–1913 was not pleasant for those who were being 'globalized' since colonial constraints prevented them from industrializing; and the period 1978–98 is shown to be uniformly worse than the period 1960–78. Following Rodrik (2000), Milanovic looks at what is probably the key study by Dollar and Kraay (2000) linking 'openness' to economic growth. Milanovic shows that their positive conclusion is almost entirely the result of including the huge population of China, one of the few remaining communist countries. Milanovic finds that only by seriously misreading the recent evidence can the partisans of globalization argue for

its unmitigated beneficence. Globalization led by capitalist interests alone, like that of a century ago, is likely to produce 'a wild global capitalism with social exclusion, unbridled competition and exploitation' (Milanovic 2002b: 1). Global capitalism needs to be 'civilized' as national capitalisms were after the Second World War, a period that then witnessed the fastest growth in history – but the civilizing role has to be assumed by global institutions as well as national states. Chinks in the ideological armour?

Criticizing the Bank

Why this new face on an old institution? From 1986 onward, the Bank came under increasing criticism from NGOs representing social and environmental movements, from people concerned about poverty, from gender-oriented groups, and from many other concerns that mobilized people and ideas and motivated liberal political constituencies in donor countries. As criticism of the World Bank mounted, the institution began to respond, certainly by adjusting its image, and arguably by modifying its substantive policies. More than the other two global institutions examined here, the Bank has appeared receptive to criticism. Increasingly, the Bank has acknowledged the necessity of pursuing more 'comprehensive strategies' that emphasize 'democratic, equitable, and sustainable development' (Stiglitz 1999: F587). Some commentators see this as a genuine attempt by the Bank to reinvent itself; others detect creative window-dressing as part of a process some describe as the art of 'paradigm maintenance.'

Robin Broad, a professor at the American University, describes the mechanisms by which the World Bank performs 'paradigm-maintenance' – a term she takes from Robert Wade (1996) – on its research and thinking on development economics. The Bank, she says, is not only the main lender of public money, it is also the world's largest development research body. The Bank's development research department is important because it performs work for other aid agencies and banks, which often follow the course prescribed by the Bank – she calls the Bank's DEC (the World Bank's research department, currently under the development economics vice-president) the 'research powerhouse of the development world.' The Bank claims that governments and researchers should view DEC as an impartial 'knowledge bank' on development, conducting rigorous and independent research.

But after a careful look inside, including a couple dozen interviews

with former and current Bank staff, Broad reached a different conclusion: the World Bank has played a critical role in legitimizing the neoliberal free-market paradigm over the past quarter-century, and its research department has been vital to this role. The work of perhaps the best-known World Bank researcher, the appropriately named David Dollar, exemplifies neoliberal paradigm-maintenance. For many in the media, academia, and policy-making circles, Dollar's work on trade and economic growth produced empirically proven 'facts' that 'globalizers' – countries wedded to the Washington Consensus, especially to liberalized trade – experience higher economic growth rates than 'non-globalizers.' As Dollar and Kraay (2002) phrased it in an article in *Foreign Affairs*: 'openness to foreign trade and investment, coupled with complementary reforms, typically leads to faster growth.'

How did Dollar's work become prominent? Why does the work of Bank DEC researchers who support the neoliberal policy agenda get widespread attention? Broad discovered a set of six interrelated processes and mechanisms through which DEC, at times collaborating with other parts of the World Bank, performs its paradigm-maintenance role by privileging individuals and work resonating with this ideology. These mutually reinforcing structures include a series of incentives – increasing an individual's chances of being hired, of advancing his or her career, of being published, of being promoted by the Bank's external affairs department, and, in general, of being assessed positively. And they also include selective enforcement of rules, discouragement of dissonant discourse, and even the manipulation of data to fit the paradigm. As Broad's article demonstrates, this incentive or reward system is typically unstated, may even negate formal or stated procedures and, as such, functions as 'soft' law. This is done in a way that undermines debate and nuanced research conclusions, instead of encouraging the confirmation of *a priori* neoliberal hypotheses. These incentives raise significant questions about the World Bank's own argument that it produces work of the utmost quality and integrity. Broad's research should raise alarm about further concentrating and aggrandizing this role of knowledge production and marketing in the World Bank. The present moment of identity crisis within the Bank, Broad thinks, is an opportune moment to question paradigm maintenance and to rethink fundamentally research-knowledge production and dissemination at the World Bank. Governments and private foundations that support World Bank research and publicity would do far better to support independent

research institutions that are stimulating a more diverse development debate (Broad 2006).

After the article was published, Daniel Lederman and Martin Ravallion of the Bank's DEC wrote to the editorial board of the journal (*Review of International Political Economy*) calling into question the quality and accuracy of Broad's article. Quoting from their letter (a copy of which fell into our email system from 'out of the blue'): 'It is plain to us that Broad's article was published without an adequate scholarly assessment of the validity of her allegations … This was poor scholarship on her part. But what went wrong with your own journal's reviewing process? It is regrettable that a scholarly journal has not done its due diligence in making sure that the alleged evidence provides an accurate and fair account of reality' (Lederman and Ravallion 2006).

The journal's editorial board, however, defended its decision to publish Broad's piece and offered the Bank a chance to debate about it in the journal. They declined. 'Paradigm maintenance' by the Bank includes this kind of polite threat aimed at critics. At one time such an action would have devastated a critic's career. Now it passes almost unnoticed.

So, as we have said, throughout the 1980s the World Bank, acting in concert with the IMF, exercised considerable powers of control over most Third World and post-communist countries. Much of this power resided in the policy conditionality of the widespread structural adjustment programs. But power was exercised also in the Bank's traditional 'investment' or project lending. Investment loans finance a range of physical and social infrastructures and account for 75 to 80 percent of all Bank lending. Originally the loans were for physical infrastructure projects and engineering services, under the assumption that these would increase productivity and lead to economic growth. Beginning in the late 1980s Bank investment lending came to focus more on social development and the public policy infrastructure facilitating private sector activity, under the new assumption that these help alleviate poverty. Projects range from urban housing construction to rural development, water and sanitation, natural resource management, education and healthcare. The Bank's extensive power in this area comes from the huge amounts of loan capital it can raise, the additional amounts its stamp of approval leverages, and its ability to actually get things done when other agencies, including those of governments in recipient coun-

tries, cannot – low-cost housing and site and service provision are outstanding cases in point.

But it was in exactly this area of project lending that the Bank was first massively criticized – especially by environmental movements and related NGOs. From the mid-1980s on, the Bank faced mounting criticism for lending money to projects that cause large-scale environmental damage. The big early case was the Polonoroeste project, involving five World Bank loans to the Brazilian government in the early 1980s to construct a 1,500-kilometer highway and feeder roads into the northwest Amazon region. The highway was seen as connecting frontier areas of the Amazon forest with the more heavily populated south central region, and was expected to result in a model case of integrated rural development. The (paved) highway was completed in three years, however, long before support services or governmental authority could be organized. The population of the affected area grew from 600,000 to 1,600,000 in six years and extensive logging occurred, along with incursions into Amerindian reserves. Thousands of people died of malaria in areas where public health services were virtually non-existent. As a result, the Bank was heavily criticized for supporting an environmental and social disaster by Brazilian and US environmental groups, by members of the US Congress, and by Sixty Minutes, the most widely watched US television current affairs program, which called the project a massive waste of taxpayers' money. Criticism from environmental NGOs was largely ignored until the US Treasury Department, under James Baker, told the Bank to 'clean up' its environmental act as part of the Treasury's renewed role in the debt crisis. Indeed, the USA voted against a proposed loan to Brazil for dam construction in 1986, supposedly on environmental grounds. Environment, development and human rights groups held an alternative summit during the IMF/Bank annual meeting in September 1986, during which activist rock-climbers hung a sign reading 'World Bank destroys tropical rain forests' from the top of the Bank building. In response the Bank was forced to create an Environmental Department, to integrate environmental assessment into its project lending, and to consult, at least in setting up assessment procedures, with NGOs (Kapur et al. 1997, vol. 1: 279–80; Wade 1997).

The Brazilian rainforest adventure was, however, but a prelude to an even greater controversy. This concerned the World Bank's funding of the Sardar Sarovar dam project on the Narmada river

in northwest India. World Bank involvement in the Narmada Valley began in 1985, in the project's early stages, before thorough studies had been conducted, and long before the government of India knew much about the environmental and human costs. The Bank's loan of $350 million to fund the Sardar Sarovar dam did more than pay for the concrete – the Bank's approval legitimized a project that had no input from the people whose homes were to be flooded. The earliest estimate by the Indian government, in 1979, of the number of families to be displaced by flooding created by the dam was around 6,000. By 1992, that figure had grown to 40,000, while local people calculated that 85,000 families containing nearly half a million people would be displaced. The government's argument was that the 'displaceable' people, who happened to be overwhelmingly Adivasi (an indigenous group), should suffer for the 'good of India,' or more truthfully, for large landowners in need of water for irrigation (Roy 1999: 34). The Indian Ministry of Environment cleared the project for construction in 1987. But arguments were soon made that damming the Narmada river would destroy 4,000 square kilometers of natural deciduous forest and would lead to the spread of malaria, to soil erosion, to a range of damaging effects on the river and its estuaries, and to waterlogging and salinization of an extensive surrounding area (Fisher 1995: 34). Three major contentions arose about the Bank's handling of these potential environmental catastrophes: (1) discrepancies between World Bank policies and the obvious practices followed at the project; (2) the quality of the official studies carried out by the Indian government; and (3) post-completion studies replacing comprehensive pre-construction assessments (ibid.: 34).

In the Narmada Valley, few people knew of the threat to their homes and lives until after the deal with the Bank had been finalized. Thanks, however, to organizers such as Medha Patkar, an activist working with the affected people since the beginning, by 1986 the news had got around. Patkar suggested that 'the World Bank, even to us, was distant, remote, and powerful – a mere abstraction' (Patel 1995: 183). A people's group had been formed in each affected state. Subsequently these local organizations formed an alliance called the Narmada Bachao Andolan (NBA, Save the Narmada Campaign). The NBA formed ties with NGOs from each affected region and all began to work for improved policies on resettlement and rehabilitation. A national debate on the dam began. In 1987, the government of the state of Gujarat offered an 'improved' resettlement policy. NGOs

differed in their reactions. Some continued to work with the government and the proponents of the project. Many others followed the lead of the NBA in opposing the construction of the dam altogether (Fisher 1995: 23). Through continuous struggle with the government, the latter group shifted from wanting a voice in the plans, to rejection of top-down decision-making in India and the World Bank. In 1989, 50,000 activists gathered in the valley to fight 'destructive development' (Roy 1999: 37). The NBA announced that they would drown rather than move. In late 1990 and early 1991, a dedicated group of 6,000 people marched 100 kilometers toward the dam site, with a seven-member sacrifice squad resolved to give their lives for the cause. With their hands tied with yarn to symbolize non-violence, they encountered police and proponent activists before they reached the site. The Adivasi were seen as a 'handful of activists holding the country to ransom,' and were beaten, arrested and dragged onto trucks by the police, who had joined the side of the middle-class urban Indians (ibid.: 38). The activists were dropped off miles away, but that did not stop them from marching back and beginning again. Demanding a halt to the construction and a comprehensive review, the sacrifice squad escalated the pressure by beginning a hunger strike that lasted twenty-six days.

As news of the NBA's non-violent actions spread, NGO support arrived, including assistance from groups in countries supplying most of the funds for the dam project, namely the USA and Japan. The Narmada Action Committee was formed from NGOs specializing in the environment, human rights, development, religion, housing, agriculture, energy and indigenous rights. Bitter local dissent also arose as the NBA took its struggle to the international stage, since its interests were at odds with those of many NGOs. Many feared that local actions would be dictated from above. But the NBA took a vigilant stance toward outside NGOs, with their financial and intellectual power, and a relatively healthy exchange of information and energy occurred. All the groups involved shared a criticism of the current development discourse, a skeptical attitude toward the West and the 'modernizing' Indian government's notion of 'progress' (Fisher 1995: 26–7).

Because the World Bank was seen as steering this overall development trajectory, not to mention its direct financial influence, the institution became a main target for the international campaign. The message was that World Bank approval was dangerous if it funded

projects indiscriminately. As a result of mounting pressure, specifically from a campaign by Friends of the Earth in Japan, the Japanese government canceled a loan funding part of the Sardar Sarovar project. In India human rights were increasingly violated as the government violently cleared the way for the rising water. Since the World Bank is part of the United Nations system, the Narmada Action Committee pressured the Bank to be accountable to international human rights law, and to take responsibility for the increasing number of random arrests, beatings and illegal detentions. European NGOs, together with a spokesperson from the NBA, toured shareholding countries in Europe. The tour influenced finance ministries and brought European activists to the international struggle in solidarity with the people of the Narmada Valley. Further environmental activist protest occurred in Washington, DC, and 'acutely embarrassed by the glare of unfavorable media, the World Bank announced that it would commission an independent review of the Sardar Sarovar Projects – unprecedented in the history of Bank behavior' (Roy 1999: 39). In 1992 an independent review said that environmental considerations had not been taken seriously in planning the project and that there was no possible solution to the resettlement and rehabilitation problems in the valley using the existing approaches (Udall 1995: 216). The review recommended that the Bank cease its involvement immediately in order to reassess the situation. In response, the Bank sent a mission to find an alternative to the embarrassing option of simply pulling out entirely. Bank officials had to be protected by hundreds of police during the mission. Nevertheless, a document emerged outlining the steps the Indian government should take during a six-month provisional period. On the day before the end of the provisional period, the Indian government announced that it would finish the project independently, and the $170 million remaining in the Bank's original $450 million commitment was withdrawn. Since the Bank pulled out, hunger strikes and Gandhian civil disobedience have continued, along with (unsuccessful) appeals to the Supreme Court of India.

Under intense outside pressure, and for the first time, the Bank allowed an independent commission to investigate whether the institution's own rules on social and environmental impacts had been violated in approving the project. After ten months, the review panel published a report that was highly critical of the project and found numerous violations of the Bank's own procedures and regulations, which eventually led to the decision to withdraw from the project. The

Narmada episode, and an emboldened NGO community, pushed a reluctant Bank into establishing a permanent independent Inspection Panel in 1993 (Wade 1997: 726–9). NGOs from countries in which the Bank funds projects can now appeal to this commission, asking that it investigate whether the Bank has violated its own standards, although the final decision on whether to start an inquiry still rests with the Bank's Board of Governors – contrary to initial NGO demands. Nevertheless, the Inspection Panel's mere existence is evidence that severe external pressures on the Bank by actors other than G7 finance ministries have led to changes in institutional behaviour that leave lasting impressions on its governance structure.

A new Bank?

Relationships of some kind have long existed between the Bank and the NGO community. But until the early 1980s, many NGOs involved in development issues were quietly supportive of the World Bank's project-based lending. NGOs and the Bank seemed to share a common goal of furthering progress in the development of the Third World. With the Bank's new-found emphasis on structural adjustment in the 1980s, and the demise of McNamara's basic needs strategy, that relationship grew more acrimonious and, by extension, the World Bank's external image worsened significantly (Kapur et al. 1997, vol. 1: 1207–10). Over time the Bank became a focus of public protest and a unifying adversary for many NGOs. The NGO community has grown rapidly, making NGOs ever more visible players shaping public opinion on an international scale. For example, as concern about the environment weighed heavier in mainstream political debates in the West, the resulting growth of the environmental movement meant that the World Bank would now come under increasingly close scrutiny with regard to its environmental policies (Wade 1997: 653–62). WEDO (the Women's Environment and Development Organization) looked at the gender make-up of the top posts at the global financial institutions and found the following:

Boards of Governors:
IMF: men 97.8 percent; women 2.2 percent
World Bank: men 94.5 percent; women 5.5 percent
Boards of Directors:
IMF: men 100 percent
World Bank: men 91.07 percent; women 8.93 percent

Yet a rough breakdown of the gender composition of the world's poor finds men making up 30 percent and women 70 percent (WEDO 2002). The point was to connect global institutional policy with the actual causes of poverty. In making these arguments many NGOs shifted strategy from lobbying national governments, and their various ministries and departments, to addressing the World Bank directly through public campaigns – for example, sending them the kind of information revealed by WEDO. The Bank has increasingly come under pressure from civil society and NGOs in the First and Third Worlds. But for the Bank even to engage seriously with civil society actors, the traditional reluctance of the institution to deal with anyone but the national governments of member states and their finance ministries had to change. External criticism of the World Bank for failing to adequately address the social, cultural and environmental impacts of its projects and structural adjustment conditions has tended to increase. For example, Kevin Watkins of the British NGO Oxfam summed up the effects of structural adjustment in sub-Saharan Africa as follows:

> the application of stringent monetary policies, designed to reduce inflation through high interest rates, has undermined investment and employment. At the same time, poorly planned trade-liberalisation measures have exposed local industries to extreme competition. Contrary to World Bank and IMF claims, the position of the poor and most vulnerable sections of society has all too often been undermined by the deregulation of labour markets and erosion of social welfare provisions, and by declining expenditures on health and education. Women have suffered in extreme form. The erosion of health expenditure has increased the burdens they carry as care-takers, while falling real wages and rising unemployment have forced women into multiple low-wage employment in the informal sector. (Watkins 1994: 126)

Meanwhile Africa Action was arguing that the World Bank and the IMF had undermined the health of Africans through the policies imposed by structural adjustment. The key issue with adjustments, Africa Action argues, is whether they build the capacity to recover and whether they promote long-term development. The adjustments dictated by the World Bank and IMF did neither of these. African countries, the organization said, require essential investments in health, education and infrastructure before they can compete internationally.

But the World Bank and IMF required countries to reduce state support and protection for many social and economic activities, and insisted on pushing weak African economies into markets where they were unable to compete. The austerity policies attached to World Bank and IMF loans led to intensified poverty in many African countries in the 1980s and 1990s. This increased the vulnerability of African populations to the spread of diseases and to other health problems. Public sector job losses and wage cuts associated with World Bank and IMF programs increased hardship in many African countries. During the 1980s, when most African countries came under World Bank and IMF tutelage, per capita income declined by 25 percent in most of sub-Saharan Africa. The removal of food and agricultural subsidies caused prices to rise and created increased food insecurity. This led to a marked deterioration in nutritional status, especially among women and children. Between one-quarter and one-third of the population of sub-Saharan Africa is chronically malnourished. So the policies dictated by the World Bank and IMF exacerbated poverty, providing fertile ground for the spread of HIV/AIDS and other infectious diseases. Cutbacks in health budgets and privatization of health services eroded advances in healthcare made after independence and weakened the capacity of African governments to cope with the growing health crisis. The dramatic drop in health expenditure in the 1980s and 1990s resulted in the closure of hundreds of clinics, hospitals and medical facilities. Those still open were left understaffed and lacking essential medical supplies. Consequently, during the past two decades the life expectancy of Africans has dropped by fifteen years.

The World Bank and the IMF, Africa Action says, have recently professed greater commitment to 'poverty reduction.' The World Bank has also increased its funding for health, especially for HIV/AIDS programs. While Africa Action welcomed the shift in focus toward prioritizing social development and poverty eradication, it thought that fundamental problems remained. New lending for health and education could achieve little when the debt burden of most African countries was already unsustainable. The organization thought that the new spin on World Bank and IMF priorities failed to change their basic agenda. Indeed, it appeared to be largely a public relations exercise. The conditions attached to World Bank and IMF loans reflected the same orientation of the past two decades. Indeed, recent moves toward promoting poverty reduction had actually permitted the institutions to increase the scope of their loan conditions to

include social sector reforms and governance. This allowed even greater intrusion into the domestic policies of African countries. Africa Action found it inappropriate that external creditors should have such control over the priorities of African governments, and it was disingenuous for such creditors to proclaim concern with poverty reduction when they continued to drain desperately needed resources from the poorest countries.

Africa Action therefore called for an end to World Bank and IMF policies that undermine health. This required canceling the debts that prevent African governments from making their full contribution to addressing the health crisis. It also required ending the imposition of harmful economic policies as conditions for future loans or grants (Colgan 2002).

Recognizing the public perception that it needed to address these critiques, the Bank tried to institutionalize various kinds of co-operation with non-governmental actors. For instance, the World Bank's NGO and Civil Society Unit is responsible for coordinating the Bank's relationship with its external interlocutors in civil society – the express aim is to 'mainstream civic engagement into the World Bank's operations' (World Bank NGO and Civil Society Unit 2001; Fox and Brown 1998; Nelson 1995). We focus here on an assessment of one initiative, the Structural Adjustment Participatory Review Initiative (SAPRI).

SAPRI is supposed to be a cooperative effort between the Bank and a network of 250 NGOs with the stated purpose being 'to improve understanding about the impacts of adjustment policies as well as about how the participation of local, broad-based civil society can improve economic policymaking' (SAPRI 2000). The initiative is the direct result of a proposal to the incoming World Bank president, James Wolfensohn, in 1995, from a group of NGOs calling for a bottom-up review of structural adjustment lending. After months of negotiations, the Bank agreed to a joint review exercise in seven countries, with steering boards equitably composed of representatives of local civil society, governments and the World Bank. On a global level, the NGOs are represented by the SAPRI Network (SAPRIN), and their slogan, 'Standing Up to Structural Adjustment,' indicates that they are not likely to agree with the Bank on an assessment of structural adjustment projects (SAPRIN 2000a). In addition, a number of features built into the SAPRI structure – equal representation of NGOs, independent financing – ensured that the World Bank does

not have direct control over the selection of the civil society actors it engages with, or over the particular policy areas examined by SAPRI. The review initiative started in 1997 with two global public forums, followed by country assemblies in each of the seven participating nations (Ghana, Uganda, Zimbabwe, Ecuador, El Salvador, Bangladesh and Hungary), with informal work conducted also in Mexico and the Philippines. In each country, SAPRIN involved hundreds of organizations, from unions to peasant federations, women's groups and environmentalists. Research into the effects of structural adjustment was undertaken in four stages: (1) mobilization of a broad cross-section of local populations affected by structural adjustment; (2) national public forums organized by local civil society steering committees in conjunction with Bank and government officials; (3) participatory research by World Bank and SAPRIN teams into selected issues to deepen analysis; and (4) public review of the results of the forums and the research at a second national forum with modifications suggested for a final report. SAPRIN then prepared a draft synthetic report and presented it to the World Bank in July 2001. A final report, published in April 2002, reached the following conclusions about structural adjustment programs:

1 Trade liberalization, financial sector liberalization, the weakening of state support and reduction of demand for local goods and services have devastated local industries, especially small and medium-sized enterprises providing most national employment.
2 Structural and sectoral policy reforms in agriculture and mining have undermined the viability of small farms, weakened food security and damaged the natural environment.
3 A combination of labor market reforms, lay-offs resulting from privatization and the shrinking of labor-intensive productive sectors has undermined the position of workers causing employment to drop, real wages to fall and workers' rights to weaken.
4 Privatization of public utilities and the application of user fees to healthcare and education have disproportionately reduced the poor's access to affordable services.
5 Increased impoverishment caused by structural adjustment has affected women more than men.
6 Many of the anticipated gains in efficiency, competitiveness, savings and revenues from privatization have failed to materialize. Trade liberalization has increased rather than decreased current-account

> deficits and external debt, while transnational corporations have become more powerful in the structurally adjusted countries. (SAPRIN 2002)

As the work on the report proceeded, however, SAPRIN encountered 'difficulties in working out terms of reference and other agreements among the three local partners – SAPRIN, the Bank and governments – that form the national technical teams' (SAPRIN 2000b). In addition, the NGO network complained that the Bank had failed to honor some of its negotiated commitments. Especially, the Bank proved unwilling to respond to the concerns of civil society participants about structural adjustment policies voiced at the country forums. The NGOs asserted that the institution, 'despite its stated interest in consultation and partnership, has not been accustomed to working in equal relationships in which it is not dictating the terms of engagement.' SAPRIN acknowledged the political realities of powerful influences on the World Bank, especially those connected to its largest member country: 'The Bank is, of course, constrained in its ability to respond to civil society by the U.S. Treasury and its financial-sector constituencies' (ibid.). In effect, institutional inertia combined with external interests severely limited the ability of new initiatives, such as SAPRI, to result in fundamental shifts in policy, regardless of the support these changes might receive from individual World Bank staff members, up to the president of the Bank himself. Then, as the research findings summarized above were being announced in interim reports and public forums, and as the critical content became clear, the World Bank withdrew from SAPRI in August 2001. A 'Town Hall Meeting' on Poverty Reduction Strategies in spring 2002 at the IMF headquarters in Washington, DC, was attended by the managing director of the IMF and the president of the World Bank. At a press conference after the meetings both were asked about structural adjustment. The IMF managing director, Horst Kahler, replied that 'We should not put in doubt this basic principle – that sound macroeconomics is good for growth, and growth … may not be everything, but is needed to fight poverty.' James Wolfensohn, president of the World Bank, said that 'the position which is being taken by both the Fund and the Bank at the moment is moving much more to assisting countries develop the [macroeconomic] framework, as we tried to do in the PRSPs' – that is, both merely reiterated the basic positions taken by their respective institutions (IMF/World Bank 2002).

About this time, in 2000, the World Bank published a report entitled *Voices of the Poor: Can Anyone Hear Us*? (Narayan 2000) with an introduction by Clare Short, UK Secretary of State for International Development, and James Wolfensohn, president of the World Bank – the report reached safe, moralistic conclusions such as 'poverty is multidimensional' and 'households are crumbling under the stresses of poverty.' The last sentence of the introduction reads: 'Our hope is that the voices in this book will call you to action as they have us.' But in the case of SAPRIN, where thousands of civil society movements called on the World Bank to listen, its own action was simply to leave the discussion. Why might this be? What these social movements were telling the Bank was that the poverty they sought to 'alleviate' had been produced by the structural adjustments they themselves had imposed – that they were merely rectifying a small part of their own massive mistakes. This made everything they had done in the way of structural adjustment over the previous twenty years not meaningless (if only we were dealing with mere existential angst!) but pernicious, even malevolent, given that thousands of people active in development had been telling them for years to stop 'structurally adjusting' desperate countries. So the president of the World Bank did not listen to SAPRIN, because he could not. For he would hear, and he might even learn, that his finest, most splendid ideas had produced the worst, most harmful effects.

Millennium Development Goals

Thus, the turn of the millennium saw the neoliberal policy discourse and its institutions take a liberal turn (in the sense of New Deal liberalism) toward debt relief and development goals. Looking behind debt relief, we can see a tension between kind-hearted benevolence – the people of the developed world vowing to help the poorest people of the world by forgiving their debts – and cool-headed control – the will to manage the Third World and to make it into a mimic of the West. You would hardly know it from the sensational news reports appearing at the time. But this 'writing off $40 billion owed to international agencies' mainly amounted to a refinancing of the IMF and World Bank's HIPC initiative. As part of this, the HIPC countries have to demonstrate, to the economists at the IMF and the World Bank, that they have adopted, and are carrying out, policies judged 'sound by the international community.' That 'community' is represented by the IFIs, and behind these the secretary of the US

Treasury Department and the British Chancellor of the Exchequer. At their meeting in early June 2005, the finance ministers of the G7 countries agreed to provide additional financial resources, ensuring that the financing capacity of the World Bank, the IMF and the African Development Bank was not reduced by the HIPC initiative. This will eventually lead to 100 percent debt cancellation of outstanding obligations of eighteen of the poorest countries in the world. The agreement was formalized at the G7 summit meeting in Gleneagles, Scotland, later in 2005. There was a lot of criticism about the fact that only a small part of poor-country debt would be forgiven and that relief would be long in coming. But whatever its problems of timing and coverage, this commitment to ending the international debt of the poorest countries does show signs of being motivated by a genuine benevolence. It does contribute to achieving the UN Millennium Development Goal of halving world poverty by 2015.

But look beneath the headlines, down the list of conclusions from the June G8 meeting, not too far, only to point 2. This reads as follows:

> We reaffirm our view that in order to make progress on social and economic development, it is essential that developing countries put in place the policies for economic growth, sustainable development and poverty reduction: sound, accountable and transparent institutions and policies; macroeconomic stability; the increased fiscal transparency essential to tackle corruption, boost private sector development, and attract investment; a credible legal framework; and the elimination of impediments to private investment, both domestic and foreign. (G8 2005)

The aspect of point 2 seized on by just about all the media was 'good government practices,' such as transparency, anti-corruption and credible legal frameworks. The other aspect of point 2, macroeconomic stability, private sector development, and removing impediments to private investment, domestic and foreign, together with bits on free trade and open markets in later points, went almost unmentioned. Here we find the G8 countries, or rather their treasury departments, in collusion with the IFIs, telling poor countries how they must run their economies if they want to receive debt relief. Just as the 'deserving poor' are made to do the repentance shuffle to earn a charitable handout, or the homeless pretend instant arm-waving Christian conversion to get a bed for the night, now we find the rich countries

telling the poor countries of the world how they must 'reform' (that is, obey) to get their debt relief. And the 2008 G8 meeting said at its conclusion:

> Globalization is a key driver for global economic growth and strong, prosperous economies, supported by shared values of political democracy, economic freedom and accountable institutions. Globalization and open markets offer great opportunities for our societies, emerging economies and developing countries … Open trade and investment policies strengthen economies. All countries should take steps to develop, maintain and promote regimes that welcome foreign investment, guarantee non-discriminatory treatment for foreign investment, and ensure freedom to transfer capital and returns from investment. Any foreign investment restrictions should be very limited, focusing primarily on national security concerns, and should adhere to the principles of transparency and predictability, proportionality, and accountability. Furthermore, we note the importance of high standards of investment protection in international agreements including fair and equitable treatment, prompt, adequate and effective compensation in the event of expropriation, and access to international arbitration to resolve disputes … Open and competitive capital markets can promote economic growth. (G8 2008)

In other words, neoliberal Washington Consensus policies prevail, despite protests, critique, proven failure, supposed reform, and so on. Paradigm maintenance by ostentatiously 'listening to our critiques' before ignoring everything they say.

The key terms in the new liberal neoliberalism are the Millennium Development Goals (MDGs) and debt relief; the key institutional actors include, besides the USA and the IFIs (the World Bank and the IMF), a broader range of wealthy countries meeting as the Group of 7 or 8 (G7/G8), the United Nations as a body and as specific development agencies (UNDP especially), and one important development economist, Jeffrey D. Sachs. At the Millennium Summit held at the UN in September 2000, the largest gathering of world leaders in history adopted the UN Millennium Declaration, committing their nations to a global partnership that would reduce extreme poverty and setting out a series of time-bound targets, with a deadline of 2015, that became known as the MDGs. The MDGs, outlined in Box 4.1, are said to be 'basic human rights – the rights of each person on the planet to health, education, shelter, and security.'

Box 4.1 Eight UN Millennium Development Goals and eighteen time-bound targets

Goal 1: Eradicate Extreme Poverty and Hunger

Target 1 Reduce by half the proportion of people living on less than a dollar a day

Target 2 Reduce by half the proportion of people who suffer from hunger

Goal 2: Achieve Universal Primary Education

Target 3 Ensure that all boys and girls complete a full course of primary schooling

Goal 3: Promote Gender Equality and Empower Women

Target 4 Eliminate gender disparity in primary and secondary education preferably by 2005, and at all levels by 2015

Goal 4: Reduce Child Mortality

Target 5 Reduce by two-thirds the mortality rate among children under five

Goal 5: Improve Maternal Health

Target 6 Reduce by three-quarters the maternal mortality ratio

Goal 6: Combat HIV/AIDS

Target 7 Halt and begin to reverse the spread of HIV/AIDS

Target 8 Halt and begin to reverse the incidence of malaria and other major diseases

Goal 7: Ensure Environmental Sustainability

Target 9 Integrate the principles of sustainable development into country policies and programs; reverse loss of environmental resources

Target 10 Reduce by half the proportion of people without sustainable access to safe drinking water

Target 11 Achieve significant improvement in the lives of at least 100 million slum dwellers, by 2020

Goal 8: Achieve a Global Partnership for Development

Target 12 Develop further an open trading and financial system that is rule-based, predictable and non-discriminatory, includes a commitment to good governance, development and poverty reduction, nationally and internationally

Target 13 Address the least developed countries' special needs. This includes tariff- and quota-free access for their

exports; enhanced debt relief for heavily indebted poor countries; cancellation of official bilateral debt; and more generous official development assistance for countries committed to poverty reduction

Target 14 Address the special needs of landlocked and small island developing states

Target 15 Deal comprehensively with developing countries' debt problems through national and international measures to make debt sustainable in the long term

Target 16 In cooperation with the developing countries, develop decent and productive work for youth

Target 17 In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries

Target 18 In cooperation with the private sector, make available the benefits of new technologies – especially information and communications technologies

Source: UN Development Goals, un.org/millenniumgoals/

The MDGs synthesize commitments made separately at various international conferences and summits during the 1990s. They are said to be innovative in that they explicitly recognize interdependence among growth, poverty reduction and sustainable development; they say that development rests on the foundations of democratic governance, the rule of law, respect for human rights and peace and security; they are based on time-bound and measurable targets accompanied by indicators for monitoring progress; and they bring together, in the eighth Goal, the responsibilities of developing countries with those of developed countries, founded on a global partnership endorsed at an International Conference on Financing for Development in Monterrey, Mexico, in March 2002, and a similar conference held at the Johannesburg World Summit on Sustainable Development in August 2002.

The nearest the MDG initiative comes to making sense is in Jeffrey D. Sachs's (2005) book *The End of Poverty*. Sachs is director of the Earth Institute at Columbia University, and Special Advisor to UN secretary-general Ban Ki-moon. From 2002 to 2006, he was director of the UN Millennium Project and Special Advisor to United Nations

secretary-general Kofi Annan on the MDGs. Economic development, he says, is a ladder with the higher rungs representing steps up the path to economic well-being. But a billion people are too ill or hungry to even lift a foot to the first rung. Our generation's 'challenge,' Sachs says, is to help the poorest of the poor escape the misery of extreme poverty so they can begin their ascent to full humanity. Why have the poorest countries failed to achieve economic growth? There are several 'factors,' such as governance failure and lack of innovation, but Sachs relies most on a kind of environmental determinism – many poor countries are poor because they are landlocked and situated in high mountain ranges (like Switzerland?), trapped in arid conditions with low agricultural productivity (like Saudi Arabia?), with tropical climates (like Singapore?) that favor killer diseases (as did once the north of England's hills and dales). The key to ending extreme poverty is to enable the poorest of the poor to get a foot on that ladder of development. The extreme poor, Sachs argues, lack six major kinds of capital: enough human capital, as health, nutrition and skills, to be economically productive; business capital, as machinery and transport, to increase productivity; infrastructure that forms critical inputs into business productivity; natural capital that provides the environmental services needed by human society; public institutional capital that underpins peaceful and prosperous division of labor; and knowledge capital that raises productivity and promotes physical and natural capital (the MDGs). Breaking the poverty trap involves donor-based investments that raise the level of capital per person, producing a capital stock high enough that the economy is sufficiently productive to meet basic needs. Without outside donor funds the necessary investments simply cannot be financed. Ending global poverty by 2025 requires a global compact between rich and poor countries, as with the UN Millennium Project, whereby the rich countries follow through on their previous pledge (made long ago in a similar spasm of optimism) to provide 0.7 percent of GNP as aid. Indeed, the bottom line is about $135–195 billion a year in assistance, significantly less than the 0.7 percent figure. As Sachs (ibid.: 299) says: 'The point is that the Millennium Development Goals can be financed within the bounds of the official development assistance that the donor countries have already promised.' This essentially means that the USA, presently contributing 0.15 percent of GNP as development assistance, would have to contribute half the necessary increase, followed by Japan, Germany, France, Italy and Britain. Hence, our generation, heir to two

and a half centuries of economic progress, can realistically envision a world without extreme poverty. But why should 'we' (the people of the rich countries of the world) do it?

The answer comes suddenly: because 'hard evidence has established strong linkages between extreme poverty abroad and the threats to national security' (ibid.: 331). An economy stuck in the poverty trap often leads to state failure and failed states are seedbeds for violence, terrorism, drug trafficking and disease. If the USA and western Europe want to spend less time responding to failed states in the post-9/11 era, they will have to reduce the number of failed economies. The richest of the rich should therefore do what they 'comfortably can' and come up with their contribution as a 'profound and meaningful demonstration of our generation's unique moment to secure global well-being' (ibid.: 346). Sachs is for an enlightened globalization, in the tradition of Thomas Jefferson, Adam Smith, Immanuel Kant and Marie-Jean-Antoine Condorcet, that would direct criticism at the rich governments of the world, that would encourage the anti-globalization movement to change to a more pro-corporate position, that would encourage trade by removing barriers and agricultural subsidies, and yet would press the USA to end its 'reveries of empire.'

Hence the MDGs are intended to lift a billion of the world's poorest people on to a development ladder that acts as a kind of escalator taking them up into prosperity.

It is truly amazing how many people, including many critical intellectuals, are taken in by this argument. There are a couple of small points of disagreement, however, mentioned with trepidation in the face of such power, concerning the argument presented in Sachs's book, which have to be made. The first is economic in principle and the second is ethical in nature. As to the first trepidation, we doubt that foreign assistance can 'end global poverty.' This is not because not enough aid will be delivered, as indeed will prove to be the case, consuming 95 percent of the subsequent hand-wringing debate, and allowing an easy, moralizing excuse for poverty not being eliminated by 2025 ('if only we had given more'), should anyone remember then. Instead our skepticism concerns the ability of charity-based theories even to begin to understand the causes of world poverty and thus suggest policies that might indeed enable the end of poverty. Sachs's Fifth Avenue approach – appealing to the rich to help the poor – comes with a price label attached. Immediately, that price is a necessary lack of criticism about the sources of wealth in the presently prevailing global

financial capitalism. Associated with this is a lack of criticism of the presently hegemonic policy regime, the neoliberalism that has done so well for the super-rich and quietly famous, so that Sachs blithely asserts that the rich countries have only to enable countries to get to the first rung on the ladder and then 'the tremendous dynamism of self-sustaining growth can take hold' (ibid.: 73) – this is because Sachs forgets that a country can have a high growth rate, and seem to be climbing, while at the same time further impoverishing the poor. In the longer term, the price includes accepting a largely conventional economic historical geography, replete with take-offs, ladders of development and successful transformations, as supposedly bits of India and China represent – he needs to go back to Mumbai and get outside the Hotel Intercontinental. As a result of this blindness, in the present global context, increasing the health and education level of Third World workers through donor investments, as Sachs suggests, is likely to produce a healthier and more educated but unemployed workforce. For to earn 'aid,' supplicant countries have to restructure their economies neoliberally, and join global financial capitalism, so that they reward foreign investment. All this has to be ignored, or merely sniped at (quibbles with the IMF), when appeals are made to the rich to open their pockets … generously.

As for the second trepidation, we find the ethical argument presented by Sachs abhorrent. After hearing an argument on the supposed benefits of foreign aid, all the time assuming that the aim is to make people healthier for their own sakes, we are told that the rich countries should invest in poor countries for the sake of their own security, to prevent failed states, to prevent the poor from becoming terrorists! We should invest in them … because we fear them. This cruel pragmatism that passes for moral reasoning is detached from the rest of the argument, as an afterthought rather than a moving gesture. This is not just because, having written a book on ending poverty, the author was confronted with the practical question: why should a Republican administration that just illegally invaded a Third World country support investing in the Third World poor? It is because the largely conventional economic reasoning produces an ethical vacuum from which emerges, by random choice, depending on the circumstances and the capricious whim of the sorry moralist, an ethics of simple morality ('we should just do good things'), or moral utilitarianism ('it will not cost much') or, at worst, moral pragmatism of fear ('do it to save ourselves'). Sachs's environmental determinism,

in blaming nature, leaves little but pity as the basis for morality. Most seriously the two deficient ideologies combine to disguise the real culprit behind global poverty – the Western imperialist expansion that ruined the civilizations already existing in these 'environmentally deprived' lands that were home to great civilizations – and, thereby, misses too the only viable reason for aid – as reparation for damages done in the past, and continuing into the present. The will to assist the Third World has to come from a sense of global justice, from the critical understanding that the wealth of a few causes the poverty of the many. It has to come from anti-imperialist sentiment, not from the reimposition of a benevolent imperialism.

In 2001, the UN secretary-general presented a *Road Map towards the Implementation of the United Nations Millennium Declaration* (UN 2001), which is said to be 'an integrated and comprehensive overview of the situation, outlining potential strategies for action designed to meet the goals and commitments of the Millennium Declaration.' This 'road map' has been followed by annual reports on progress toward meeting the goals by the UN secretary-general. The main agency charged with 'coordinating global and local efforts' is the UNDP, an organization started in 1946 that sees itself 'advocating for change and connecting countries to knowledge, experience and resources to help people build a better life' (UNDP 2007). But the UNDP has virtually no money to give out as loans or grants. The organization with the money and the neoliberal expertise is the World Bank. So, unlike the IMF, the Bank has been given a new lease on life through the millennium initiatives. Here the central institution is the joint World Bank–IMF Development Committee, formally known as the Joint Ministerial Committee of the Boards of Governors of the World Bank and the IMF on the Transfer of Real Resources to Developing Countries. At the Bank–Fund Annual Meetings in September 2002, the Development Committee set up a monitoring unit with an annual global monitoring report, prepared by Bank and Fund staff in collaboration with other agencies such as the UNDP. The *Global Monitoring Report* reports on how the world is doing in implementing the policies and actions for achieving the MDGs and related development outcomes. The main work is performed by the Bank's Development Economics Vice Presidency (the 'DEC' mentioned earlier). The 2008 *Monitoring Report*, prepared at midpoint to 2015, typically 'presents a mixed picture, one of both significant progress and formidable challenges. The first MDG, reducing extreme

poverty by half, is likely to be met at the global level, thanks to a remarkable surge in global economic growth over the past decade. However, on current trends, the human development MDGs are unlikely to be met' (World Bank 2008a).

But exactly the most optimistic part of this, reducing poverty through the MDGs and neoliberal growth (Sachs's 'ladder of development'), is highly contested. An analysis by Sanjay Reddy and Camilia Minoiu (2007) concludes that, because of uncertainties in the methods used to measure levels of poverty ($1- and $2-a-day incomes per person) and deficiencies in the data collected, 'global poverty may or may not have increased. The extent of the estimated increase or decrease in world poverty is critically dependent on the assumptions made.' In a major review of the World Bank poverty data, Robert Wade (2004) concludes: 'The magnitude of world population increase over the past 20 years is so large that the Bank's poverty numbers would have to be huge underestimates for the world poverty rate not to have fallen. Any more precise statement about the absolute number of the world's people living in extreme poverty and the change over time currently rests on quicksand.' After a detailed critique of the official measurement techniques for Indian rural poverty data, Utsa Patnaik (2008) concludes that between 1993 and 2004 the proportion of the population living below the poverty line increased from 74.5 percent to 87 percent. She adds that China's current official rural poverty line is also absurdly low at about 800 yuan per year or 2.2 yuan per day (less than $0.30), identical to the Indian one, and its estimates of rural poverty are equally gross underestimates. Her observations on India are applicable to other developing countries following reform policies advised by the IFIs that have increased poverty and reduced nutritional levels. But these institutions claim the opposite, namely poverty reduction, because they base their own global dollar poverty lines on the unrealistically low developing-country rural poverty lines. Patnaik concludes: 'Never in the history of economic thought have we seen such wholesale use of illegitimate statistical techniques and such falsification of real trends, as we observe today' (ibid.: 49).

In other words, the World Bank is in the business of 'officially confirming' that the MDGs are 'partly working' by manufacturing the relevant statistics. Its reports on attaining the MDGs are then read as truth. But the truth is that no one knows if poverty is being reduced as part of the millennium effort. We suspect a massive act of global fraud.

What we do know is that neoliberal developmentalism is associated with rising inequality – in the USA and other rich countries, but also more generally in global capitalism. Using data collected by the University of Texas Inequality Project on national structures of pay, Galbraith (2007: 587) finds 'a worldwide pattern of declining inequality from 1971 until 1980, followed by a long and sharp period of increasing inequality from 1981 through the end of the century,' a tendency that he associates with changing 'global macroeconomics' (i.e. the move to neoliberalism and finance capitalism). In a 2007 report, *Inequality in Asia*, the Asian Development Bank (2007) finds that over the last decade most Asian countries, especially the most populous, China and India, have experienced increases in inequality, especially absolute inequality (i.e. absolute differences in the incomes of the richest 20 percent of the population versus the poorest 20 percent). As the ADB puts it, mildly: 'Increases in inequality dampen the poverty-reducing impact of a given amount of growth.' We might add the obvious, although the ADB does not: such 'dampening' occurs because nearly all the additional income produced by neoliberal growth goes to a few rich people.

Essentially the MDGs are just a wish list of goals based in fine ideals, but lacking means of realization – they are supposed to be realized by each national government, in part using funds made available from debt relief, with 'advocacy, monitoring and advice' from the UNDP, the World Bank and other international agencies. The trouble with this kind of proclamation is that it makes it look as though something serious is being done about development, when in fact governments are just carrying on as before. And carrying on as before means organizing the economy so that it benefits the rich. The MDGs are the smily face on this process, and the World Bank is its optimistic guarantor.

Along with this, the World Bank tries to position itself as a liberal player in other global crises. So the Bank is involved in climate change and low-carbon economies – its Clean Energy Investment Framework 'catalyzes markets' to address three 'core development pillars': (1) increasing energy access for the poor in sub-Saharan Africa ('lighting Africa'); (2) helping industrializing countries foster economic growth and move along a sustainable low-carbon development path; and (3) helping developing countries adapt to the impacts of climate change. One problem with this, however, is that industrial growth organized through market systems, the kind of development

pushed by the Bank for decades now, is exactly the main source of increased emissions of carbon dioxide and climate change. A report by the World Resources Institute criticized the Bank itself for not integrating climate change considerations into its own lending. It found that 'almost 50 percent of lending in [the energy] sector was made without any attention to climate change at all' and, further, 'operationally, opportunities to mitigate emissions and reduce climate risk are still not systematically incorporated into strategies and project development' of the MDBs (Multilateral Development Banks) in question. More than 60 percent of financing in the energy sector across these institutions does not consider climate change at all and MDBs remain heavily invested in 'business as usual' (Nakhooda 2008). Another report from the Institute for Policy Studies, *World Bank: Climate Profiteer*, analyzes the World Bank's rapidly developing role as a global carbon broker. With a $2 billion portfolio of carbon finance funds (money used to buy cuts in greenhouse gas emissions from projects in developing countries), the report says that the Bank 'irresponsibly and recklessly continues to perpetuate the world's dependence on climate-altering fossil fuels while profiting from carbon trading.' It finds that the bulk of the Bank's carbon finance portfolio (75–85 percent) has been directed to carbon trades involving the coal, chemical, iron and steel industries, while less than 10 percent of all the funds flowing through these carbon trust funds support 'new renewable' energy, defined as wind, geo-thermal, solar and mini-hydro. The report also states that the Bank is charging 13 percent of the project cost for its brokering role (Redman 2008; BWP Update 59).

Similarly, the Bank announced in May 2008 a new $1.2 billion 'rapid financing facility' to address immediate needs arising from the global food crisis, including $200 million in grants targeted at the vulnerable in the world's poorest countries (essentially giving grants of $5–10 million to very poor countries mainly in Africa). This involves transferring funds from the IBRD to the IDA to increase support for global agriculture and food to $6 billion from $4 billion, and launching risk management tools and crop insurance to protect poor countries and smallholders (World Bank 2008b). A report from the Swedish Nordic Africa Institute, however, points out the obvious: under structural adjustment conditionality the World Bank has deepened rural poverty in Africa, and its proposed solution – relying on liberalized markets – will lead to 'further impoverishment and rising demoralization on the part of African farmers who have faced

deteriorating production and marketing conditions and struggled largely unaided for the past 25 years' (Havnevik et al. 2007: 12).

Dances with wolves

In 2005 James Wolfensohn's second term of office expired. Wolfensohn, to give him his due, had at least tried to change the Bank in what he thought was a progressive direction. He tried to get approval for a third term, but was unable to win the support of the Bush administration. Instead Bush put forward the neoconservative Paul Wolfowitz, former United States ambassador to Indonesia, signer of the Project for the New American Century (PNAC) 'Statement of Principles on American Global Leadership' and, subsequently, as deputy secretary of defense, an architect of Bush's Iraq policy and its most passionate and compelling advocate. (From the wolf in sheep's clothing, to the wolf at the door.) As ambassador, Wolfowitz had played a key role in privatizing and deregulating the Indonesian banking system, reforms blamed by many for the financial crisis of the late 1990s. Opposition to the nomination, however, was centered on his key position in the war in Iraq. Many believed that his predilection for unilateralism and support for ideologically driven reconstruction efforts bode poorly for the future of the Bank. The Brussels NGO Eurodad compiled a list of 1,650 organizations worldwide outraged by the appointment. Polls conducted by the *Financial Times* and the World Bank's own staff association showed support for Wolfowitz at below 10 percent.

Wolfowitz commissioned an external review of the Bank's systems of transparency, accountability, ethics and integrity. The World Bank's negligence in allowing corruption to occur in recipient countries had supposedly been made a theme of the Bank's analysis and lending decisions by Wolfensohn. Wolfowitz made corruption his leading theme, preventing hundreds of millions in Bank lending to countries while corruption was investigated, coordinating the MDBs' anti-corruption efforts, and ordering internal reviews of corruption in Bank programs.

Less than two years into his presidency, however, issues of corrupt practices by Wolfowitz himself began to surface. The Bank's senior human resources officer was not consulted over the terms and conditions offered to Robin Cleveland and Kevin Kellems, former Bush administration officials that Wolfowitz brought with him to the Bank. Of the top five outside international appointments made by Wolfowitz, three were senior political appointees of right-wing

governments that provided backing for US policy in Iraq. It was then revealed that Wolfowitz had increased his girlfriend Shaha Riza's salary, from $136,000 to $193,000 tax free, in violation of Bank rules. Questions were also raised about the propriety and legality of Wolfowitz's role in securing Riza a position with a Defense Department contractor in 2003, before his arrival at the Bank. After a six-week media frenzy, Wolfowitz admitted what he had done, and was allowed to resign without acknowledgment of his ethical and governance violations. In the wake of the Wolfowitz affair, several high-profile commentators, including former Bank chief economist Joseph Stiglitz, UN secretary-general Ban Ki-moon, and South African finance minister Trevor Manuel, called for an end to the gentleman's agreement that allows the USA to appoint the head of the Bank and the Europeans the director of the IMF. Seven hundred participants in a poll conducted by US development think tank Center for Global Development rejected the traditional selection prerogative of the USA by large margins, with equally strong support for an open, transparent, competitive selection process (BWP Update 56).

Immediately the Bush administration moved to quell this challenge to the status quo. After little or no consultation, they nominated Robert Zoellick, at a salary of $493,940 tax free, former official at the US investment bank Goldman Sachs, previously on the advisory board of Enron, a corrupt US energy conglomerate, deputy secretary of state and former US Trade Representative (see Chapter 5). In 1998, Zoellick had also joined a group of neoconservatives and militarists, many of whom would later form the upper ranks of George W. Bush's foreign-policy officials, in signing statements of the neocon Project for the New American Century. In an essay in *Foreign Affairs* in January 2000 entitled 'Campaign 2000: a Republican foreign policy,' Zoellick criticized US president Bill Clinton for promoting social and environmental clauses within free trade organizations. Zoellick then outlined a new foreign policy based on a concept of a new American century in which unquestioned US military superiority would allow the USA to shape an international order by attacking evil in the world. In a speech to the Heritage Foundation, a right-wing think tank, he said: 'history is not shaped by the faint of heart. We must move now if we are going to build on the global trends favoring private markets, business competition, deregulation, limited taxation, open trade, and flexible labor policies. These trends are sparking economic creativity and dynamism, while helping to knit the world together in

new ways' (Zoellick 2001a: 3). NGO reactions to the appointment were universally unfavorable. In *Behind the Scenes at the WTO*, Fatoumata Jawara and Aileen Kwa (2004) interviewed thirty-four trade ambassadors, negotiators and secretariat staff members, to reveal an extensive catalog of arm-twisting, pay-offs and abuse by the developed countries to force developing countries to sign up to an agenda they disagreed with, while ignoring the issues they had raised (again, see Chapter 5). But Zoellick was immediately and unanimously confirmed as president by the Executive Directors of the World Bank.

The World Bank's website proclaims: 'Our mission is to help developing countries and their people reach the goals by working with our partners to alleviate poverty. To do that we concentrate on building the climate for investment, jobs and sustainable growth, so that economies will grow, and by investing in and empowering poor people to participate in development.' This is totally contradicted by the appointments of Bank presidents like Wolfowitz and Zoellick. If it is to survive by changing, the World Bank needs to be guided by a global democratic political-economic process. The first glimpse of this will come when the USA no longer unilaterally chooses who will be its president.

FIVE
The World Trade Organization

Established on 1 January 1995, the WTO is a more formal, institutionalized version of the General Agreement on Tariffs and Trade (GATT), signed by twenty-three governments in 1947. The GATT/WTO system regulates international trade in goods and services using a system of objectives and rules laid out in articles of agreements among member governments. As an organization, the WTO consists of a director-general (currently Pascal Lamy, former CEO of Credit Lyonnais, and former Commissioner for Trade at the European Commission), four deputy directors-general and a secretariat (or bureaucracy) housed in Geneva, Switzerland, where many UN agencies have their headquarters. Like the IMF and the World Bank, it also exists as a broader institution, in this case consisting of trade representatives sent from member countries to meetings organized at a number of levels, and thousands of specialists, consultants and lobbyists who exercise considerable power – the intricacies of trade regulations inviting expertise. The WTO operates within a discourse that, while changing in emphasis over time, has consistently advocated the 'liberalization of trade' – that is, the freeing of international movements of commodities and (recently) services from governmental restraint. Freeing trade from tariffs and other governmental restrictions, and thereby allowing competition and markets to function more freely at the international level, is said to lead to more rapid economic growth that benefits everyone. Trade liberalization is one of the leading aspects of the post-war economic regime that led to global neoliberalism. But while the GATT was relatively uncontroversial, the WTO, as a leading proponent of neoliberal ideas, is at the center of controversy over the direction globalization has taken. Indeed, protests against the WTO ministerial meeting in Seattle in 1999 have come to symbolize the entire debate over the future course that globalization might take.

History of the GATT

The idea that trade between countries should be freed from governmental intervention is actually quite new. For most of its 500-year

history, capitalism was directed by mercantilist policies involving state restrictions on imports, and incentives for exports, as a way of increasing national power, concentrated in the political might of the state. In particular, under mercantilism a country was considered prosperous when it had a favorable balance of trade, with 'favorable' interpreted as trade yielding a surplus of gold and silver. To achieve this favorable balance, the state intervened vigorously in international relations rather than leaving important economic forces such as trade to be guided solely by the vagaries of the market. Then, in the first half of the nineteenth century, a shift in the class balance of power in the leading capitalist country, Great Britain, led to a change in economic policy. The emerging industrial bourgeoisie was interested in low-cost food imports for workers and expanding export markets for textiles and other products of the Industrial Revolution for which Britain had a clear cost advantage. Yet the British Corn Laws, introduced in 1815, kept food prices high by restricting imports of grains, ensuring high incomes for the landowning class. These laws were repealed in 1846. Only with repeal did capitalism move decisively in the direction of a market-oriented, free-trade regime.

Trade liberalization – that is, the freeing of trade from state-imposed restrictions – and the increased integration of national economies that followed, began in earnest with the Cobden–Chevalier Treaty of 1860, an interstate, bilateral agreement to reduce tariffs (state import taxes) on goods exchanged between Britain and France. It was followed by a series of bilateral trade agreements elsewhere in Europe. In the second half of the nineteenth century international trade expanded rapidly, with the global economy becoming more regionally specialized, especially between an industrial core and an agricultural periphery, and more integrated by trade relations and investment flows, than at any time previously and, arguably, more than at any time since, including the globalization of the turn of the twentieth century.

With the economic dislocations following the First World War, however, most leading capitalist countries reverted to mercantalist-type protectionism. During the Depression years of the 1930s, arguments that imports ruined domestic industry and increased unemployment made sense to political regimes hard pressed by angry populations. Typically for the period, in 1930 a Republican-dominated US Congress passed the Smoot–Hawley Tariff Act, which increased tariffs on imports by an average of 52 percent. Unilateral increases like

this were met by widespread retaliation in the form of even higher tariffs, trade barriers and countervailing duties elsewhere, in what became known as the 'tariff wars of the thirties.' In the later years of the 1930s, however, big businesses with extensive exporting interests managed to move US Democratic opinion in the direction of a gradual freeing of trade restrictions. Let it be said that this kind of seesawing in external policy position is typical of capitalist economies, even when they are deeply internationalized and apparently completely committed to free trade. States react to crises by protecting their domestic economic base, source of tax revenues and home of the populace that elects them. Even neoliberal presidents, such as George W. Bush, have felt free to impose tariffs on imports that threaten vital domestic industries, as with steel in 2001/02.

After the Second World War, as we saw in Chapter 2, the tendency was to establish international organizations in the search for a new kind of global economic stability. Initially, the idea was to establish three main international institutions, the IMF and IBRD, and an International Trade Organization (ITO) that would regulate trade, as a necessary complement to the other two organizations. Indeed, the USA chaired a preparatory conference in 1943 to draft a charter for the ITO. The USA wanted an organization that would free up trade in the specific interests of large, exporting corporations, but with a market-oriented, deregulated international economy more generally in mind. As the main source of funds for the reconstruction of Europe in the post-Second World War period, and as the world's most powerful economy, an emergent USA could exert considerable political pressure in gaining foreign acceptance for the economic policies its corporations wanted and in charting the eventual course of trade agreements (Hoekman and Kostecki 1996: 2–3). There was, however, a large fly in the international ointment. UN approval would grant universal legitimacy to multi-state agreements, especially those forged under considerable single-state pressure. But the UN was not necessarily or completely under any single state's domination. The UN used more democratic means to reach crucial decisions than the newly hegemonic USA favored. It was regarded with suspicion, especially by conservative groups in the USA, who saw any kind of egalitarian international democracy as a communist plot. Considerable maneuvering was necessary before the USA could get international approval.

Four preliminary conferences on trade were convened under UN auspices: a 'Preparatory Committee' meeting in London in 1946;

a 'Drafting Committee' meeting at Lake Success, NY, in 1947; the Geneva Conference later in 1947; and the Havana Conference, lasting between November 1947 and March 1948. The Geneva Conference produced an interim measure known as the General Agreement on Tariffs and Trade (GATT). The following international conference in Havana, Cuba, was supposed to draft a charter for a regulatory organization, the ITO, that would give the GATT its organizational enforcing mechanism. A US State Department proposal for the ITO was heavily amended in the UN, however, evoking, in turn, opposition from the US Congress. In a statement aimed at Congress, Robert Loree, chairman of the National Foreign Trade Council, said:

> The Council firmly believes that if the United States subscribes to the [Havana] Charter it will be abandoning traditional American principles and espousing instead planned economy and full-scale political control of production, trade and monetary exchange. The Charter does not reflect faith in the principles of free, private, competitive enterprise. Yet these are the basis of the economic well-being, the political liberties, and ultimately the religious liberties of the American people. (Loree 1950: 2)

The greatest problem for Congress lay in granting authority to a UN organization, the proposed ITO, to make agreements, or impose sanctions, that might threaten US national interests. The organization would be able to veto congressional decisions and the Charter for the ITO could be amended by a two-thirds majority, with members not in agreement, or not in compliance with its rulings, potentially expelled from the organization. As Loree put it:

> Acceptance by the United States of a charter which could be amended without its assent, or over its dissent, would be a most unusual proceeding, involving a sacrifice of sovereignty unprecedented in the history of this country. Such provisions relating to amendment in a trade charter, carrying authority for such extensive exceptions and special dispensations as does the Havana Charter, would entail grave danger to the trade and economic well-being of the United States and should not be accepted by this country. The Congress of the United States should, in no event, forfeit the right of review of any amendment of an international trade charter which involves rights and obligations pertaining to American foreign trade and investment. (ibid.: 9)

Thus the USA was not willing to commit to trade policies that might, potentially, hurt the domestic economy for the sake of international economic stability. The USA was specifically opposed to an international organization controlled by UN-type international democracy, with each nation-state having one vote, at a time when the USA considered itself to be far more than one country in terms of economic power and political might.

As a result, legislation approving the ITO agreement reached in Havana never emerged from the US Congress. The earlier GATT, by comparison, was a more tenuous agreement, easily manipulated by powerful countries because it lacked an enforcing organization. Any member country could voluntarily withdraw from the agreement, or selectively bend the rules, whenever necessary. This left the agreement 'flexible and pragmatic,' even though in practice, with the intricacies of trade, the GATT necessarily came to be treated somewhat like an international organization. This is how a tentative agreement became the 'rule book' governing the world's commerce in commodities.

The early GATT rounds

With the failure of the ITO to get off the ground, governments reverted to the provisional agreement on trade and tariffs agreed to at Geneva in 1947 and signed on 15 November 1947 at the Havana Conference. The GATT regulated trade in goods (physical commodities) using agreed-upon principles of liberalization, equal market access, reciprocity, non-discrimination and transparency. Taking these in turn, the principle of trade liberalization and equal market access essentially involved reducing tariffs and deregulating trade in the belief that state intervention disrupted the naturally efficient workings of the market. The principle of reciprocity meant that if one country made tariff concessions, another country had to do the same. The principle of non-discrimination meant giving all kinds of trade between all types of countries 'equal and fair treatment'; within this, the most favored nation (MFN) principle meant that formal agreements between any two member countries had to apply to all members, while the National Treatment policy stated that any member of the GATT had to treat foreign firms in the same way as domestic firms with regard to trade. Finally, the principle of transparency declared that protectionist measures employed by governments should be clearly stated and take a visible form (for example, as a tariff), this being aimed at eliminating non-tariff barriers, such as

systematic obfuscation by customs officials. The basic idea behind the GATT was to eliminate protectionism and discrimination, allowing the trade in goods (but not yet in services) to flow smoothly from one country to another, without disruption or distortion, supposedly permitting all countries to achieve larger output levels, and ultimately increasing the level of economic growth everywhere. The GATT, in other words, attempted to resurrect the classically liberal free-trade principles of the nineteenth century, with more of an appeal to the notion of growth being universally beneficial. Hence the Preamble to the thirty-eight Articles of Agreement read as follows:

> 23 Governments, recognizing that their relations in the field of trade and economic endeavor should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods; and being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce; agree through their Representatives [to thirty-eight Articles of Agreement]. (GATT 1966)

Since the GATT lacked an organizational structure, the Interim Commission for the International Trade Organization within the UN served as an administrative body regulating the agreement. This provisional GATT Secretariat subsequently coordinated eight rounds of multilateral trade negotiations among an increasing number of countries over the next half-century.

The first round in Geneva in 1947 resulted in 45,000 tariff concessions on trade in goods between the twenty-three attending countries. The following three rounds of negotiations resulted only in unilateral and bilateral tariff concessions among attending countries: twenty-nine countries attended the 1949 Annecy Round in France, resulting in modest tariff concessions; thirty-two countries participated in the Torquay Round in the UK in 1950/51, resulting in 8,700 tariff concessions; and a further meeting at Geneva in 1955/56, with thirty-three countries participating, resulted in modest tariff concessions. Taking place after the formation of the European Economic Community (EEC) in 1957, the Dillon Round, named after the US secretary of the Treasury who led the talks, took place in 1960 and 1961 with thirty-

nine contracting parties. This round tried to ensure that regional trade agreements did not raise average tariff levels among other trading partners. The Kennedy Round, named for the US president, with discussions lasting from 1963 to 1967, and forty-six countries participating, produced a new formula for negotiating tariff concessions in industrial products that resulted in tariff reductions on 35 percent of the attending countries' trade in these goods. This was the first round to negotiate non-tariff barriers to trade. The Kennedy Round extended the anti-dumping code adopted by the GATT (that is, restricting a country's ability to dump goods elsewhere at prices below the cost of production). And it also discussed, in detail, preferential treatment for developing countries (Hoekman and Kostecki 1996). The Tokyo Round, lasting from 1973 to 1979, attended by 102 countries, resulted in further tariff concessions on thousands of industrial and agricultural products, in the adoption of codes addressing subsidies and countervailing duties, with discussions on technical barriers to trade, mainly product standards, government procurement, customs valuations, import-licensing procedures and revisions to the anti-dumping code. The Tokyo Round ended at a time of economic crisis, marked by deep stagflation. Many countries were using (unregulated) non-tariff barriers to restrict imports, while entire economic sectors, such as agriculture and textiles, were slipping beyond GATT control. Powerful countries, such as the USA, simply intervened directly and unilaterally, rather than through the GATT, when they saw vital economic interests threatened. State industrial policies, such as those pursued by the Japanese Ministry of Trade and Industry, were seen to be more effective in producing economic growth than free trade. It was widely thought that the GATT was close to being finished (Prestowitz 1991; Dunkley 2000: 34–41).

The economic crisis of the late 1970s and early 1980s could have seen international trade policy move in any of a number of directions – for example, in the direction of greater guidance by developmental states. Yet, as we have seen, neoliberalism defeated a discredited Keynesianism as right-wing regimes assumed political power in the USA, the UK, West Germany and elsewhere. Free trade was a central component of this selective revival of liberal principles. As Dunkley (2000: 41–5; Milner 1988) suggests, the political-economic balance of power swung against domestically oriented industries and in favor of transnational corporations, especially the new fringe of high-technology firms interested in trade-related issues such as secure

exports and the protection of intellectual property rights, which they thought could be protected only by international agreements, such as a renewed and extended GATT.

The Uruguay Round

Thus the last negotiations to take place under the GATT, the Uruguay Round, lasting from 1986 to 1994, represented not a swansong but a phoenix for international trade agreements. The Uruguay Round signified a new phase in world trading history within a new era of neoliberal globalization. The round attempted to eliminate export subsidies on agricultural goods and textiles and dealt with non-tariff barriers, technical aspects of trade and trade-related investment measures. The round produced a particularly large number of new trade agreements. The Agreement on Textiles and Clothing established a fixed quota on the quantity of textiles exported from the Third World, to be phased out over ten years. The Agreement on Agriculture eliminated all export subsidies for agricultural products over six years for developed countries, ten for less developed countries, with the least developed countries being exempted from the agreement. All state subsidies to farmers were classified according to their impact on production. Subsidies with minimal linkage to the quantities produced, the inputs used, or prices paid, were classified in a Green Box, and not subject to reduction. Other subsidies, including market price supports, were classified in an Amber Box. Amber Box subsidies are subject to an overall limit called the Aggregate Measure of Support (AMS), which was capped, and had to be reduced by 20 percent over six years for developed countries. Exemptions allow support for a particular product to be excluded from the calculation of a country's AMS if that support is not greater than 5 percent of its total value of production. Non-product-specific support which is less than 5 percent of the value of total agricultural production is also exempt from inclusion in the AMS. Specific payments linked to quantities produced, but subject to output controls, were classified in a Blue Box. These are also excluded from the AMS and are exempted from reduction. The Agreement on Subsidies and Countervailing Duties called for the elimination of export subsidies meant to increase exports, or to make domestic products preferable to imports, by 1 January 1998 for developed countries, and 2003 for developing countries, with the least developed countries exempt, and also called for the elimination of countervailing duties

implemented to offset the effects of export subsidies by importing countries. The Uruguay Round again revised the Anti-Dumping Code and made investigation of violations more stringent. Two agreements with significant effects on the environment, food and health security, the Agreements on Technical Barriers to Trade and the Agreement on Sanitary and Phytosanitary Measures, will be discussed later in the chapter. The Uruguay Round also established the WTO as enforcing organization (Dunkley 2000).

Three trade agreements covering entirely new areas emerged from the Uruguay Round: GATS, TRIPs and TRIMs.

The General Agreement on Trade in Services (GATS) is described by the WTO Secretariat as 'perhaps the most important single development in the multilateral trading system since the GATT itself came into effect in 1948' (WTO Secretariat 1999). The GATS extended internationally agreed rules and commitments, comparable to those of the GATT dealing with physical commodities, into the rapidly growing area of the international exchange of services, equivalent in value to about one-quarter of the international trade in goods. A further volume of international transactions in services does not cross national frontiers, because the service supplier (such as a branch of a foreign bank) or the service consumer (such as a foreign tourist) does so instead; yet GATS rules were extended to these kinds of international services as well. The GATS contains a central set of rules modeled on the GATT, and relying on many of the same principles. A preamble to the GATS agreement outlines three considerations that shaped negotiations. First, the establishment of a multilateral framework of principles and rules aimed at progressive liberalization might enable an expanding trade in services that contributed to worldwide economic development. Second, WTO members, and particularly developing countries, would still need to regulate their supplies of services to meet national policy objectives. And third, developing countries should be helped to play a more complete part in world trade in services, particularly through strengthening the capacity, efficiency and competitiveness of their domestic services. Following this, the twenty-nine Articles of the GATS agreement are divided into six parts. An opening section, Part I, sets out the scope and definition of the agreement – Article I says that the GATS (as with the GATT under Article XXIV: 12) goes beyond central governments to include measures taken by regional and local governments, including those of non-governmental bodies exercising powers delegated by governments,

and that the GATS covers all services, except those 'supplied in the exercise of governmental authority' such as central banking and social security. Part II deals with general obligations and disciplines, or rules that apply, for the most part, to all services and all members – GATS Article II, on MFN treatment, states that 'each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favorable than it accords to like services and service suppliers of any other country,' subject to a list of exemptions. Part III sets out the rules that, together with a basic categorization of services laid out in Article I, shape each WTO member's individual commitments to admit foreign suppliers of services to its market. In Part IV, Article XIX provides that, starting no later than January 2000, WTO members shall enter into 'successive rounds of negotiations with a view to achieving a progressively higher level of liberalization' of trade in services. Parts V and VI cover institutional provisions similar to those for other agreements in the Uruguay Round package: dispute settlement will take place under central WTO rules and mechanisms; and specialized experts serve as panelists for disputes on services questions.

The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) claims that widely varying standards in the protection and enforcement of intellectual property rights, together with lack of a multilateral framework of principles, rules and disciplines dealing with international trade in counterfeit goods, have been a growing source of tension in international economic relations. In response, the TRIPs agreement addresses the applicability of basic GATT principles, together with those of already existing international agreements, to the provision of intellectual property rights; enforcement measures for those rights; and multilateral dispute settlement procedures. Part I of the agreement sets out general provisions and basic principles, notably a national treatment commitment under which the nationals of other parties to the agreement must be given treatment no less favorable than that accorded to a party's own nationals with regard to the protection of intellectual property. Part I also contains an MFN clause, under which any advantage a government gives to the nationals of another country must be extended immediately and unconditionally to the nationals of all other governments, even if such treatment is more favorable than that given to some of its own nationals. Part II addresses each separate intellectual property right. With respect to copyright, parties to the agreement are required to

comply with the substantive provisions of the Berne Convention, in its latest version (Paris, 1971), for the protection of literary and artistic works. Computer programs are protected as literary works under the Berne Convention, and the TRIPs agreement lays down the grounds for copyrighting programs, databases and other software. Authors of computer programs and producers of sound recordings and films are given the right to authorize or prohibit the commercial rental of their works to the public through TRIPs. Performers are given protection from unauthorized recording and broadcast of live performances (bootlegging) for fifty years. There are a number of other similar provisions for trademark and service marks, geographical indications, industrial designs, and so on. The agreement requires that twenty-year patent protection be available for all inventions, whether products or processes, in almost all fields of technology. Inventions may be excluded from patentability if their commercial exploitation is prohibited for reasons of public order or morality; otherwise, the permitted exclusions are for diagnostic, therapeutic and surgical methods, and for plants and (other than micro-organisms) animals and essentially biological processes for the production of plants or animals (other than microbiological processes). Plant varieties, however, must be protectable either by patents or by a *sui generis* system (such as breeders' rights). Compulsory licensing and government use without the authorization of the right-holder are allowed, subject to conditions aimed at protecting the legitimate interests of the right-holder. The conditions are mainly contained in Article 31. These include the obligation, as a general rule, to grant such licenses only if an unsuccessful attempt has been made to acquire a voluntary license on reasonable terms and conditions within a reasonable period of time; the requirement to pay adequate remuneration in the circumstances of each case, taking into account the economic value of the license; and a requirement that decisions be subject to judicial or other independent review by a distinct higher authority. Certain of these conditions are relaxed where compulsory licenses are employed to remedy practices that have been established as anti-competitive by a legal process. These conditions should be read together with the related provisions of Article 27.1, which require that patent rights shall be enjoyable without discrimination as to the field of technology, and whether products are imported or locally produced. Part III of the agreement sets out the obligations of member governments to provide procedures and remedies under their domestic laws to ensure

that intellectual property rights can be effectively enforced by foreign rights-holders as well as by their own nationals. Governments have to provide for criminal procedures and penalties at least in cases of willful trademark counterfeiting or copyright piracy on a commercial scale, with remedies including imprisonment and fines sufficient to act as a deterrent. The agreement establishes a Council for TRIP Rights to monitor the operation of the agreement and governments' compliance with it. Dispute settlement takes place under the integrated GATT dispute-settlement procedures as revised during the Uruguay Round.

The Agreement on Trade-Related Aspects of Investment Measures (TRIMs) deals with investment issues thought to restrict and distort trade. It provides that no contracting party shall apply any TRIM inconsistent with Articles III (national treatment) and XI (prohibition of quantitative restrictions) of the GATT. An illustrative list of TRIMs includes measures against requiring particular levels of local procurement by an enterprise ('local content requirements') or measures that restrict the volume or value of imports an enterprise can purchase or use to an amount related to the level of products it exports ('trade-balancing requirements'). The agreement requires mandatory notification of all non-conforming TRIMs, and their elimination within two years for developed countries, five years for developing countries and seven years for least developed countries. It establishes a Committee on TRIMs that monitors the implementation of these commitments.

The agreement finalizing the Uruguay Round was signed in the Moroccan city of Marrakesh in 1994 and was, for the most part, routinely approved by the legislatures of member countries. (In the USA the president signed NAFTA and the Uruguay Round Agreements Act under 'fast-track authority' that minimized public or even congressional input.) The Uruguay Round vastly expanded the coverage of international trade agreements and greatly increased the power of the global institution responsible for regulating what were now movements of goods, services, ideas and capital. Under the WTO, ministerial meetings have subsequently been held at Singapore in 1996, Geneva, 1998, Seattle, 1999, and Doha, Qatar, in 2001.

The WTO

The WTO is headed by a Ministerial Conference that is supposed to meet at least every two years. Below this is the General Council,

normally made up of trade ambassadors and heads of delegations, but sometimes attended by officials sent by member counties to meetings held several times a year in Geneva. The General Council also meets as the Trade Policy Review Body (TPRB) and the Dispute Settlement Body (DSB). Some member countries participate in an Appellate Body, various Dispute Settlement panels, the Textiles Monitoring Body, and several multilateral committees. The WTO has procedures for resolving trade issues under the Dispute Settlement Understanding – under this, countries bring disputes to the WTO if they think their rights under agreements are being infringed, and judgments are made by specially appointed independent experts. Numerous specialized committees, working groups and working parties deal with individual agreements and other areas, such as the environment, development, membership application and regional trade agreements. Three other working groups deal with the relationship between trade and investment, the interaction between trade and competition policy, and transparency in government procurement. The existing councils and committees examine the area of electronic commerce. The WTO Secretariat, based in Geneva, has a staff of 550, mostly lawyers, and is headed by a director-general and a deputy director-general.

The 153 members of the WTO, as of 2008, account for almost 100 percent of world trade. Two-thirds of the members of the WTO are 'developing nations,' although the descriptions 'developed' and 'developing' are self-designations. Developing countries are granted longer time periods for implementing agreements and commitments. Legally the WTO votes differently than the IMF or World Bank – one country, one vote. But such a vote has never been taken. Instead decisions are made by consensus. WTO agreements have to be subsequently ratified by member states. Thus, when the USA agreed to WTO membership, Congress tacked on a special stipulation stating that if three or more issues were decided against the USA in the DSB in one year, the USA must opt out of the organization.

The WTO's declared objective is to 'help trade flow smoothly, freely, fairly and predictably.' It claims to do this neutrally, by administering trade agreements, acting as a forum for trade negotiations, helping to settle trade disputes, reviewing national trade policies, providing assistance to developing countries in trade policy issues through technical assistance and training programs, and cooperating with other international organizations. The WTO has been well described as follows:

> At a distance from the hurly-burly of domestic politics, government representatives and the WTO staff make significant decisions about international trade out of the public's view. It has no written bylaws, makes decisions by consensus, and has never taken a vote on any issue. It holds no public hearings, and in fact has never opened its processes to the public. Its meeting rooms do not even have a section for the public to observe its activities. And its court-like rulings are not made by US-style due process. Yet the WTO today rivals the World Bank and International Monetary Fund in global importance, because it has a dispute settlement mechanism with enforcement powers. (Wachtel 1998)

The WTO claims that its Secretariat does not have decision-making capacities like those granted to other international bureaucracies. Instead the Secretariat's duties include supplying technical support for the various councils and committees and the Ministerial Conferences, providing technical assistance for developing countries, analyzing world trade and explaining WTO affairs to the public and media. The Secretariat also provides legal assistance in the dispute settlement process and advises governments wishing to become members of the WTO.

WTO trade discourse

In terms of 'explaining WTO affairs to the public and media' the WTO claims ten benefits for the trading system it administers:

1. *The WTO/GATT system contributes to international peace*. Smoothly flowing trade helps people become better off; and more prosperous, contented people are less likely to fight.
2. *The system allows disputes to be handled constructively*. Nearly two hundred disputes have been brought to the WTO since 1995. Without a means of tackling these constructively and harmoniously, some could have led to more serious political conflicts.
3. *A system based on rules rather than power makes life easier for everyone*. Decisions in the WTO, made by consensus, with agreements ratified in all members' parliaments, apply to rich and poor countries alike. The result for smaller countries is increased bargaining power.
4. *Freer trade cuts the cost of living*. All people consume. The prices paid for food and clothing are affected by trade policies. Protectionism raises prices. By comparison, the WTO's global system lowers

trade barriers through negotiation and results in reduced costs of production, reduced prices of finished goods and services, and ultimately a lower cost of living.

5 *The system gives consumers more choice*, and a broader range of qualities to choose from. Even the quality of locally produced goods can improve because of competition from imports.

6 *Trade raises incomes*. Lowering trade barriers allows trade to increase, which adds to national and personal incomes. The WTO estimates that the 1994 Uruguay Round trade deal added between $109 billion and $510 billion to world income, depending on the assumptions behind the calculations.

7 *Trade stimulates economic growth* and that means more jobs. It is also true that some jobs are lost even when trade is expanding. But there are problems in reliably analyzing this. Some countries, however, are better at making the adjustment than others. Those without effective policies are missing an opportunity.

8 *The basic trading principles make the system economically more efficient and cut costs*. Trade allows a division of labor between countries and lets resources be used more effectively. But the WTO's trading system also further increases efficiency because, under WTO rules, governments charge the same duty rates on imports from all countries, and use the same regulations for all products, whether imported or locally produced. This makes life simpler for companies as sourcing components becomes more efficient and costs less.

9 *The system shields governments from narrow interests*. The GATT–WTO system helps governments take a more balanced view of trade policy. Governments are better placed to defend themselves against lobbying from narrow interest groups by focusing on trade-offs made in the interests of everyone in the economy.

10 *The system encourages good government*. Under WTO rules, once a commitment has been made to liberalize a sector of trade, it is difficult to reverse. The rules also discourage a range of unwise policies. For businesses, this means greater certainty and clarity about trading conditions. For governments it can often mean good discipline. (WTO n.d.: '10 benefits')

Taken as a whole, these ten benefits elaborating the basic position on trade, growth and incomes, laid out originally in GATT 1947 and updated by the WTO, constitute a coherent economic discourse, as

outlined earlier in this book. It is time to switch intellectual gears from a description of the GATT/WTO system to an extended critique.

Critique of the WTO

We must first deal with the WTO as an institution regulating the conditions of trade. The WTO presents itself as a neutral place where governments can make agreements about trade and resolve the disputes that inevitably arise in an equitable way. The WTO conveys the impression that member governments, meeting in the various councils and committees that convene under WTO auspices, make the basic decisions, and the organization merely carries them out. Yet as the ten benefits cited by the WTO, and listed above, clearly show, the organization does not adopt a neutral stance on trade policy. It is passionately against protectionism and just as profoundly for trade liberalization. The WTO says that it merely provides the forum within which countries decide how low barriers should fall and that it adjudicates the rules written into agreements on how liberalization takes place – that barriers be lowered gradually so that domestic producers can adjust, for instance, or that special provisions for developing countries be taken into account. Here, the WTO says, its objective is 'fair trade,' as in non-discrimination, or ensuring that conditions for trade are stable, predictable and transparent. In other words, the WTO's interpretation of 'fairness' is limited to the exact conditions under which free trade occurs – that countries follow the rules, act in transparent ways, and so on. With this narrow restriction, trade can operate 'fairly' under a system that more generally favors some interests while harming another.

Take, for example, the benefits and costs of trade. When it comes to evidence proving the growth and income benefits of the 1994 Uruguay Round, for instance, the WTO is satisfied with investigative methods that yield estimates of 'between $109 billion and $510 billion' added to world income, depending on the assumptions behind the calculations (see point 6 above). In other words, the WTO is willing to take dubious evidence (the higher figure being five times the lower!) as proof of the validity of a position on free trade's beneficial effects on growth and income. But when it comes to free trade's effects on workers and unemployment (point 7 in the list above), analytical problems suddenly emerge, so that reliable estimates become impossible and the issue can be deemed statistically non-resolvable, and thereby politely dropped. Well, not quite – on its website, the WTO also

addresses 'ten misunderstandings' of its own operations. It counters the 'misunderstanding' that the WTO 'destroys jobs and widens the gap between rich and poor' as follows: 'Not true: The accusation is inaccurate and simplistic. Trade can be a powerful force for creating jobs and reducing poverty. Often it does just that. Sometimes adjustments are necessary to deal with job losses, and here the picture is complicated. In any case, the alternative of protectionism is not the solution' (WTO n.d.: '10 common misunderstandings').

It then adds two supportive arguments: that in many cases, workers in export (trade-oriented) sectors of economies enjoy higher pay and have greater job security; and that among 'producers and their workers' who were previously protected by tariffs, but are now exposed to foreign competition, some survive by becoming more competitive, while others do not, and some workers adapt quickly, by finding new employment, while others take longer. So the consequences of free trade in creating unemployment depend on the worker's adaptability and the producer's competitiveness – how they respond to the 'challenge' of rapid change (challenge being the neoliberal euphemism for losing one's job), or more generally how the fittest survive – Social Darwinism in a brave new globalized world!

Yet global organizations, even when unelected, must seek mass approval. What aspect of the person (as worker, consumer, citizen, and so on) does the WTO side with? Under points 4, 5 and 6 above the WTO says that 'we are all consumers' and that 'we' benefit from free trade through higher personal incomes, lower prices, more choice, lower costs of living, and so on. This is a vision of societies as consumer, rather than worker, democracies, with consumption rather than labor as source of freedom – a nice, populist-consumerist addition to the overall neoliberal discourse. The general point is this: the WTO does not practice organizational, bureaucratic neutrality. As an organization it has a total commitment to a single, well-defined and elaborated, carefully defended, ideological position: free trade 'fairly adjudicated' that benefits people as consumers. In what follows, the WTO will be taken to be an organization with an ideological mission.

We can glimpse this mission in the choice of Michael Moore as director-general of the WTO between 1999 and 2002. Moore had been minister of external relations and trade in the New Zealand Labor government that came to power in 1984. That government, led by Prime Minister David Lange and Finance Minister Roger

Douglas, introduced a radical program of neoliberal restructuring that rapidly removed all restrictions on foreign investment, eliminated import controls, erased most tariff barriers, floated the New Zealand dollar and created an independent Reserve Bank with responsibility for controlling inflation, conducting extensive corporatization and privatization and radically restructuring the public service (Kelsey 1995). As a result, New Zealand went into a recession marked by the highest unemployment rates the country had seen since the 1930s depression. In 1990, with the Labor government in disarray, and on its way to a massive defeat in the November elections, Moore was installed as caretaker (or, rather, undertaker) prime minister by his party caucus, the third such leader within a year. Ousted as leader of the Labor Party in 1993, he has not repudiated the policies followed by the Lange/Douglas government and, until appointed to the WTO, was a core member of the right wing of the Labor Party in opposition. In his book *A Brief History of the Future*, Moore (1998: 71) says that 'the World Bank and International Monetary Fund (IMF) have unearned reputations born of the Cold War of being anti-poor, anti-developing countries … [but] no one believes that any more, except a few deranged misfits on the edges of obscure universities, people who tuck their shirts into their underpants, the remnants of pressure groups and a few geriatrics who claim that Marxism, like Christianity, has not been tried yet.' Despite this kind of right-wing diatribe (or perhaps because of it!) Moore was an active participant in international discussions on trade liberalization. As minister of overseas trade and marketing in the New Zealand government, he played a leading role in launching the Uruguay Round of GATT negotiations. He was a member of the 'International Eminent Persons Group on World Trade' (formed in 1989 to support the Uruguay Round) and he attended key GATT meetings in Punta del Este (1986), Montreal (1988), Brussels (1990) and Marrakesh (1994). And on 1 September 1999 Moore became director-general of the WTO – just in time for the debacle at Seattle, a fitting reward.

The main point, however, is not personalities but whether indeed trade produces economic growth and higher incomes for poor countries. The UNCTAD *Trade and Development Report* for 2002 addressed the question: why are developing countries trading more, yet earning less? The report notes that the past two decades have seen a rapid opening up to trade in developing countries. Indeed, trade volumes in developing countries have grown faster than the

world average. Developing countries now account for one-third of world merchandise trade, and much of the increase in trading volume has been in manufactures. The UNCTAD report notes, however, that this massive increase in exports has not added significantly to developing countries' income. Why, it asks, have developing countries not benefited from the increased openness to trade that in many cases is a condition for assistance from multilateral institutions? Many countries have been unable to shift production out of primary commodities such as agriculture and natural resources. The markets for these products have been stagnant and prices tended to go down in the long run (with the exception of fuel). Countries that shifted production from primary commodities to manufactures focused on resource-based, labor-intensive products, which generally lack dynamism in world markets and have a lower value-added. Reliance on exports of labor-intensive manufactures to galvanize growth in the face of declining commodity prices has been a common development policy. This led to many simultaneous export drives, causing falling prices and intense competition for foreign direct investment (FDI), and hence a weakened bargaining position for developing countries. As a result, developing countries end up competing with each other on the basis of wage levels. And these trends are occurring even while some of the larger countries, such as China, are yet to be fully integrated into the global trading system. At the same time developed countries have themselves liberalized trade slowly and insufficiently in the area of clothing, textiles and other labor-intensive manufactures. Along with trade liberalization, the last two decades have also seen substantial increases in flows of foreign direct investment. Success in attracting large amounts of FDI, however, has not necessarily resulted in greater growth. Mexico, for example, has experienced massive FDI in the last few years and a corresponding increase in exports. GDP per capita has not, however, risen in response. In contrast, Taiwan (with more state intervention in planning the direction taken by the economy) has seen lower levels of FDI and has been selective and more focused on building domestic investment. Here we have seen growth in exports and a corresponding growth in GDP. UNCTAD concludes that the liberalization of trade and FDI should no longer be the sole focus of development agencies. Instead, developing countries, and the development agencies that impose conditionalities on them, should ensure that trade policies are designed to maximize domestic growth and development – which may not involve reducing external barriers

(UNCTAD 2000). In other words, the basic argument made for free trade by the WTO turns out not to be proven in the developing-country experience.

Critique of trade policy review

As part of the Marrakesh agreement, the Trade Policy Review Mechanism (TPRM), originally set up under the GATT in 1989, was confirmed as an integral component of the WTO. The purpose of the TPRM, according to the WTO, is 'to contribute to improved adherence by all Members to rules, disciplines and commitments made under the … Agreements' and hence to making the trading system function more smoothly 'by achieving greater transparency in, and understanding of, the trade policies and practices of Members.' Through trade policy reviews, members of the WTO 'undertake the regular collective appreciation of the trade policies and practices of trading partners' – that is, the whole membership of the WTO discusses the trade policy of each member government at regular intervals (every two years for the largest countries, less regularly for smaller countries). A Trade Policy Review Body (TPRB) made up of the WTO General Council, operating under special rules and procedures, and open to all member countries, elects a chairperson to supervise the process and summarize its results. Reviews are 'set against the background' of the country's wider economic policies. For each review, two main documents are prepared: a policy statement by the government of the member country under review; and a detailed report written independently by the Trade Policy Review Division (TPRD) of the WTO Secretariat, based on information from the country, but also using material from other sources that the Secretariat finds appropriate. The process includes a visit by a Secretariat team (two or three staff members of the TPRD) to the country under review, where they consult with governmental agencies, chambers of commerce, research institutes and other elite organizations. The TPRD 'assists' small, developing countries in preparing for a trade policy review. This is described as an onerous process that nevertheless 'encourages' trade policy-making in directions foreseen in the WTO agreements which contribute to a member country's 'greater integration into the multilateral trading system.' Trade policy reviews cover all aspects of the country's trade policies, including its domestic laws and regulations, the institutional framework, bilateral, regional and other preferential agreements, wider economic needs and

external (socio-economic) environment. The two documents are then discussed by the WTO's full membership in the TPRB, employing two discussants advised by the TPRD Secretariat, and with other intergovernmental organizations (IMF, World Bank, OECD, UNCTAD) attending as observers. The process ends with summary observations by the Secretariat and concluding remarks by the chairperson of the TPRB, with all documents eventually being published (WTO).

As described by the WTO Secretariat, trade policy review appears to be a helpful, democratic process, using procedures that come close to resembling a neutral socio-political scientific endeavor. Yet within the discursive space of a center of power, phrases such as 'encourage,' 'assist' and 'collectively appreciate' suggest something more than a neutral review, something more like disciplining, directing, prompting and even warning countries that they should adhere to a given line so they can be 'more integrated' into the multilateral trading system administered by the WTO – which, by the way, is the only game in town, or, in the case of international trade, the only game in the world. With this suspicion raised, let us look at a case example in some detail – the TPRB's third review of Brazil's trade policies, with meetings held at the WTO on 30 October and 1 November 2000.

The Brazilian delegation's report to the TPRB discussed how its trade policy was directed at minimizing the risks of globalization and maximizing opportunities for the national socio-economic development effort. Adjusting the Brazilian economy to the new international context had been translated, on the domestic front, into processes of deregulation and privatization of the economy. And the opening of the Brazilian economy, implemented throughout the 1990s, had led to undeniable benefits in the areas of modernization, productivity and competitiveness. But Brazil's delegation complained that opening up the economy had also generated a significant growth in imports. The sustainability of this process would require, in the long term, a corresponding access to foreign markets for Brazilian goods and services. And while the successive GATT negotiation rounds had produced a significant reduction of tariff levels, a number of sophisticated, and not entirely transparent, non-tariff measures and regulations on the parts of most developed countries were major restrictions to international market access. Developing countries, Brazil complained, still faced discrimination in terms of market access, especially for their agricultural products. The process of broad market opening undertaken by Brazil since the beginning of the 1990s had not resulted

in commensurate access to foreign markets, and this situation was reflected in large trade deficits with the European Union, the USA and Japan. On behalf of Third World countries, Brazil complained of problems deriving from the implementation of trade policies and practices, declared very often on a unilateral basis, by developed countries, which had an adverse impact on balance of trade relations at the international level. (All this proved prescient when Brazil experienced significant currency and balance of payments problems two years later – see Chapter 4.)

By comparison, the TPRD Secretariat report on Brazil mentioned none of this. It 'congratulated' Brazil for continuing a program of economic reform, initiated over a decade ago, that had led to more open trade and investment regimes. A more market-driven, decentralized environment had emerged through the deregulation of state monopolies and prices, investment liberalization and privatization. The Secretariat thought that this 'must have' resulted in improved resource allocation and greater flexibility that helped the Brazilian economy deal successfully with external and other shocks facilitating, in particular, rapid recovery from the financial crisis that led to the floating of the Brazilian currency, the real, in 1999 (again, remember the 2002 Brazilian crisis). And the Secretariat thought that market-set exchange rates would now provide the opportunity for Brazil to reduce, and perhaps remove, some measures taken to restrict imports or support exports, and to make a definitive break from the last remaining traces of its inward-looking policies of the past.

The TPRB chairperson's 'summary' of the entire review said that members attributed Brazil's recovery from the financial crises in 1997 and 1998 largely to 'sound macroeconomic policies' and liberalization pursued over the last decade, both unilaterally and in the context of international agreements. Greater exposure to competition from foreign goods and services had helped contain inflation, had enhanced productivity and competitiveness and had attracted foreign investment. Members 'recognized' that, as a result, Brazil had now moved unequivocally away from the import substitution model it had used in earlier years. Members of the TPRB, the chairperson said, 'commended' Brazil for its active participation in the multilateral trading system, with several 'welcoming' its support for the launching of a new round of trade negotiations. Members observed 'with concern,' the chairperson added, that since Brazil's last trade policy review in 1996 the average MFN tariff had risen to 13.7 percent as a result of

Box 5.1 Trade policy review by the WTO

Excerpts from TPRB chairperson's summary remarks

TPRB review of the Philippines, September 1999 Members warmly commended the Philippines on the economic reforms undertaken since its previous Review in 1993. The opening of the trade and investment regimes has contributed to a more resilient economy which, in general, had dealt well with the Asian financial crisis and natural disasters. The Philippines thus provides a good example of the advantages of structural reform, particularly trade liberalization, in withstanding external shocks. Continued efforts to enhance the outward orientation of the economy would bring further benefits to Filipino workers and consumers. Members encouraged the Philippines to continue on its liberalization path and domestic reform process …

TPRB review of Poland, July 2000 Members were clearly impressed by Poland's economic transformation to a market economy. The economy is performing robustly and future growth prospects are favorable. This has been achieved by generally prudent macroeconomic policies combined with structural reforms, particularly trade and investment liberalization. Members acknowledged the remarkable results of the Polish transition process, including in the privatization of state-owned enterprises; this has undoubtedly played a significant role in attracting foreign investment. Members also appreciated Poland's overall commitment to liberal trade and investment policies.

TPRB review of Korea, September 2000 Members were impressed by Korea's strong and swift recovery from the 1997 crisis and recognized that this recovery was largely the result of prudent macroeconomic policies and far-reaching structural reforms. In addressing the crisis, Korea had, by and large, eschewed protectionist measures and had instead taken steps to further improve the competitive environment both through domestic reform, particularly in the corporate, financial and labor spheres, and through trade and investment liberalization. Members urged Korea to reduce state involvement and facilitate foreign participation in several sectors.

TPRB review of Mozambique, January 2001 Members were very impressed by the excellent economic performance of Mozambique in recent years, attributing this to its economic reforms, including privatization of enterprises, the elimination of most export restrictions and of exchange controls, and simplification of its customs tariff.

TPRB review of Ghana, February 2001 Members were heartened by Ghana's commitment to freer trade and economic reform … welcomed continued efforts to open its market by refraining from using non-tariff measures and relying on tariffs as the main instrument of trade protection. The central role to be played by trade, investment and the private sector in Ghana's economic restructuring and improving its international competitiveness was widely recognized, and Ghana was urged to pursue further liberalization. Revitalization of the privatization program was also encouraged. While appreciating Ghana's efforts, Members highlighted the urgent need to restore macroeconomic stability through sound fiscal and monetary policies.

TPRB review of Costa Rica, May 2001 Members were all favorably impressed by Costa Rica's good economic performance in recent years. They noted that underlying this performance was Costa Rica's generally liberal trade regime, open investment environment and successful strategy to shift production toward manufacturing, notably into export industries. Costa Rica is a prime example of how small WTO economies may benefit from trade liberalization and the multilateral trading system.

Source: WTO

temporary tariff increases; they 'took note of Brazil's reassurances' that the increase would be eliminated at the end of the year. Questions were also 'raised' about non-tariff measures, many focusing on Brazil's customs valuation and the role of minimum prices, as well as on a non-automatic import licensing regime. After 'expressing a number of other concerns' raised by members, the chairperson concluded that the review had met the vision for the TPRM, and that discussion had enhanced transparency and understanding of Brazil's trade

policies and practices through a collaborative quest. Members were 'appreciative' of Brazil's efforts to implement wide-ranging economic reforms and 'encouraged' it to continue down this path.

We might continue by looking in detail at a number of other 'fair, open discussions aimed at transparency and clarification' in a forum where 'members of the organization can comment freely on the trade and economic policies of any country.' Box 5.1 summarizes a number of trade reviews conducted by the TPRB in the period 1999–2001.

Clearly, far more than reviews of trade policy are involved. These are WTO assessments of the entire system of economic policies pursued by governments made under conditions of power and duress, in that continued membership means continuing access to MFN status (that is, the lowest import duties available in markets such as the USA). The summaries show that policy prescriptions coming from the TPRB *always* follow the same model, using a nearly identical language. In their depositions, member countries of the WTO may present vaguely phrased objections to the existing free trade regime. They may hint, as with Brazil, that they are merely doing their best to adapt to the 'objective conditions' of globalization. These demure complaints are then politely ignored as discussion is phrased exclusively in neoliberal terms. In this neoliberal model, 'good' is represented by optimistic phrases such as: openness, liberalization, export orientation, structural reform, deregulation, privatization, competitiveness, macroeconomic soundness, stability, flexibility, simplification, prudence and, best of all, 'rationalization' – that is, determination of the direction taken by an economy by purely market processes, including random chance and competitive, speculative upheaval! Bad is represented by pessimistic phrases such as protection, closed, controlled, restriction, subsidy, tariff, inward-looking, import substitution and, most of all, direction of the economy through state regulation. Billed as 'peer-group assessments,' the WTO trade policy reviews are more like peer group pressure, examinations, conducted by expert trade representatives, of the economic policies of the member countries, within a disciplinary lexicon phrased in the polite terms of economic diplomacy – members 'congratulating' countries and 'welcoming' measures taken, but always in one direction, always that of liberalization, while 'expressing concern' and 'raising questions' about tendencies in other directions, always those of national state regulation. A process that always reaches the same model conclusion turns the meaning of 'open' discussion into its opposite, 'closed

prescription.' The model country showing others their future is the USA, described by its own 1999 trade policy review as 'among the most open and transparent [economies] in the world' – despite massive state subsidization of agriculture which enables low-priced exports that ruin millions of small farmers in countries forced by the WTO to open their borders 'freely' to imports. Countries are pressured to adhere to a process that yields a single end point, the 'open' and 'liberalized' economy that supposedly fits the US model, but in fact fits an idealized, right-wing, neoliberal model. On top of all this, the WTO Secretariat earnestly characterizes itself as merely doing the 'factual leg-work' and providing 'technical assistance' and 'training' to poor Third World countries facing a daunting review procedure. Fact and technique, assistance and training, all these are code-words for political-economic disciplining (Foucault stirs in his urn). The trade policy reports of the TPRB are documents of disciplinary power, and the fifteen or so 'professionals' of the TPRB wield more economic clout than the thousands of policy-makers in the finance ministries of member countries, who in turn control the destinies of billions of people. Through the TPRB, the WTO serves as an international court of economic opinion, with neoliberalism as the norm against which policies are judged.

Trade and environment

The purpose of the WTO is to liberalize trade across national boundaries – that is, to remove governmental restrictions on the free movement of goods and services. But 'restrictions on trade' may include local state, national or international regulations to protect the environment, ensure food quality and safeguard public health. What happens when the WTO's imperative for freeing trade from governmental restriction conflicts with the need for environmental protection in an age of burgeoning production, massive consumption and the use of powerful technologies?

The WTO insists that it is not an anti-environmental organization. It points to 'several references to the environment' actually made in the organization's provisions. Thus the preamble to the Marrakesh Agreement says that the purpose of the WTO is to expand member countries' production and trade in goods and services while 'allowing for the optimal use of the world's resources in accordance with the objective of sustainable development.' Additionally, the WTO says, Article XX of GATT, dealing with 'General Exceptions,' specifies a

number of instances, including cases of environmental protection, in which member countries may be excepted from the usual trade rules. The WTO also refers to the Agreement on Technical Barriers to Trade and the Agreement on Sanitary and Phytosanitary Measures, two closely linked health and safety agreements emerging from the Uruguay Round. These need explaining in a little more detail.

The WTO Agreement on Technical Barriers to Trade (TBT) tries to ensure that technical regulations and standards, and their testing and certification procedures, do not create unnecessary obstacles to trade. In its preamble, the agreement recognizes countries' rights to adopt such safety measures to the extent they consider appropriate – for example, to protect human, animal or plant life or health, or to protect the environment. Members are allowed to take measures to ensure that their standards of protection are met – this is known as adopting 'conformity assessment procedures.' Among the agreement's important features are: non-discrimination in the preparation, adoption and application of technical regulations, standards and conformity assessment procedures; avoiding unnecessary obstacles to trade; adopting international standards as far as possible; and the transparency of these measures, through governments notifying the WTO Secretariat and establishing national enquiry points. In brief, the TBT agreement allows countries to adopt technical regulations, standards and conformity assessment procedures to safeguard human and animal health and the environment, provided non-discrimination, transparency and other requirements are met.

The Agreement on Sanitary and Phytosanitary Measures (SPS) – 'phyto' referring to plants – is similar in that it deals with human, animal and plant health and food safety regulations. It recognizes members' rights to adopt SPS measures, but stipulates that these must be based on science, should not create unnecessary obstacles to trade, and should not arbitrarily or unjustifiably discriminate between members where similar conditions prevail. The agreement encourages members to adapt their SPS measures to the areas (regions, countries or parts of countries) that supply their imports (WTO n.d.: 'Agreement').

The WTO relies on three international bodies to set standards for the TBT and SPS agreements: for food standards, the Codex Alimentarius Commission (Codex), created in 1963 and run jointly by the UN Food and Agriculture Organization (FAO) and the World Health Organization (WHO), whose main purpose is protecting the health

of consumers, ensuring fair practices in food trade and promoting coordination of food standards work undertaken by international governmental and non-governmental organizations; for animal health, the International Office of Epizootics, an intergovernmental organization that informs governments about animal diseases and harmonizes regulations for trade in animals and animal products; and for plant issues, the Secretariat of the International Plant Protection Convention, a multilateral treaty deposited with the FAO, which tries to prevent the spread of plant diseases and acts as a source for international standards for phytosanitary measures affecting trade.

Additionally, the WTO says that, long ago, it established special committees on trade and environmental issues. And indeed, in 1971, the GATT Council of Representatives agreed to set up a Group on Environmental Measures and International Trade that would convene at the request of GATT members. No country asked that it convene until 1991, however. A somewhat more active group, the Committee on Trade and Environment (CTE), came into existence along with the WTO in 1995. Its mandate is: 'to identify the relationship between trade measures and environmental measures in order to promote sustainable development; and to make appropriate recommendations on whether any modifications of the provisions of the multilateral trading system are required, compatible with the open, equitable and non-discriminatory nature of the system' (WTO n.d.: 'The WTO and its Committee on Trade and Environment'). In its statement of the basic principles that guide its work, the CTE points out that the WTO is not an environmental protection agency and that its competency is limited to aspects of environmental policies related to trade. This competency, however, includes looking at 'how trade policy can benefit the environment.' The committee says that the WTO is interested in building a 'constructive relationship' between trade and environmental concerns in order to promote sustainable development, without undermining its open, equitable and non-discriminatory character.

The WTO holds symposia on trade, environment and sustainable development in Geneva, involving senior trade and environment officials together with representatives of selected NGOs. Likewise, the WTO Secretariat organizes a series of regional seminars on trade and environment for government officials, the objective being 'to raise awareness on the linkages between trade, environment and sustainable development, and to enhance the dialog among policy-makers from different ministries in WTO member governments' (WTO n.d.: 'Work

of the Trade and Environment Committee'). At these seminars, the basic argument originally propagated by the GATT, and elaborated by the WTO, is that trade benefits the environment. Expanding trade and increased market access, the argument goes, lead to larger per capita incomes that, in turn, provide more resources to contain environmental damage. If the average citizen can also be convinced of the need to devote more material and human resources to achieving a better environment as incomes rise, the growth of per capita income ultimately leads to increased expenditures on the environment. A country with a stagnant economy, by contrast, tends to spend less on improving the environment. Furthermore, new technologies often appear first in countries at the frontier of environmental regulation, and products embodying these technologies have to be exported if other countries are to catch up. Similarly, trade can help consumers make environmentally beneficial choices – for instance, imports of low-sulfur coal could discourage the use of polluting high-sulfur coal. Trade in recycled inputs can help countries economize on resource use (GATT Secretariat 1992).

A new WTO Secretariat report on trade and environment, the longest and most sophisticated of all, was released in 1999, again just before the Seattle ministerial meetings. The report argued that most environmental problems resulted from polluting production processes, certain kinds of consumption and the disposal of waste products – trade as such was rarely the root cause of environmental degradation, except for the pollution associated with the transportation of goods. The key question was this: is economic growth, driven by trade, part of the environmental problem or part of the solution? The WTO Secretariat report provided a complicated answer. But on the whole it argued that low incomes were one reason that environmental protection lagged in many countries. Here the report referred to the notion of an Environmental Kuznets Curve (EKC) – the idea of an inverted U-shape pollution path taken by countries undergoing economic growth. Pollution increases at early stages of growth, but decreases after a certain income level has been reached. Trade entered into this debate for several reasons: trade was one of the cylinders propelling the engine of growth; trade might affect the shape and relevance of the EKC; competitive pressures might prevent environmental standards from being upgraded; and growth driven by liberalization of the world economy might then prevent the onset of mechanisms that could generate an environmental Kuznets curve. Countries that lived on the

margin might not be able to afford to set aside resources for pollution abatement, nor did many think they should sacrifice their growth prospects to help solve global pollution problems caused in large part by the consuming lifestyles of richer countries. So, if poverty was at the core of the pollution problem, economic growth would be part of the solution – this was because growth allowed countries to shift gear from immediate concerns to long-term sustainability issues. National accountability, good governance and a democratic political process should also not be underestimated. Good governance was also needed at the international level – the 1987 Montreal Protocol and the Kyoto Agreement were cited as examples. The growing number of multilateral environmental agreements (MEAs, currently 216 in number) might be a further indication of the trend in that direction. Initiative might have to shift from the national to the supranational level. The cooperative system of the WTO, based on legal rights and obligations, could potentially serve as a model for a new global architecture of environmental cooperation. The way forward, it seemed, was to strengthen the mechanisms and institutions for multilateral environmental cooperation, just as countries, fifty years ago, decided that it was to their benefit to cooperate on trade matters by forming GATT (Nordstrom and Vaughan 1992).

These are sophisticated arguments indicating that the WTO takes seriously protests by environmental social movements. Its director-general said that the WTO's Doha Round was the first ever to include a 'green chapter' (Lamy 2007). We have seen earlier that the WTO claims that liberalizing trade leads to higher GDP levels, higher incomes and especially more consumption, by freeing production from trade restrictions. Indeed, 'change in the scale of economic activity' in an upward direction and more consumption choices are *the* main benefits the WTO claims for the broad mass of the world's people. But this creates a dilemma when it comes to the effects of production on the environment. For if, indeed, the WTO trading system generates growth, and growth is accompanied by pollution, then the trading system championed by the WTO generates pollution. The trade and growth policies of the WTO can be held accountable for the environmental destruction wrought by higher production and consumption levels. This is particularly the case when the increased international competitiveness favored by a liberalized WTO trading system reduces the political and economic ability of the national and local state to environmentally regulate production. Indeed, this

counter-argument is so compelling that the WTO, through its 1999 report, for instance, has to address the relations among trade, growth and environmental degradation previously so neglected that its committee on trade and environment had never met. On the one side, the WTO agues that trade-induced growth provides the resources to address environmental problems (or, rather, environmental 'challenges' – the shift in terms reveals a guilty conscience). On the other side, when it comes to environmental degradation, neither trade nor growth is a root cause. Instead, the root cause of environmental degradation is pollution. Most environmental problems result from polluting production processes that can be effectively regulated, even in the face of increased competitiveness, by national environmental policy and, with globalization, through MEAs – the 1999 report uses as examples the Montreal Protocol and the Kyoto Accords on greenhouse gas emissions and global warming, and it is often mentioned that the GATT and the WTO supported the Rio Declaration on the global environment. Notice here the logical ellipses, and the attempt at turning critique into supportive claim.

In the first ellipse, the WTO denies that trade-induced economic growth is the basic causal condition for the increased pollution that causes dangerous levels of environmental degradation; yet the WTO claims that trade-induced growth is definitely part of the solution. This is a case of denying you caused that bite-shaped hole in the cake, but spitting a bit back to fill the gap! The WTO relies on the dubious notion of an EKC in which pollution decreases after a certain point as incomes rise in growing economies. But this finding has been hotly contested. For example, one study used data on ambient air pollution in cities worldwide to examine the relationship between national income and pollution. It concludes that there is little empirical support for an inverted U-shaped relationship between several important air pollutants and national incomes (Harbaugh et al. 2000). Another study on sulfur emissions, using a larger and more globally representative sample than previous sulfur EKC studies, finds that sulfur emissions per capita are a monotonic function of income per capita when a global sample of countries is used, but an inverted U-shape function of income when a sample of *only* high-income countries is used – that is, the U-shape findings occur only when a certain set of already developed countries is chosen (Stern and Common 2001). For us, even a casual glance at the pollution data demonstrates one undeniable fact about environmental destruction.

The main cause of pollution is not population pressure, as claimed by organizations such as the World Resources Institute (itself in desperate need of a deconstructive critique), nor is it poverty, as the WTO more perniciously claims. Instead the advanced countries spend more on environmental programs because their affluence and their huge production/consumption social machines cause the environmental problem in the first place. (Note here, as a side issue, the WTO's tendency to blame the victims for environmental problems in that poor countries lack the financial resources to follow the lead of the advanced countries in cleaning up environmental pollution.) Taking one key indicator in an area of pollution – carbon dioxide emissions – mentioned prominently by the WTO: the high-income countries, with 15 percent of the world's population, generate (within their borders) 47 percent of global emissions, because for each person 12 tons of carbon dioxide are emitted annually; whereas the low-income ('poor') countries of the world, with 40 percent of the world's population, generate 11 percent of emissions because for each person 1 ton of carbon dioxide is emitted. And further, middle-income countries, following an export-oriented industrialization model of growth of the type advocated by the WTO (that is, also producing for the markets of the rich countries) show rapidly increasing levels of carbon dioxide emissions (World Bank 2000c: 278–9, 292–3). In brief, the single, most prominent cause of global pollution is the same process of trade-oriented, unregulated global industrialization that the WTO wants further to deregulate through 'liberalization.'

In the second ellipse, the WTO claims that despite the increased international competitiveness brought on by the liberalization of trade, governments can, through multilateral agreement, implement effective environmental regulations. This shunts responsibility for environmental destruction away from liberalized trade, and places the onus squarely on government policies. (Notice also that these are always 'clean-up policies' rather than preventive policies.) It also substitutes vague, wishful thinking for concrete, real environmental action. The WTO favors the notion of 'sustainable development' proclaimed by the Declaration on Environment and Development at the United Nations Conference on Environment and Development, in Rio de Janeiro, 1992, a conference in which the GATT actively participated. The key position established by the Rio Declaration summarized by its Principle 7 says: 'States shall cooperate in a spirit of global partnership to conserve, protect and restore the health and

integrity of the Earth's ecosystem.' The Declaration goes on to suggest that to achieve sustainable development and a higher quality of life for all people 'States should reduce and eliminate unsustainable patterns of production and consumption and promote appropriate demographic policies.' Under Principle 12, the Rio Declaration follows the lead of the GATT by saying that:

> States should cooperate to promote a supportive and open international economic system that would lead to economic growth and sustainable development in all countries, to better address the problems of environmental degradation. Trade policy measures for environmental purposes should not constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade. Unilateral actions to deal with environmental challenges outside the jurisdiction of the importing country should be avoided. Environmental measures addressing transboundary or global environmental problems should, as far as possible, be based on an international consensus. (CIESIN 1992)

The Rio Declaration sets up a fine-sounding ideal in the form of a loose, malleable objective defined by the term 'sustainable development.' Yet the Declaration advocates 'cooperation in good faith and in a spirit of partnership' with the means for carrying this out left for 'the further development of international law in the field of sustainable development' – that is, the means of implementation are to be worked out some time in the future. Population growth (in Third World countries) features prominently as the basic cause of environmental pollution rather than economic growth or overconsumption. And further still, the GATT managed to insert its own position into the Declaration in one of its few more exact statements, the notion that unilateral trade action should not be used to address environmental problems but instead measures must be based on 'international consensus' – should that, one day, maybe, if 'we all work together,' perhaps, occur!

In terms of reducing pollution through multinational environmental agreements the WTO mentions the Montreal Protocol and the Kyoto Accords. The Montreal Protocol on Substances that Deplete the Ozone Layer, agreed upon in 1987 after 'rigorous negotiations,' sets the 'elimination' of ozone-depleting substances as its 'final objective' and was ratified by countries accounting for 82 percent of world consumption. Yet the Kyoto treaty, signed by 100 countries in 1997,

mandating that the USA and other industrialized nations 'find a way' by the year 2012 to reduce greenhouse gas emissions by between 5 percent and 7 percent of 1990 levels, and often described as 'the only practical measure we have to tackle climate change,' was specifically rejected by the US G. W. Bush administration, in March 2001, on the grounds that it damaged the American economy, excused developing countries from decreasing emissions, and that the scientific evidence on global warming remained unclear – all this despite the fact that, according to a *Time*–CNN poll released soon afterward, a huge majority of Americans see global warming to be a serious problem, believing three to one that carbon dioxide emissions help account for global warming, with two-thirds wanting Bush to find a way to reduce such emissions. In brief the WTO places responsibility for environmental action on vague MEAs that, when specified in terms even of objectives such as limiting emissions to the already dangerous levels reached in 1990, are rejected by trade- and growth-oriented administrations. In other words, the WTO is a global growth machine, and international environmental policy is its thin disguise.

Furthermore, the WTO takes the position that its decisions rest on the basis of 'scientific expertise.' We mentioned earlier that the goal of the TBT agreements is to harmonize product standards, packaging provisions and safety requirements with the aim of eliminating unnecessary trade obstacles. The SPS covers measures applied to protecting animal or plant life from disease and disease-carrying or -causing organisms, toxins, pests and the like. There are two genres of harmonization: (1) product standards, meaning the characteristics of a good; and (2) process standards, or the way in which the good was produced. In several instances, the WTO has granted exemptions for product standards, but not process standards. Under the TBT and SPS Agreements, the WTO uses product standards set by the Codex Alimentarius Commission (Codex) to adjudicate important trade issues dealing with food issues (WTO 1998). The very name 'Codex Alimentarius Commission' suggests scientific judgment beyond reproach and seems to vindicate the WTO's claim that its findings rest on science. Yet Codex meetings are heavily influenced by the food industry. Large food corporations have identified Codex as a critical target to influence, either through lobbying the body itself, or by having their interests represented by government delegations. The official, governmental delegations sent to the Codex meetings include many industry representatives – 40 percent of the delegates in

the case of the USA, for instance. In a report to the president of the European Commission in 1999 one observer of the Codex committee meetings discussing standards on the cattle growth hormone rbST stated: 'The ways and means by which rbST was re-evaluated last year strengthens our belief that powerful politico-economic interests and multinational companies exercise improper influence and control in the work of Codex Alimentarius and its scientific committees whose supposed primary task is to protect human health' (Food Magazine 1999: 2).

Once accepted by Codex, a standard becomes extremely difficult for national governments to override – by setting higher standards, for instance. Governments able to produce scientific evidence to support their case might be able to argue for higher standards. Final judgment on the evidence, however, is made by a WTO dispute settlement panel. If there is scientific uncertainty, as is often the case with the potential long-term health effects of food production processes, for example, the WTO system prevents national governments from adopting the precautionary principle and regulating trade. Yet the Codex standards for food trade are low, by comparison with those set by regional groups of countries, such as the European Union, even allowing for residues of artificial hormones in beef (Wallach and Sforza 1999: 56). Codex standards allow DDT residues to be fifty times greater than allowed by US law (Korten 1995: 179), and Codex is considering a standard that would allow for higher amounts of lead and other contaminants in mineral water (Wallach and Sforza 1999: 73). The main point is this: the notion that the WTO makes fair judgments based on issues relating to trade, the environment, food issues and the like, based on neutral scientific evidence provided by experts beyond question or reproach, is a figment of the imagination. Instead, the WTO makes anti-environmental judgments biased by its guiding principles of the 'liberalization' of trade and disguises them as fair, equitable and based in the neutral principles of science.

A confidential document from the WTO Secretariat dated 19 March 2001 obtained by Greg Palast, a journalist at the *Guardian* and the *Observer*, two British newspapers, discusses Article VI.4 of the GATS agreement. It addresses the balance between two potentially conflicting priorities: promoting trade expansion versus protecting the regulatory rights of governments. Under the GATS treaty, Article VI.4, known as the Necessity Test, the GATS Disputes Panel will determine whether a national or state law or regulation is 'more burdensome than

necessary' to trade. A similar Necessity Test, included in NAFTA, has recently been applied to the state of California's banning of a gasoline additive, methyl tertiary butyl ether (MBTE), which has leaked from gasoline storage tanks and contaminated water supplies. A Canadian seller of the 'M' chemical in MBTE filed a complaint with NAFTA saying that the rule fails the Necessity Test, in that the state could require all service stations to dig up their storage tanks, reseal them and inspect the results. This would be the least trade-restrictive method for protecting the water supply – 'least trade-restrictive' being NAFTA's Necessity Test. If California does not drop its ban on MBTE, the US Treasury may have to compensate the Canadian chemical firm to the extent of $976 million. Likewise, under the GATS, as described in the Secretariat memo, national regulations will be struck down if they are 'more burdensome than necessary' to business. The notion of 'safeguarding the public interest' is to be rejected in cases brought before GATS tribunals and primacy is to be given instead to the principle of 'economic efficiency.' Under the GATS, the Disputes Panel will decide whether national laws or regulations serve 'legitimate objectives' (Palast 2001b).

We have saved the best for last, however. The WTO makes the audacious claim that the GATT/WTO agreements on trade, together with the WTO dispute settlement system, provide an effective model for enforceable international environmental regulation. From this, the WTO miraculously moves from environmental savage to environmental savior. Such a claim can be examined only through the practice of an institution – in the sense that deeds speak more truthfully than claims. The WTO's practice in this area occurs mainly through the settlement of disputes among member governments about conflicts between issues of trade and issues of environment. Briefly, the dispute settlement system starts when member governments bring conflicts over trade, largely different interpretations of the Articles of Agreement, to the WTO. Should consultation not result in settlement, the WTO's Dispute Settlement Understanding (DSU) requires the establishment of an investigative panel, normally consisting of three persons of 'appropriate background and experience' proposed by the WTO Secretariat or the director-general, from countries not party to the dispute. Panel reports are adopted by the WTO Dispute Settlement Body (DSB), unless the DSB decides by consensus not to adopt the report, or one of the parties notifies the DSB of its intention to appeal. Appeals are handled by a WTO Appellate Board made up of

three of the seven (semi-permanent) members of the WTO Appellate Body. Appeals are limited to issues of law covered in the panel report and legal interpretations developed by the panel. The resulting report is then adopted by the DSB and unconditionally accepted by the disputing parties, unless the DSB decides by consensus against its adoption. Once the panel report or the Appellate Body report is adopted, the government found against has to notify the WTO of its intentions with respect to implementing the adopted recommendations. The DSB keeps implementation under regular surveillance until the issue is resolved, with rules set for compensation, or the suspension of trade concessions in the event of non-implementation.

In DSB cases concerning trade and the environment, intergovernmental disputes have focused on Article XX of the 1947 GATT Agreement. This allows exceptions from the other articles of the agreement dealing with the rules governing trade, for measures: necessary to protect human, animal or plant life or health (sub-section b); and relating to the conservation of exhaustible natural resources (sub-section g), subject to the requirement that these measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade. We looked in detail at the seven cases from the records of the DSB dealing with Article XX in the period 1982–99 (Nordstrom and Vaughan 1992: 81–4). We found that when issues essentially of free trade, on the one hand, and environmental regulation, on the other, come into conflict, the GATT/WTO dispute system always found in favor of trade, and against national environmental regulation. There might be a partial exception to this. In an eighth environmental case, the Shrimp–Turtle case, the WTO dispute settlement system again found several times in favor of trade (WTO 2001a). But in this case the government requesting an exception under Article XX, the USA, made extensive efforts to comply with a series of findings by the WTO's Panel and Appellate Board. In particular, the USA under the Clinton administration made a sustained attempt, which would be difficult to replicate, especially under more right-wing administrations, to comply with the WTO's conception of MEAs. For example, a regional agreement between twenty-four countries was tentatively agreed upon in Kuantan, Malaysia, in July 2000, dealing with the conservation of sea turtles, with the USA actively participating. Even more importantly, the panel's finding came after massive environmental criticism of the

WTO, by demonstrators dressed as turtles, at its Seattle ministerial meeting. (One newspaper account described them as Ninja Turtles!) Yet even this, the panel's decision, was the most tentative finding that could be imagined for environmental exemption under Article XX: in its summation, the panel noted that should any one of its conditions cease to be met in the future, the recommendations of the DSB might no longer be complied with. In other words, in the entire history of GATT/WTO disputes, the WTO has very tentatively allowed one, single exception that conserves environmental resources under Article XX, in this case conservation of an endangered species, under the condition that its trade-oriented rules be strictly followed.

As important as these findings may be, we might look at the method used to conduct such inquiries. Under the GATT/WTO Dispute Settlement Understanding, panel proceedings are confidential. People who are not parties, or third parties, to the dispute are not permitted to attend panel proceedings, nor are transcripts made available. Only the panel's final report, or the Appellate Body report, together with some non-confidential summaries, is publicly released, after the case is over. Moreover, the panelists are selected essentially from Geneva-based officials, ambassadors to the WTO, trade advisors to government trade ministries or academic specialists in trade law and policy, but never environmentalists, usually from an 'indicative list' maintained by the WTO Secretariat. For example, several key decisions on trade and the environment were made by panels chaired by Michael D. Cartland, formerly financial services and economic analysis secretary to the Hong Kong government, and its trade representative to the GATT. The Appellate Body is staffed by semi-permanent members each serving for four years, with the possibility of one reappointment, a process that ensures Geneva-insider representation. Access to the dispute settlement system is limited to WTO member governments. NGOs have a limited ability to participate through *amici curiae* briefs, although panels often refuse to consider their contents. Panels may ask for expert opinions on scientific and technical matters on an ad hoc basis, and have broad discretion on whether they follow the advice they get, or whether to mention this advice (Stewart and Karpel 2000). In one assessment (Ragosta 2000: 9) there is a 'lack of serious democratic controls on the DSB' because the views of ad hoc panelists and Appellate Body members becomes international 'law' without effective means for legislative intervention while, in addition, open hearings, open decisions, rights of affected parties to be heard,

and many other democratic procedures, are absent. And while many people called for opening WTO operations to public scrutiny after the Seattle demonstrations, little has subsequently changed, although at the WTO ministerial meeting in Doha, in 2001, a proposal was accepted to evaluate the dispute settlement process by May 2003 (Finer 2002). Finally, the panel reports on disputed cases are lengthy legal dossiers of several hundreds of pages with long summations of each party's arguments, third-party arguments and expert opinions. Sometimes thousands of pages of records are involved – 20,000–40,000 pages for instance. The panel findings are similarly lengthy – 100 pages single-spaced in the Shrimp–Turtle case. They are phrased in language accessible only to lawyers, making public discussion difficult. And this anti-democratic, legalistic, 'expert'-dominated system, the WTO suggests, is ideal for enforcing international environmental agreements!

Trade and labor

The relationship between free trade and labor rights has long been a contentious issue in the GATT/WTO system. Currently, labor standards are not subject to WTO rules and disciplines. Instead the WTO refers labor standards issues to the International Labour Organization (ILO), formed in 1919, and now a UN agency, where labor rights have been discussed since 1930. Most members of the ILO are also members of the WTO.

As members of the ILO many, but not all, countries approve of the setting of minimal standards for employment and work. Even when countries have ratified such standards, however, implementation and enforcement by the ILO have proved problematic. To revive interest in ratifying and applying a set of conventions, the ILO adopted a Declaration on Fundamental Principles and Rights at Work at its 86th Session in Geneva, June 1998. The declaration argued that, while essential, economic growth was not sufficient to ensure equity, social progress and the eradication of poverty. Instead, the ILO said, guaranteeing fundamental principles and rights would enable people to claim freely 'on the basis of equality of opportunity' their fair share of the wealth they had helped to generate. The fundamental rights subject to ILO conventions were listed as follows:

- freedom of association and effective recognition of the right to collective bargaining;

- the elimination of all forms of forced or compulsory labor;
- the effective abolition of child labor;
- the elimination of discrimination in respect of employment and occupation.

The ILO said it would assist member governments in fulfilling these objectives by making use of its constitutional, operational and budgetary resources, including the mobilization of external resources and support, as well as encouraging other international organizations with which the ILO had established relations to support the effort. The ILO stressed, however, that labor standards should not be used for protectionist trade purposes, and that the comparative advantage of any country should in no way be called into question by the universal declaration of rights (ILO 1998).

In the GATT/WTO, similar issues of labor standards were debated at Ministerial Conferences held at the beginning of the Uruguay Round in Punta del Este in 1986 and at the end of the Marrakesh Round in 1994, at Singapore in 1996, and at Seattle in 1999, the latter two held under the auspices of the WTO. Advocates for linking trade with labor rights in the WTO argue that two of the original GATT articles justify trade restrictions based on violations of fundamental labor rights: Article XX on general exceptions is cited as allowing member governments to restrict trade to protect 'public morals' and 'human life and health' – amending Article XX to include core labor standards would provide more specific exceptions; Article XXIII on dumping is cited when contending that suppressed worker rights in export industries constitute 'social dumping.' The USA, a main supporter of labor rights in the WTO (when Democratic administrations are in power), has not explicitly proposed such interpretations or amendments of Articles XX or XXIII. Since 1987, the USA has instead merely proposed establishing a working party to examine how internationally recognized labor standards relate to international trade and to the objectives of the GATT and the WTO. In this discussion, the USA has gradually come to focus on the ILO core labor standards as key benchmarks for workers' rights.

According to the WTO, member governments are deeply divided on the labor standards issue. On the one hand, some governments in Europe and North America believe that public confidence in the WTO and the global trading system would be strengthened by addressing labor standards. Many organizations, especially among the trade

union movement, want the WTO to take on the labor issue. The Congress of South African Trade Unions (COSATU), among others, has been a strong advocate of this position. Besides trade unions, many non-governmental organizations (NGOs), especially those advancing the cause of human and workers' rights, also advocate this position. Several member governments have suggested that the formation of a working group to study the issue would provide incentives for WTO member governments to improve conditions for workers. On the other hand, member governments, mainly from underdeveloped countries, believe that core labor standards do not belong in the WTO. Governments in these latter countries see labor standards as a disguise for protectionist policies on the part of developed countries. In this view, attempts to bring labor standards into the WTO are a smokescreen for undermining the comparative advantage of lower-wage developing countries. Instead, developing countries argue that better working conditions and improved labor rights come through economic growth. Were core labor standards to be enforceable under WTO rules, they say, sanctions imposed against countries with lower labor standards would merely perpetuate poverty and delay improvements in workplace standards. When the issue was discussed at the 1994 Ministerial Conference of the GATT in Marrakesh the chair of the meeting concluded there was no consensus among member governments on labor standards, and thus no basis for an agreement. At the WTO Ministerial Conference in Singapore in 1996 members of the WTO made the following Ministerial Declaration:

> We renew our commitment to the observance of internationally recognized core labor standards. The International Labor Organization (ILO) is the competent body to set and deal with these standards, and we affirm our support for its work in promoting them. We believe that economic growth and development fostered by increased trade and further trade liberalization contribute to the promotion of these standards. We reject the use of labor standards for protectionist purposes, and agree that the comparative advantage of countries, particularly low-wage developing countries, must in no way be put into question. In this regard, we note that the WTO and ILO Secretariats will continue their existing collaboration. (WTO 1996)

In a closing statement, Singapore Trade Minister Yeo Cheow Tong interpreted the paragraph to mean that 'there is no authorization in

the text for any new work on this issue … Some delegations had expressed the concern that this text may lead the WTO to acquire a competence to undertake further work in the relationship between trade and core labor standards. I want to assure these delegations that this text will not permit such a development.' By comparison, the trade minister of France, Yves Galland, said: 'the major debate of labor standards is here to stay in the WTO. It will never go away.' The acting US trade representative at the time, Charlene Barshefsky, said that Yeo's closing statement represented his own opinion, and that the binding statement on this issue was the ILO's Declaration of Fundamental Rights (Khor 1997).

The US Democratic administration, however, subsequently came under increasing pressure from organized labor, a main base of political support, to make a stronger argument for adding discussion of labor standards to the WTO agenda. At the 1999 Seattle ministerial meetings, the Clinton administration finally proposed that the WTO set up a working party to consider: the relationship between trade, core labor standards, and social protection; positive trade incentives; trade and forced labor; and trade-induced deterioration of national labor standards, with emphasis on export processing zones. In this, the USA was supported by Belgium, France and Norway. After President Clinton told the *Seattle Post-Intelligencer* that the WTO should, at some future point, use sanctions to enforce core labor rights, however, negotiations proved even more difficult than had been expected. As reported by the *New York Times*, the Egyptian trade minister, Youssef Boutros-Ghali, said the Clinton proposal on trade sanctions 'derailed any hope of a compromise agreement' while the trade minister from Pakistan said: 'We will block consensus on every issue if the United States proposal goes ahead … We will explode the meeting' (Greenhouse and Kahn 1999). India, Brazil and Egypt, speaking for the governments of developing countries, opposed creating a working group to discuss labor rights. They argued that the WTO was a commercial contract between governments based on rules and disciplines governing commercial activity and free trade; it was not based on judgments about other aspects of member states' domestic policies, including worker rights and other non-trade issues. To introduce judgments about member countries' domestic policy choices would fundamentally change the legal nature of the GATT/WTO agreements, they said. Developing countries see their low labor costs as essential to export competitiveness. Many trade ministers

from developing countries said that WTO sanctions over labor rights could be disguised protectionist measures that would be used to ban imports from developing countries. The Egyptian trade minister asked: 'Why all of a sudden, when Third World labor has proved to be competitive, do industrial countries start feeling concerned about our workers?' The trade minister of Kenya, Nicholas Biwott, added: 'The best forum to deal with such matters is the International Labor Organization.' By comparison, the American labor movement pushed the Clinton administration to make the WTO impose trade sanctions on nations that violated basic workers' rights, as with the right to form trade unions. They complained that the ILO was a toothless, underfinanced agency, unable even to prevent child labor, or protect the most basic labor rights. Thousands of protesters outside the meetings at Seattle were also insisting that the WTO adopt rules on labor, human rights and the environment. In response to pressures from both sides, and with an election coming up the next year, the Clinton administration transferred its allegiance to a compromise European Union proposal to set up a Standing Working Forum on Trade, Globalization and Labor Issues in which the WTO, the ILO, the IMF and other multilateral groups would examine how globalized trade affects workers (Grace 2000).

When the WTO reviewed Guatemala's trade policies in 2002 the Brussels-based International Textile, Garment and Leather Workers' Federation (ITGLWF), with 225 affiliated organizations in 110 countries, and a combined membership of 10 million workers, drew attention to Korean-owned garment plants, Choishin and Cima-textiles, producing for export to the USA. In 2001, workers at the two plants tried to organize workplace unions under a union federation called FESTRAS. Retaliatory actions by management included inciting non-union workers to commit violence, to the point where the lives of union supporters were at risk if they went to work; bribing workers to resign from the union, or securing letters of resignation from union members under duress; and threatening leaders with blacklisting. The ITGLWF general secretary, Neil Kearney, said that such gross violations of the right to organize demonstrated a clear need for a social dimension to trade and required holding the government of Guatemala to account. The argument was that the WTO's trade review mechanism was intended to encourage governments to fulfill their commitments, including the commitment to observe internationally recognized core labor standards made at the Singapore ministerial

meeting and reaffirmed at the WTO ministerial meeting in Qatar. The WTO was urged to use this review as a way of pressuring the government of Guatemala to honor that commitment. Guatemala's maquila sector is notorious for its anti-union behavior, to the extent that there are currently no collective agreements between employers and any of the 80,000 workers (ITGLWF 2002).

The concluding remarks by the chairperson of the Guatemala trade review committee made no reference to this request from a 10-million-strong international workers' federation, but instead said:

> In conclusion, through this Review we have gained a first-hand appreciation of Guatemala's achievements since the signing of the Peace Accords, and the challenges that lie ahead. It is my sense that Members very much appreciated Guatemala's efforts to improve its economic and social conditions, and encouraged it to continue down this road in order to further its prospects for sustainable economic growth and social development. Economic growth has come hand-in-hand with trade liberalization and other modernization efforts, and Members invited Guatemala to count on the help of the international community to both secure lasting institutional stability and enhance its participation in the global economy. (WTO 2002)

Note especially in this 'summary' the appreciation expressed by the WTO for an improvement in 'economic and social conditions' and the invitation to Guatemala to 'count on the international community' in securing 'institutional stability'!

The result of all this is that the WTO has no worker-oriented policies, despite a vague commitment to 'observe' core labor standards, or even a mechanism for discussing workers' rights and employment standards, or any interest in doing anything to help desperate people in export-oriented plants. While consistently linked to incomes, consumption and lifestyles in WTO rhetoric, trade is isolated from employment and work conditions. This is consistent with a neoliberal perspective that pays respect to people as consumers, yet denies their rights as workers. Notice also that the advanced capitalist countries, where workers have earned some rights through unionization, advocate a more socialized form of neoliberalism, but only in the safe form of trying to get member governments of the WTO to make vague commitments to standards that the ILO has not been able to enforce. Governments representing export-oriented regimes in developing countries resist even this pretense, arguing that their

main comparative advantage, low-cost labor, might be jeopardized. Yet economic activity founded on low-cost labor brings only desperate and precarious social forms of economic growth. We conclude that the WTO trading system, as presently constituted, fosters an antagonistic attitude toward development, in the sense of social benefits to people as workers, as distinguished from economic growth, in the particular form of benefits to people as consumers of low-cost goods. The WTO is anti-labor.

By comparison, business exercises considerable influence at WTO meetings. Confidential documents leaked to Greg Palast, whom we mentioned earlier, provide the minutes of private meetings between the Liberalization of Trade in Services (LOTIS) committee, the UK government's chief services trade negotiators, and the Bank of England, just before the Doha meeting of the WTO. Those attending the closed LOTIS meeting included Peter Sutherland, international chairman of the US investment bank Goldman Sachs and formerly the director-general of the WTO. LOTIS is chaired by the Right Honourable Lord Brittan of Spennithorne, QC, former head of the European Union, and currently vice-chairman of the international banking house UBS Warburg Dillon Read. Other LOTIS members include the European chiefs of Morgan Stanley Dean Witter, Prudential Corporation and PriceWaterhouseCoopers, all heavily involved in investment banking. LOTIS is an outgrowth of the 'British Invisibles,' more formally known as the Financial Services International London group. They were joined at various times by specially invited members of the European Commission's trade negotiating team. The minutes of the meetings indicate that government officials shared confidential negotiating documents with the corporate leaders, as well as inside information on the negotiating positions of the European community, the USA and developing nations. At a meeting held on 22 February 2001, Britain's chief negotiator on the GATS made reference to a European Commission paper on industry regulation that had been privately circulated to LOTIS members for their comment. As mentioned previously, the GATS agreement would affect all public services, from healthcare and education to energy, water and transportation, and would challenge national environmental, labor and consumer laws as 'barriers to trade.' Two sets of documents suggest that LOTIS and other corporate lobbyists have been successful in getting Western governments to adopt their plans to expand the reach of the GATS treaty radically. A confidential memo from inside

the WTO's Secretariat, written four weeks after the LOTIS meeting, indicates that European negotiators had accepted industry-favored amendments to GATS Article VI.4, known as the 'Necessity Test,' requiring nation-states to prove that regulations – from pollution control to child labor laws – are not hidden impediments to trade. Two of the LOTIS meetings dealt with hiring consulting firms and academics to provide government agencies with answers to criticisms by the World Development Movement (WDM), an NGO that questions GATS and the wider globalization agenda. The minutes noted that 'the pro-GATS case was vulnerable when the NGOs asked for proof of where the economic benefits of liberalization lay.' By comparison, an executive of Reuters, a global information company, offered to use his news service for spreading the LOTIS view. The executive told the LOTIS group that he 'wondered how business views could best be communicated to the public' and that Reuters 'would be most willing to give them publicity.' When the minutes of the meeting were released (leaked), the WDM said: 'For a long time conspiracy theorists thought there had been secret meetings between governments and corporations,' but that 'looking at these minutes, it was worse than we thought. [The WTO GATS proposals] are a stitch-up between corporate lobbyists and government' (Palast 2001b).

TRIPs

Our final critique deals with the TRIPs agreement emerging from the Uruguay Round. TRIPs applies basic GATT principles and existing international agreements to intellectual property rights with the WTO as adjudicator. The agreement has raised concerns about the centralization of control over multiple forms of 'intellectual property' (knowledge and its products) in multinational corporate hands. The pharmaceutical industry was a major player in the agreement. This is a highly concentrated industry in which ten companies control 50 percent of global sales mainly in developed countries (25 percent of the world's people consume 90 percent of the drugs). The main benefits of TRIPs have gone to the international pharmaceutical industry, which aggressively protects a highly profitable business with the intensive use of political power – trade sanctions, withdrawal of aid, and so on.

The most controversial issue involves drugs for people suffering from AIDS. Some of the main national actors include India, where the pharmaceutical industry was regulated by the fiercely nationalistic

India Patents Act of 1970. This act fostered the phenomenal growth of the pharmaceutical industry that came to be regarded by UNCTAD as a model for developing countries. In the mid-1990s prices for four typical drugs were ten times more expensive in Pakistan, seventeen times more expensive in Britain and thirty-seven times more expensive in the USA than in India. A year's worth of AZT therapy could be bought in India for $500, compared with $10,000–15,000 elsewhere. In Brazil, the state produces most of the AZT drugs and provides them free, cutting the AIDS infection rate in half (Rosenberg 2001); and in South Africa, where 20 percent of the people are HIV-positive, the minister of health was given permission in 1998 to import Indian drugs and cheap pirate copies. Thirty-nine drug companies brought suit against the South African government to prevent this, but the suit had to be withdrawn under public outcry in 2001, with the drug companies forced to reduce prices on limited quantities of drugs provided to Third World countries. The USA, however, continued to pressure Brazil to stop unlicensed production.

While mandating that WTO members have to allow patenting for medicines, the TRIPs agreement contains some flexibilities. For example, if patented drugs cost too much, government authorities can take measures such as issuing a compulsory license to an agency or company to manufacture or import a generic version of that patented drug, which can then be made more available to patients more cheaply. At the WTO's Ministerial Conference in 2001, the Doha Declaration on the TRIPs Agreement and Public Health was adopted as a response to protests. The resolution recognized the right of member governments to grant compulsory licenses to local drug producers to make drugs needed in emergency situations such as AIDS, malaria and other epidemics. The Declaration said: 'We agree that the TRIPs Agreement does not and should not prevent Members from taking measures to protect public health … We affirm that the Agreement can and should be interpreted in a manner supportive of WTO Members' right to protect public health and in particular, to promote access to medicines for all.' Several flexibilities were established that WTO members can use, such as the right to grant compulsory licenses and the freedom to determine the grounds for these. But countries have to establish appropriate provisions in their national patent legislation by using 'to the full' the flexibilities in the TRIPs agreement. They also have to formulate and implement national policies aimed at providing access to medicines for all. If such laws and policies are not

introduced, the provisions in the Doha Declaration do not translate into actual benefits for patients (Khor 2007).

The issue is, however, complex, and controversy continues. In 2007, in a landmark decision, the High Court in Chennai upheld India's Patents Act in the face of a challenge by Swiss pharmaceutical company Novartis, the world's third-largest pharmaceutical corporation, which hoped to secure patent rights for its Gleevec cancer med. Novartis claimed that India's patent law was not in line with the country's WTO obligations. Half a million people signed a petition, distributed by Doctors without Borders, calling on Novartis to drop this case. India is the primary supplier of cheap generic drugs to the rest of the world. Confusion remains about the WTO rules on drug patents. Under the WTO, only the fifty least developed countries can eliminate patents on pharmaceutical products until 2016. Other countries, including India, Brazil and Thailand, must grant and enforce patents. Any country can, however, issue a compulsory license on a patent and allow third parties, including generic drug companies, to use the patent in return for the payment of a royalty to the patent owner. Brazil and Thailand issued patents, but also granted compulsory licenses in return for royalty payments. The Indian Novartis dispute concerns the amount of discretion WTO members have in deciding what constitutes a patentable invention.

To give another example of this ongoing struggle over low-cost pharmaceutical drugs, in 2007 Thailand was warned by Peter Mandelson, Trade Commissioner of the EU, for trying to decrease prices of drugs for poor patients. Thailand uses compulsory licenses, allowing it to import cheaper generic versions of branded medicines produced by Western companies. The specific case involved Sanofi-Aventis, Franco-German maker of Plavix, a drug for heart disease that has been supplanted by cheaper Indian imports. Thailand was the first middle-income country to break the patent on a medicine to treat a non-infectious disease and to threaten compulsory licenses for an array of other drugs. The Thai government thinks that drug companies doing business in Thailand should offer drugs for no more than 5 percent above the generic cost. The cheap drugs were available through its public health system, covering 48 million poor Thais. And the Thai Ministry of Public Health conducted discussions with pharmaceutical companies for two years, before it made its decision. The EU and the USA protested this formally in February 2007 when the Thai government suspended the patents of three drugs

treating HIV/AIDS and heart conditions. The USA also threatened retaliatory action, placing Thailand on a watch list for intellectual property infringement. Mandelson said this approach is a matter of concern for the EU. It would be detrimental to the patent system, and to innovation and the development of new medicines. Mandelson said it would infringe WTO regulations that allow countries to waive intellectual property rules only to fight emergency health epidemics once all other avenues have been explored (Bounds 2007).

Saga of Doha

The Seattle ministerial meeting in 1999 launched the WTO's Millennium Round. But, untrue to its name, the round disappeared soon after the millennium dawned. And, for a while, it looked as though the Seattle protests had made it impossible for the WTO ministers to meet again. The WTO General Council, meeting in Geneva, tried to re-establish regular meetings and discussions. And, after fifteen years of negotiations, disputes and stand-offs, China was finally given formal approval to join the WTO – China's entry is particularly important given the low cost of its manufactured goods and the threat its exports pose to manufacturing systems all over the world under free-trade conditions. Robert Zoellick, G. W. Bush's appointment as US Trade Representative, tried to launch a new 'market access' round of WTO negotiations, but was unsuccessful. At the European Community, Pascal Lamy, European Community Trade Commissioner, called for the WTO to proceed without ending the EU's huge agricultural subsidies, again without result. Then came the September 11, 2001 attacks on the World Trade Center in New York and the Pentagon in Washington, DC. From the ashes of the World Trade Center came a new argument for a global economy centered on world trade. A new round of WTO negotiations was seen by First World politicians as a way of addressing the economic turmoil exacerbated by the September 11 attacks. Some politicians and business leaders equated liberalism (openness, trade) with freedom and prosperity, as opposed to terrorism (closed, isolated). Robert Zoellick deftly combined neoconservative geopolitics with neoliberal economics in a call for WTO action:

> Why is this WTO meeting important for America and the world right now?
>
> The events of September 11 have set the stage for our work,

> just as officials meeting in Geneva 54 years ago needed to consider the imperatives of their time. America and the world have been attacked by a network of terrorists who are masters of destruction, but failures at construction. They stand for intolerance and abhor openness. They fear foreign ideas, religions, and cultures. They see the modern world as a threat, not an opportunity. They leave people in poverty and half of humankind, women, in subjugation. Their strategy is to terrorize and paralyze, not to debate and create. The international market economy – of which trade and the WTO are vital parts – offers an antidote to this violent rejectionism. Trade is about more than economic efficiency; it reflects a system of values: openness, peaceful exchange, opportunity, inclusiveness and integration, mutual gains through interchange, freedom of choice, appreciation of differences, governance through agreed rules, and a hope for betterment for all peoples and lands. Therefore, just as the Cold War reflected a contest of values, so will this campaign against terrorism. Just as our Cold War strategy recognized the interconnection of security and economics, so must America's strategy against terrorism. By promoting the WTO's agenda, especially a new negotiation to liberalize global trade, these 142 nations can counter the revulsive destructionism of terrorism. (Zoellick 2001b: 4)

Third World countries came under pressure to accept a new round of trade negotiations, even though they had, for years, been concerned with exactly the *un*democratic nature of decision-making at the WTO. As reported by the *Guardian*, developing countries complained that they were being pressured by the threat that failure would destroy the WTO and damage the world economy. 'We are made to feel that we are holding up the rescue of the global economy if we don't agree to a new round here,' said Richard Bernal, a Jamaican delegate. Some delegates were told by lobbyists that the EU and the USA were threatening the most recalcitrant developing countries with losing access to Western markets under established trade deals if they continued to oppose new talks (Denny 2001). Zoellick and Lamy then forced through the fourth ministerial meeting held from 9 to 14 November 2001. The meeting was held in Doha, capital of Qatar, whose repressive laws on protest made it the ideal post-Seattle convention site. The November 2001 Doha Declaration of the Fourth Ministerial Conference of the WTO said that trade could play a major role in the promotion of economic development and the alleviation of poverty. It

said that all people should benefit from the 'increased opportunities and welfare gains that the multilateral trading system generates.' In a version of the 'failed states' argument (in which disorganized, poverty-stricken regions are safe-haven breeding grounds for terrorists) it recognized the 'particular vulnerability of the least-developed countries and the special structural difficulties they face in the global economy.' It said that the WTO was committed to addressing the marginalization of least developed countries in international trade and to improving their effective participation in the multilateral trading system. The Doha Declaration sought to place their needs and interests at the heart of the WTO's work program through two routes: (1) improving market access to Northern markets for developing countries by reducing import tariffs that prevent increased prices and distort competitiveness; (2) phasing out domestic and export subsidies that enable the overproduction of goods at low prices, often leading to the dumping of these goods at prices that are cheaper than those of locally produced goods. The most strategic area identified for 'reform' at Doha was agriculture, followed by non-agricultural market access (NAMA), trade in services (GATS), developing-country issues (Special and Differential Treatment), and aid for trade. The round was optimistically set to be concluded by December 2006 (WTO 2001c).

The main issue was the WTO Agreement on Agriculture (see our outline of the agreement earlier), with negotiating proposals submitted on behalf of 121 member countries. The long-term objective of the agreement was establishing a 'fair and market-oriented trading system through a program of fundamental reform encompassing strengthened rules and specific commitments on support and protection in order to correct and prevent restrictions and distortions in world agricultural markets' (ibid.). This meant improvements in market access; phasing out export subsidies; reducing trade-distorting domestic support (subsidies to farmers); all within considerations of special and differential treatment for developing countries.

The story behind this runs as follows. In the First World, subsidies are given by governments to farmers supposedly to protect traditional values by preserving vibrant rural cultures. Beginning in the 1930s most industrialized countries developed agricultural price-support policies to reduce the volatility of prices for farm products and to stabilize farm incomes. In food-exporting countries, such as the USA and France, agricultural subsidies are designed primarily to increase

farm income, either by raising the long-term level of prices above free-market levels, or by providing direct payments to farmers. In the USA agricultural subsidization dates back to the Agricultural Adjustment Act of 1933, which paid farmers not to plant, or to destroy, crops and animals in order to reduce supply, raise prices and increase farmer incomes. By 2000 aid to farmers (including so-called emergency payments) was $22 billion, three times the 1996 level. In 2007, the US Congress passed the Farm Bill Extension Act, a $290 billion, five-year agricultural policy bill that continues a long history of agricultural subsidy as well as pursuing other areas, such as energy, conservation, nutrition, and rural development. Congress overrode a presidential veto on a vote of 316 to 108, indicating wide political support in the USA for farm subsidies and making it improbable that the USA would comply with any WTO-mandated reduction of farm subsidies. The EU similarly gives subsidies of $50 billion a year to farmers under the Common Agricultural Policy. Half the EU support goes, however, to 1 percent of producers – including the richest man in the United Kingdom, the Duke of Westminster, who owns about 55,000 hectares of farm estates, and received a subsidy of $480,000 as direct payments in 2003/04, and in addition gets $550,000 a year for the 1,200 dairy cows he keeps. In the USA 70 percent of farm subsidies go to 10 percent of the producers, mainly agribusinesses – recipients of federal agricultural support included media billionaire Ted Turner and David Rockefeller, whose family is, well, not exactly short of money. On the other side, Third World countries argue that under WTO rules they are forced, by threat of sanctions, to stop supporting their farmers, and to open their food markets to foreign competition, while the USA and the EU are allowed to massively subsidize their farm corporations. The effect of these subsidies has been to flood global markets with below-cost commodities, depressing prices and undercutting producers in poor countries. Once introduced, subsidies have proved extremely difficult to end. Agricultural subsidies in the USA, the EU and Japan were issues of contentious debate in the Uruguay (1986–94) Round of international trade negotiations under the GATT, and remained so in the Doha Round.

At the WTO, a group of middle-income agricultural exporting countries, the G20 (Group of 20, also variously known as the G21, G22 and G20+), which includes Argentina, Brazil, China, India, Indonesia, Mexico and South Africa, pressed for an end to agricultural subsidies in industrialized nations. Specifically, they called for the

elimination of export subsidies on products of interest to developing countries, the reduction of tariffs, and designation of 'Special Products' by developing countries (i.e. allowing protection for products important to a developing country's food security), reduction of 'Blue Box' supports (i.e. trade- and production-distorting supports), capping of 'Green Box' supports (those with minimal distorting effects) and reducing US subsidies to cotton farmers (Tussie 2004). Theoretically, the USA has said that it wants to remove all trade barriers. But it is subject to political pressure from farmers' groups (especially the American Farm Bureau Federation) influential in states that are key to the Republican vote. The USA wants merely to *limit* its farm subsidies in some way – and indeed, given the reluctance of Congress to countenance any intrusion into farm subsidization, that is the most that the Trade Representative can offer. The EU has said it would cut average farm tariffs by a half, eliminate export subsidies by 2013, and cut trade-distorting domestic farm subsidies (Blue Box) by 70 percent. First World countries demand that these offers to reduce farm subsidies (fragile though they might be) have to be matched by commitments from developing countries to lower their barriers on services and non-agricultural goods (NAMA). Rich countries also want to limit the scope of Special and Differential Treatment (SDT) measures that soften the impact of tariff reductions for developing countries. Also, they want to decrease or eliminate non-reciprocal Preferential Trade Agreements (PTAs), which allow least developed countries to benefit from lowered tariffs on certain products, to boost their access to international markets without the requirement of lowering their own tariffs in return. The EU wants to replace its non-reciprocal PTAs with African, Caribbean and Pacific (ACP) countries with Economic Partnership Agreements (reciprocal free-trade agreements negotiated on a bilateral basis) that would require the elimination of ACP tariffs.

The other main issues discussed in the Doha Round include making the TRIPs agreement more flexible for poor countries through a declaration by ministers that 'nothing in the TRIPs agreement shall prevent governments from taking measures to protect public health.' As well, negotiations on Non-Agriculture Market Access (NAMA) call for a reduction in or elimination of tariff peaks, tariff escalation, high tariffs and non-tariff barriers, particularly on non-agricultural goods that are of export value to developing countries.

The WTO Ministerial Conference of 2003 was held at Cancún,

Mexico, amid massive protests. South Korean Farmers and Fisheries president Lee Kyung Hai committed suicide on the first day of the conference in protest against the price-distorting agricultural subsidies of the EU and the USA. The North–South divide was most prominent on issues of agriculture. Rich countries' farm subsidies (both the EU's Common Agricultural Policy and the US government's agro-subsidies) became a major source of contention. At the conference it became clear that Third World countries were beginning to assert themselves, stick up for their interests, and resist intense US and EU pressures. The G90, otherwise known as the Group of 90, an alliance among the poorest and smallest developing countries in the WTO, emerged as a strong grouping at Cancún. The Cancún ministerial convened to forge concrete agreement on the Doha Round objectives collapsed after four days. Member countries could not agree on issues of farm subsidies and access to markets.

In August 2004 a General Council meeting in Geneva culminated in a 'framework' to restart talks, the so-called 'Geneva Decision' in which the USA, the EU, Japan and Brazil agreed to end export subsidies (although neither the USA nor the EU is mandated to remove its export subsidies until the other does so), reduce agricultural subsidies by 20 percent (although with a 'cap' on product-specific subsidies at their 'respective average levels') and lower tariff barriers, while developing nations agreed to reduce tariffs on industrial goods, with the right to specially protect key industries. The framework also provided for simplified customs, and stricter rules for rural development aid. Note that this was a General Council meeting, not a ministerial.

The Sixth WTO Ministerial Conference took place in Hong Kong, 13–18 December 2005. This meeting was supposed to culminate the Doha Round. And on the last day, the WTO member countries, some pressured by First World economic and political interests, managed to present a common Ministerial Declaration. Poor countries conceded to rich countries' interests in freeing trade in NAMA goods and services in exchange for some concessions on export subsidies for agricultural goods. The EU promised to eliminate export subsidies by 2013 – although this form of subsidy accounts for only 3.5 percent of the EU's overall agricultural support. Thousands of protesters demonstrated outside the Hong Kong Convention and Exhibition Center, the location of the talks. Clashes with the police left 116 people injured, including 56 police officers.

The July 2006 talks in Geneva failed to reach an agreement about

reducing farming subsidies and lowering import taxes. Director-General Pascal Lamy said there were no significant changes in the negotiators' positions and the gaps remained too wide. Faced with this, Lamy recommended suspension of the Doha negotiations to 'enable the serious reflection clearly necessary on the part of participants.' The US Trade Promotion Authority Act of 2002, giving the president 'fast-track' authority to negotiate trade deals with other countries, while granting Congress the right only to agree or disagree, but not to amend, expired in 2007. This authority had made promotion of trade deals easier for the US administration.

In a sign of the times, in June 2007 four regions considered to be key members of the WTO – the USA, the EU, Brazil and India, or 'G4' – met to break the deadlock blocking global trade negotiations. A major impasse opened between them. The main disagreement was over market access and cutting rich-nation farm subsidies. Brazil's foreign minister, Celso Amorim, described the negotiations as an unequal 'rate of exchange' in that the two First World countries did not want significant changes in their agricultural subsidies, while still insisting on large industrial tariff cuts in developing countries. The talks were suspended. Following this, the new US Trade Representative (after Zoellick was made president of the World Bank), Susan Schwab, began saying that a small group of developing countries was threatening to block progress in the Doha negotiations, while, in contrast, the USA was eager to reach a deal. As Schwab put it:

> slippage occurs when negotiations are reframed to placate the outliers, the naysayers, and the obstructionists. Efforts to achieve consensus in the WTO are critical, but not if they generate a lowest-common-denominator outcome that fails to generate economic growth. Second, it is crucial that developing countries continue to be fully represented at the negotiating table. With that place at the table, however, comes a degree of responsibility and accountability that several advanced developing countries, who have become major players in the global economy, have not yet been willing to undertake … this is not a North–South fight. Forward-leaning developing countries that wish to make and benefit from market access contributions in an ambitious scale should be treated with the same respect as their less albeit louder counterparts. (Schwab 2008: 5–6)

The accusatory and aggressive tone of Schwab's speeches brought negative responses from Third World countries' diplomats at the

WTO. Groups of Third World countries met separately to consider their collective position in the WTO – for example, summit meetings of the India–Brazil–South Africa (IBSA) Dialogue Forum, and four developing country groupings, the ACP Group, the African Group, the NAMA-11 and the Small and Vulnerable Economies Group. And in a landmark decision, the WTO Appelate Body in 2008 ruled against US cotton subsidies in a case brought by Brazil. The WTO report supported Brazil's claim that the $3 billion in subsidies the USA pays cotton farmers distorts global prices and violates international trade rules. In its complaint, Brazil used data from the US Department of Agriculture to argue that the subsidies increased American cotton output, taking away potential export markets from Brazil, and undermining the livelihoods of its farmers. Brazil also claimed that the USA was providing illegal export subsidies to American agribusiness, which was given $1.7 billion to buy American cotton from 1999 to 2001, the period covered in the WTO case. The combined aid has helped make the USA the world's biggest cotton exporter, with more than 40 percent of the world market (FarmPolicy.com 2008).

Finally, in July 2008, in meetings in Geneva, a last attempt was made at concluding the eight-year-old Doha Round. Trade ministers from thirty selected delegations convened in 'Green Room' negotiations – the list of countries invited was not made public, nor is there a formal record of discussions in these 'informal meetings,' leading the left-out countries to complain about 'lack of transparency.' The Indian commerce minister, Kamal Nath, objected to the double standard of developed countries wanting 'carve outs' (special treatment or exemptions) for themselves to continue to protect their rich farmers, while denying India and other developing countries the possibility of defending the livelihoods of their poor farmers. The Indian delegation insisted that there be protections for their farmers from the surge in imports that inevitably follows tariff cuts – in Ghana in 1998, for example, local rice production accounted for over 80 percent of domestic consumption, but by 2003, after liberalization, the figure was less than 20 percent. India wanted the right to protect farmers should a similar cataclysmic event begin to occur. Faced with rising food prices, a number of Third World countries, led by India and China, opposed opening up their agricultural markets, either by blocking imports of strategic products, such as rice or grains, or through rules that would allow them to rapidly increase 'safeguard' tariffs if faced with a sudden flood of imports. The USA and the EU

proposed a threshold before such support could be given that was too high to be meaningful. Backed by many other countries, India held its ground. The talks collapsed. The EU Trade Commissioner said that this 'buried' the Doha Round (Davis and Miller 2008). In the aftermath, the conventional wisdom became: 'the era in which free trade is organized around rules set in the West – with developing nations following along – definitely appears over, and few are mourning its demise. Even in America … advocates of the system are on the defensive' (Sanger 2008).

Opposition to the WTO

For years GATT operated virtually without opposition from social movements. But during the Uruguay Round of negotiations the realization developed among many ordinary people that more than just tariffs were being negotiated. Opposition by small farmers, labor unions and environmentalists began to build. And it was recognized that significant aspects of national sovereignty would be lost to an organization, the WTO, which no one had elected. A number of NGOs, representing citizens' groups, environmentalists, labor, anti-corporate and anti-globalization movements, showed increased interest in the effects of free trade. The GATT ministerial meeting in Brussels in 1990 was met by thousands of demonstrators. At the 1992 Rio Earth Summit NGOs tried to introduce alternative treaties that opposed GATT, while similar attempts were made to introduce alternative statements at the Marrakesh signing of the Uruguay Round agreements (Dunkley 2000: 101–2). Opposition to free trade became far more evident in the USA, Canada and Mexico during the extensive discussions leading to NAFTA, signed in 1992. The Zapatista rebellion, which began in January 1994, was timed to correspond with the implementation of NAFTA, which Subcomandante Marcos called 'a death certificate for the Indian peoples.' NAFTA and the GATT/WTO system came to be seen as linked expressions of a new economic model, corporate globalization, in publications by Ralph Nader, founder of Public Citizen, and Lori Wallach, director of Public Citizen's Global Trade Watch (Nader and Wallach 1996). The second Ministerial Conference of the WTO, held in Geneva in 1997, and planned as a birthday celebration to mark the fiftieth year of the free-trade system, was met by 10,000 protesters in a generally peaceful demonstration over the social dislocations caused by free trade. Gathered under the rubric of 'People's Global Action,' the

groups protesting at Geneva represented farmers who believed that with the removal of trade barriers multinational corporations would take over their markets and lands, workers protesting about job losses, and consumers concerned about harmful products such as tobacco and genetically engineered foods.

The lead-up to the Seattle ministerial in 1999 was marked by extensive preparations involving a network of environmental, labor and human rights organizations. Groups active in the Seattle protests against the WTO included the Abya Yala Fund, supporter of indigenous peoples; A SEED, an environmental and development organization; the AFL-CIO; the Alliance for Sustainable Jobs and the Environment; Amazon Watch; the Anarchist Action Collective and the Black Army Faction, two militant anarchist groups based in Eugene, Oregon; Christian Aid; CISPES, Committee in Solidarity with the People of El Salvador; Citizens Trade Campaign; Consumers International; Direct Action Network; Earth Justice Legal Defense Fund; 50 Years Is Enough; FOCUS on the Global South; French Peasants Confederation; Friends of the Earth; Global Exchange; Greenpeace; the Humane Society; Indigenous Environmental Network; Institute for Local Self-Reliance; IAMAW, a machinists' and aerospace workers' union; International Brotherhood of Teamsters; ICFTU, a confederation of free trade unions; International Forum on Globalization; NO2WTO, an anarchist group; the National Labor Committee; National Lawyers' Guild; Oxfam International; People's Decade for Human Rights Education; Peoples' Global Action; Project Underground, a human rights and environmental group; Public Citizen's Global Trade Watch; Rainforest Action Network; Ruckus Society (providing training in civil disobedience); Sheet Metal Workers' Union; Sierra Club; the Sierra Club's Responsible Trade Program; Southwest Network for Environmental and Economic Justice; Third World Network; UNITE, Union of Needle Traders, Industrial and Textile Employees; United Automobile Workers; United Farmworkers of America; United Steelworkers of America; and United Students against Sweatshops. In particular, the 'teamster–turtle alliance,' the banner phrase emerging from the Seattle protests, referred not so much to the Teamsters' Union specifically as to a newly constituted alliance between labor unions and environmental groups that characterized the protests. For example, the Alliance for Sustainable Jobs and the Environment is a coalition of Earth First!ers and Steelworkers, opposed not just to the WTO but to all manifestations of global capitalism that exploit

workers and the environment (Cockburn et al. 2000: 8–9). The Seattle protest movement was characterized also by extensive communication through the Internet and by the preparation of considerable quantities of accurate information on the WTO, particularly by Public Citizen's Global Trade Watch, Global Exchange, the International Forum on Globalization, *The Nation* and other research/political action groups, teach-ins, and a public debate held in the Seattle town hall featuring spokespersons for both sides of the argument on globalization and free trade. Indeed, the protesters probably knew more about the WTO than many of the delegates after reading *A Citizen's Guide to the World Trade Organization* published by Global Exchange (1999) or *Whose Trade Organization? Corporate Globalization and the Erosion of Democracy* put out by Global Trade Watch (1999).

The essential position of the anti-WTO demonstrators in Seattle can be gauged from a press statement, made in early November 1999, by Jerry Mander, president of the International Forum on Globalization, an educational and research institute composed of some sixty scholars, activists and economists from twenty countries. The following arguments were made:

1 The WTO has been ceded crucial new powers, including major enforcement powers, beyond those given to any other international organization, including the UN.
2 The WTO has presided over the greatest transfer in history of real economic and political power from nation-states to global corporations.
3 The WTO has come to rival the IMF as one of the most powerful, secretive, anti-democratic bodies and threatens to soon become the world's first bona fide, unelected global government.
4 Among the WTO's powers is the ability to challenge any member nation's constitutional rights to make laws and standards found to be obstacles to corporate free trade, as defined by the WTO, and as ruled upon by its own tribunals, whose deliberations are closed to the public.
5 These tribunals have consistently ruled against the environment and the interests of Southern, underdeveloped nations.
6 The obstacles to free trade that the WTO wants to remove are actually national, state and provincial laws made on behalf of the environment, small farmers, public health, consumers, food safety, local culture, small business, labor and hundreds of other

concerns and regulations that citizens of sovereign nationals may view as important, but that may be inconvenient for corporate free trade.

7 The goal of the WTO is to expand the freedoms of corporations to act beyond the reach of any national regulations and to diminish the rights of national governments to regulate commerce on behalf of human beings or nature. (Mander 1999)

While there were differences among the opposition groups, they shared the following demands:

1 No expansion of the WTO's power and authority into new areas such as investment, procurement, services or agriculture; no new biotechnology agreement; and no new Millennium Round of negotiations.
2 Public reassessment of the WTO's performance, and discussion of how it could be made more democratic, transparent, accountable and responsive to a completely different hierarchy of values, such as social equity, ecological sustainability, cultural and biological diversity, and national and regional economic and food security, above the welfare of corporations.
3 Should such a reform not be achieved, closing the WTO down, and devising a system that involves the non-corporate community as full participants in the process.

The Seattle demonstrations against the WTO marked the beginning of a new kind of radical activism different from the gender and identity concerns of the early 1990s (Cockburn et al. 2000: 3–4). Opposition to free trade produces a diverse politics composed of a network of interlocking concerns ranging from the environmental effects of trade and unregulated growth to the effects on displaced workers, to indigenous peoples and peasants, to the undemocratic nature of the WTO as an institution. This diversity lends unpredictability to the demonstrations as groups cohere and splinter. Alliances and commitments formed around the Seattle protests have continued – to the degree that, since Seattle, every major international economic meeting has attracted massive protest.

Types of critical response

Three types of critical response to the WTO have developed: contestation and reform (restrained globalization); globalization from

below (democratized globalization); and 'delinking' (localization instead of globalization).

Movements of *contestation and reform* try to recover the state's authority in regulating trade in the interests of delivering social benefits. Such movements are typically peace and human rights organizations, groups fighting structural adjustment, groups advocating land reform and some anti-corporate groups. These movements contest limitations on state authority and, thus, sovereignty in decision-making under the existing forms of neoliberal globalization. As part of this, they challenge the subordination of social priorities to 'international competitiveness.' These movements sponsor national legislation, mount judicial challenges, mobilize international agencies and actively engage in boycotting and protesting. Jubilee South and 50 Years Is Enough mobilize against the WTO because, as with IMF and World Bank structural adjustment, they see governments losing power to international agreements.

Globalization from below refers to movements based in a kind of people's internationalist populism that wants to replace the existing institutions of governance with radically democratic ones. The main groups articulating this approach are environmental movements, socialist movements, labor movements, anti-Free Trade Area movements, the Zapatistas in Mexico and other indigenous peoples' movements. The basic idea behind movements of this type is that alliances of people threatened by environmental degradation, human rights abuses and lax enforcement of labor standards can be formed that hold corporations and governments accountable to the people in what has been referred to as 'global civil society.' These movements oppose globalized neoliberalism with globalized resistance movements. The Zapatista movement in Chiapas, Mexico, characterizes globalization from below in two main ways: an insistence on self-determination rights for indigenous peoples and peasants, and at the same time a recognition of solidarity with all oppressed peoples. The Zapatistas held the 'First Intercontinental Encounter against Neo-Liberalism and for Humanity' in Chiapas in April 1996, attended by 3,000 international delegates from forty-three countries, followed by conferences in Berlin and Spain in 1997. The Zapatistas reject export-based economies, international lending agreements, free trade, privatization and other forms of economic liberalization, and want to redistribute land and abolish poor peoples' debt as the core of a different type of economic change. The Zapatistas address the

multiple oppressions of race, gender and sexual orientation, and insist that the only way to provide justice and dignity for indigenous peoples is to change the entire racialized system. They insist that power has to be 'collective and communal' and want to create non-electoral approaches to democratic change.

Delinking refers to the relocalization of livelihood ideals and a return to local sovereignty. This set of ideas proposes a radical restructuring of the globalized political economy with localities voluntarily cutting themselves off from global markets in labor, goods and capital. Although this is the least familiar form of resistance, a number of activist groups, including anarchists, movements in defense of small businesses, sustainable development movements, sovereignty movements and religious nationalist movements, embody its goals. Three distinct concerns inform their ideas: economies in dialog with their ecological bases; community economic health; and political autonomy, including the assertion of a people's right to govern their own lives. The most articulate version comes from anarchist thought, which has long advocated local economic autonomy and the disappearance of the state. With a prolific youth membership, anarchism is involved with animal rights, feminism, anti-racism, music, homelessness, free speech and concerns about police and prison abuse.

Does the WTO have to go?

After the Second World War trade reassumed the crucial position for the growth of economies it had held in the second half of the nineteenth century. Increasingly trade became the single most important part of the expansion of economies linked into a globalizing system. Global institutions governing the conditions of trading relations among countries were, at least potentially, placed in positions of great political-economic power. But the recognition by nation-states, particularly the USA, that the global governance of trade might exert significant control over national economies, and the apprehensions aroused by this in a system riven by international competition, long prevented this potential from being formalized in an institution. Instead international trade was intermittently regulated through rounds of bilateral and multinational negotiations and the set of agreements known as the GATT – 'intermittently' because agreements could be unilaterally abrogated, retaliatory actions could easily be initiated, especially by powerful countries, and there was little in the way of an enforcing mechanism. But the number of countries

involved in the GATT rounds grew, the proportion of world trade that came under its aegis increased, and a system of power relations stabilized under the domination of the USA, so that finally the GATT could be concretized as the WTO.

The basic power of the GATT and the WTO resides in GATT Article I, the general most favored nation treatment clause, saying that any advantage, privilege or immunity granted by any member country to another shall be immediately and unconditionally accorded to all other member countries. That is, lower tariffs granted to a favored nation are automatically extended to all members of GATT/WTO, but are not necessarily granted to non-members, unless negotiated separately through bilateral agreements. By joining GATT/WTO a country can gain far freer access to global markets for its exports, with the WTO deciding if access rights are granted and exercised. This places the WTO at the center of power in the regulation of the global economy, in a position different in emphasis from (in that trade is the focus), but at least equal in importance to, that occupied by the other IFIs. And given the extensions made to the power arena of the GATT during the Uruguay Round into services, intellectual property rights and the governance of certain capital movements, even as it came into being the WTO was also assuming a dominant position in the global economic governance structure.

The WTO is an institution formed through the interactions of governments under certain conditions. Governments meet at the WTO through their trade ministers, trade representatives and delegates under specific circumstances – to discuss trade issues; with declared immediate objectives in mind – to reduce trade barriers and settle trade-related problems; and with an overall purpose – to increase the volume of trade, increase production and raise incomes. Even more than an institution, the WTO is a place, or a restrictive discursive space, where intergovernmental meetings occur, experts congregate, expertise is employed, and decisions are made within a common understanding expressed in a specific, political-economic language. In other words, the WTO is an agent dominating a center of hegemonic power, as outlined in Chapter 1, part of a broader complex of institutions, mostly UN-connected, in Geneva, and ensconced within a broader geo-economic regime. In the dialog that occurs within this power-space, economies are viewed from entrenched positions, and discourse is contained within limits on what is taken seriously, as part of a 'constructive dialog,' and what is regarded as irrelevant, frivolous,

'not constructive' or, recently, 'obstructionist.' The approved dialog now centers on free trade, within an overall neoliberal conception of economic growth, justified through the universalistic belief that everyone benefits (mainly as consumers) from trade and growth.

This discursive hegemony rests on the assumption that 'free trade is good for everyone concerned' and this in turn is based in Ricardo's theory of comparative advantage – here we raise issues discussed previously in Chapter 1. Pascal Lamy, WTO director-general, said in 2006:

> There is a popular story among economists that when a critic asked Paul Samuelson, a Nobel-prize laureate, to provide a meaningful and non-trivial result from his discipline, Samuelson responded: 'comparative advantage.' The theory by David Ricardo, who uses the example of England producing cloth and Portugal producing wine, and both of them growing their output of these products through specialization, is the basis for the idea of the benefits of open trade.
>
> By producing goods and services in which it has a comparative advantage – and importing others – a country manages to create more value than it would otherwise do. In ideal conditions, trade allows countries to specialize in products that they produce best – and import others, and everyone stands to gain. As a consequence, the economies of all countries grow. (Lamy 2006)

But if we examine the England–Portugal trade exchange closely, we find that 'free trade' between cloth and wine did not benefit both countries equally, but benefited England exclusively (Sideri 1970). From the beginning of modern economics, comparative advantage and free trade moved understanding in a direction that has not only been biased, but in one main part at least (universal advantage) has been fundamentally wrong in the positivistic terms normatively accepted by the discipline of economics – truth as representational accuracy. Economists who have proclaimed on this basis that free trade is universally beneficial have been equally mistaken all along, and are wrong now. Trade policy based in this theory is equally without foundation – it is simply biased opinion. Free trade creates a global space within which benefits accumulate to a few people (industrialist capitalists, multinational corporations, finance capital) in a few dominant countries (Britain, the USA, Japan, and now China), and this does not benefit humanity but renders it into unequal parts, the rich and the poor. By comparison, the guardian of the resulting global

free-trade system, the WTO, says that it serves the interests of all equally in that free trade produces economic growth which produces higher incomes for everyone.

When everyone is equal, we suspect that some might be more equal than others. In thinking further about this, consider the items whose international movements are 'liberalized' under WTO agreements – commodities, services and the capital associated with their production. Who produces these? Corporations. And what movements are not covered? Workers wishing to move to areas where wages are higher or working conditions better. Consider too that issues of worker rights can hardly be raised, let alone discussed, within the WTO, and that the institution's record on the regulation of environmental relations belies its rhetoric on multilateral agreements. Consider as well that intellectual 'property' rights apply mostly to multinational corporations, not singers desperate for the revenues lost by pirated CDs. And remember the influence of the investment bankers on trade missions.

From these and the many other considerations arising from our detailed examination, we conclude that the WTO acts in the interests of multinational corporations in creating a global economic space freed from governmental regulations that might otherwise restrict the movement of capital. We find that governments interact within the WTO under conditions that limit discussion to an approved set of topics using the language of neoliberal optimism. Furthermore, the WTO itself, as an organization, is active in the formation, promotion and protection of the free-trade component of an overall neoliberal ideology. It promotes the extension of its own powers of regulation into vast new areas, such as intellectual property rights, which are governed in the most undemocratic of ways – within closed rooms, where an already committed expertise rationalizes foregone conclusions. Under the influence of the US Trade Representative, the WTO was a nasty, reactionary organization, employing personal attacks on those who disagreed with its positions and tactics. This led, over the last few years, to resistance from Third World countries within the organization, to the degree that each time the WTO tried to meet under the Doha Round, it disintegrated into dissensus. Meanwhile, as with the Brazil–US cotton case, the dominance of the USA is finally being seriously questioned. The power of Third World countries such as Brazil, China and India is rapidly increasing. The days when a few First World countries could dominate trade discussions are over, and

the WTO finds itself having to change radically, or be dismissed as a serious global governance institution.

The center of power around trade is a focal point of controversy. As a crucial dimension of contemporary economic life, trade is an activity that can be used for political and social change. This need not be 'reform' that benefits corporations. Trade is a discursive space that has to be opened to a broader, democratic process, where social movements represented by highly informed NGOs are active agents, and alternative conceptions such as fair trade, under which workers get a living wage and environments are actively protected, contend with equal force. Unless these kinds of fundamental changes are made, and regardless of the increasing independence of Third World countries, the WTO is a dangerous new form of global state … that has to go!

SIX

Global financial capitalism and the crisis of governance

The international financial institutions (IFIs) that form the focus of this book operate within the broader societal system of capitalism. In this final chapter, we want to stand back from our detailed discussions of the particular governance institutions to look at the changing nature of global capitalism. The IFIs, especially the IMF and the WTO, are undergoing their own internal crises – the IMF left with not much of a role to play, the WTO dissolving in struggles among groups of member states. But we have looked at these internal crises enough already. Now let us try to relate the internal crises of the global institutions to the partly external crises in the capitalist system.

The late twentieth century saw the emergence of a new kind of capitalism. A capitalism dominated by huge corporations producing commodities and services was replaced by a capitalism dominated by huge corporations controlling access to investment capital. In the new 'global finance capitalism' finance is the leading fraction of capital; dominant governments, like those of the USA and Britain, and global governance institutions, like the World Bank and the IMF, are integral parts of the financial apparatus, trying to rescue private finance and even merging with it, especially at times of crisis; financial capitalism normally operates on a global scale; and thus finance capitalism takes the total form of a political-economic-ethical-cultural and spatial system. The term 'finance capital' was coined originally by the Austrian Marxist Rudolf Hilferding (1981), meaning an increasing concentration and centralization of capital, in the institutional form of corporations, cartels, trusts and banks. More recently, David Harvey (2005) has argued that ownership (shareholders) and management (CEOs) have fused together, in capitalist enterprises, as upper management is paid more in stock options than in salaries. Increasing the price of the stock becomes the objective of operating the corporation. And productive corporations, diversifying into credit, insurance and real estate, have become increasingly financial in orientation. This is connected to a burst of activity in an increasingly unregulated,

and rapidly globalizing, financial sector in 'the financialization of everything,' meaning the control by finance of all other areas of the global economy.

Nation-states, individually (as with the USA) and collectively (as with the G7/8), together with the IMF and the World Bank, have to support these financial institutions, and the integrity of the financial order, for that is what keeps economies going (witness the massive intervention of the central banks in the financial crisis of 2007/08). The main difference between Hilferding's finance capital and today's global finance capitalism is a greater abstraction of capital from its original productive base, the faster speed at which money moves across wider spaces into more places, the level, intensity and frequency of crises that take financial rather than productive forms, and the spread of speculation and gambling into every sphere of life. We have also seen the 'democratization' of finance capital through inclusion into the reserve army of the financiers millions of people who benefit through home ownership, pension fund investments, mutual funds and education savings. No longer do we just have fat cats or sharp kids manipulating share prices, but millions of 'quasi-capitalists' worry all night about their bank savings deposits, their retirement savings, and their hopelessly inflated house prices. On the one side, finance capitalism has developed massive, sophisticated powers of social and cultural control over governments, classes and regional populations, so that critical, political response to widening inequalities and instabilities may be muted for long stretches of time – we live in a time of global co-optation. On the other hand, the level and depth of financial crisis have increased, the 'space of crisis' has widened to include virtually all national economies, and the 'space of victims' (direct and indirect) is now virtually universal – we live in a time of global catastrophe.

The intersection of these global tendencies creates an air of unreality, a distancing in which crises are dealt with superficially even as their intensity deepens. Crises that are structural and endemic appear to burst onto the political-economic stage as apparently spontaneous events. Every so often the global governance institutions are called on to intervene. The sheer size of the global financial system, however, where shifts in capital are in the order of trillions of dollars, overwhelms the monetary capabilities of the IMF or the World Bank, which are measured in billions of dollars. So in reality crises simply accumulate, for they are neither understood, nor can they be controlled, nor is there even much popular will to control them, because

many people combine the roles of perpetrator and victim, and the finance system is so big and amorphous that it seems impregnable.

As with the liberal, global system of the late nineteenth century, the neoliberal system of the late twentieth and early twenty-first centuries operates globally under the political domination of one hegemonic, 'democratic' nation-state. The change from Pax Britannica to Pax Americana maintains an essentially similar political structure, but the military might of the armed forces of the financial state has increased, while the time taken for interventions to occur has dramatically decreased with the development of new technologies of warfare. Similarly, the instantaneous transactions of finance capitalism involving trillions of dollars a day are beyond the capabilities of governments or governance institutions even to measure. This is the new financial environment in which the IMF, the World Bank and the WTO operate. In some ways their interventions into the global financial economy become increasingly necessary. In other ways such interventions become more futile. On the knife-edge between inevitability and futility, there you will find the IMF, the World Bank and the WTO, eternally optimistic about 'meeting new challenges' on their web pages, but unconfident in their minds, wondering whether they, or the system they were born to manage, will survive. They are the unholy trinity of a failed religion called neoliberalism. Faith in neoliberalism miraculously survives. Faith in the high priests, desperately making the magic sign of the cross, diminishes.

Social formations, policy regimes, IFIs

This new finance capitalism appeared on the global scene in a burst of cultural and economic exuberance that can only be admired (worshiped), as a sign of the new global times, by an awe-stricken public. At least, that is what appears in popular media that are leading parts of the very system on which they are supposed to report. But then, global finance capitalism might be rewritten as global media capitalism, because mediatization is almost as powerful culturally as financialization is economically, and both share that air of fantastic unreality that takes the place of what once was called 'everyday life.' So, the sports news gets more airtime and, alas, far more attention than news of the war. Don't get killed on a Saturday; no one will hear of your death. Yet, as Marx once almost said, analysis entails breaking the mesmerizing dazzle of the global spectacle by moving thought toward discovering structural essence.

Global finance capitalism emerges from understandable structural changes. To get at these structural changes we need to employ a couple of shorthand, theoretical terms – a few words that describe a myriad of things, so the mind does not think in lists. Thus far we have spoken of historical forms of a political-cultural-economic capitalist totality as 'social formations,' phases within an overall capitalist mode of production. There seem to have been three intra-capitalist social formations in the last hundred years or so: competitive industrial capitalism, already in demise as the hegemonic formation in the late nineteenth century, yet present still in the small business fringe and on the innovative frontier of new venture capitalism; the corporate industrial capitalism that took over hegemony in the late nineteenth century and persists today as a powerful, yet dependent, base of productive activity; and global finance capitalism, taking over the hegemonic, leading role in the reproduction of capitalism only in the 1980s and 1990s – the transition was hidden by the high-tech, information-technology, and Internet hype, which was part industrial, part media, part financial.

A more immediate terminology describes the institutions and ideologies that constitute more particular 'regimes' within (but sometimes transitioning between) capitalist social formations. Let us, for now, stay with the mundane world of 'policy regimes' – the political-economic mechanisms (institutions, ideologies, discourses) of power through which governmental and governance institutions try to direct social formations. A policy regime indicates: a systematic approach to policy formation proposed and managed by a set of government or governance institutions; dealing with a definable, limited range of leading issues; which prevails, as the dominant interventionary/regulatory framework; over a historical period lasting at least several decades. Policy regimes are lent coherence by underlying political-economic interpretations of the causes of a set of related socio-economic problems, interpretations that represent the interests of a fraction of capital. Institutions like the World Bank, the IMF and the WTO reflect and re-create these interpretations – they are interpretive agents, reflecting the old, helping to form the new. This 'interpretive moment' lends dynamism and some unpredictability to the sequencing of social formations (Peet 2007: 4–10).

For much of the nineteenth, and almost half of the twentieth, century, the capitalist countries were under a liberal-democratic policy regime that pretended to be unregulated and devoted to free trade. In

fact hegemonic states operated to increase the sphere of operations of capitalist enterprise: internally through government protection, subsidization and assistance; externally through imperial intervention and inter-state competition. As Ha-Joon Chang (2002, 2007) has pointed out, governments were integral to the development of all the leading industrial countries under nineteenth-century liberalism.

After the Second World War, the capitalist world entered a new political-economic policy regime: Keynesian democracy, predominating between 1945 and 1973. In the Keynesian policy regime, interventionist state and state-like apparatuses, like the IMF and the World Bank, committed to achieving full employment and high incomes for everyone, employed counter-cyclical and developmental macroeconomic policies within a basically free-enterprise (corporate) capitalism. This policy regime responded interpretively to the Depression of the 1930s, a crisis that delegitimized the theoretical rationality and the persuasive claims of the previous, long-lasting liberal policy regime, by using state and governance authority to stabilize accumulation and democratize economic benefits. Regional differences in theoretical-interpretative and political-economic tradition informed three main variants: social democratic Keynesianism in west European countries and their former settler colonies; liberal democratic Keynesianism in the USA; and developmental state Keynesianism in Japan and many industrializing Third World countries (Chang and Rowthorn 1995; Kohli 2004).

The years 1973–80 represent a transitional period, when interpretations of crisis and redirection contended for dominance. Advocates of neoliberalism won the day. The neoliberal policy regime revives late-nineteenth-century, 'free trade' liberalism, apparently by withdrawing the nation-state from macroeconomic management in favor of an increased reliance on market mechanisms. Yet as with its liberal, nineteenth-century predecessor, this apparent withdrawal of state from the economy disguises a movement that is better described as a redirection of governmental intervention toward serving multinational corporate interests, within an upward displacement of power to the global governance institutions, the IFIs initially, the G7/8 increasingly. 'Redirection,' however, is merely the gloss on a deeper process of ever-greater control over the state by wealthy people, corporations, banks and investment management companies, especially the investment banks under a system of 'managed democracy' that begins with control over the electoral process by big donors to political

campaigns, and control over the legislative process by lobbying groups (Peet 2007: 94–8).

The neoliberal policy regime responded positively to the globalization of economy, society and culture of the late twentieth century. Indeed, neoliberalism helped to organize the emergence of a globalization that benefits a newly re-emergent, super-wealthy, financial-capitalist class, residing mainly in the leading Western countries, but operating transnationally in terms of the range of its investment activity. Let us concentrate on the moment of interpretation within policy regimes seen as creative collective agencies in remaking capitalist society. Keynesianism interpreted the political-economic crisis of the previous liberal regime of the 1930s as stemming from fear about an unpredictable future. As we discussed in Chapters 1 and 2, for Keynes, uncertainty on the part of business owners led to inconsistent, delayed purchases of plant and equipment – that is, insufficient demand for capital goods. But things changed in the post-war period. The term 'Fordism' refers to an economy in which mass production is matched by mass consumption by unionized workers making good wages. Fordism is supposed to have been initiated by Henry Ford in the pre-First World War period – Ford produced the first assembly-line car and paid his workers more than the going wage so they could buy the product they were making. With the spread of Fordism, systemic deficiencies in demand originated more in inadequacies and instabilities in the mass purchase of consumer goods. In the context of post-war social and liberal democracy, states responded to under-consumption through Keynesian demand management. Policies centered on massive redistribution of income from rich people toward working-class consumer-voters – people who, by virtue of necessity and/or persuasion, *had to spend* every cent they got … and then more! The main device for income redistribution was progressive federal taxation of incomes – the marginal tax rate on the highest income bracket under the mildly Keynesian policy regime in the USA ranged from 70 percent to 92 percent in the years between 1945 and 1981. Instead of adding to stored wealth, income was recycled immediately into consumption. This kept the Fordist production-consumption cycle going and fueled high rates of economic growth. The IFIs, especially the IMF, were parts of this Keynesian governance system, controlling exchange rates, lending to Keynesian states with balance of payments problems, building infrastructure, and so on.

The convention is that, during the 1970s, Keynesianism, Keynesian

developmentalism and the Keynesian global institutions entered into crisis. The term used to describe this crisis in the First World was 'stagflation' – high rates of inflation coinciding with high rates of unemployment. Linked with this were balance of payments and currency crises – dealt with so arrogantly by the IMF that First World countries never borrowed from that institution again. In the Third World blame was placed on 'failed state intervention,' corruption, overspending and ineffective development. Further, the convention is that Keynesianism was quite simply replaced by a more effective neoliberal policy regime. But, as we have argued, analytical conventions are made from competing, interest-based interpretations, each given different purchase on decision-making by the political and cultural temper of the times. Recall that governments, economies, social systems and cultures in the West faced massive and continuous protests in the 1960s and 1970s. In the face of the escalating contentiousness that threatened social, cultural and political order, the capitalist elite committed itself to counter-revolutionary activity. 'During the 1970s, the political wing of the nation's corporate sector staged one of the most remarkable campaigns in the pursuit of power in recent history,' so that by the early 1980s 'corporations had a level of influence not seen since the boom days of the 1920s' (Edsall 1985: 107; Harvey 2005). An essential part of this was the propagation of an interpretation of economic crisis that found the main structural contradiction to lie in lack of investment in sluggish, underperforming economies. States responded through neoliberal economic policies centered on redistribution of income toward the rich who had so much they had to save and invest. Compared with Keynesianism with marginal tax rates of 70–90 percent, the neoliberal policy regime in the USA brought marginal tax rates on high incomes down to a range of 28–50 percent in the 1980s. The ideological guises of this redistribution were 'recovery, reform, growth,' terms that suggest a regime serving broad, popular national and international interests. The reality was stagnation in the real incomes of working-class and poor people. In the Third World the IFIs 'reformed the corrupt, ineffective state that accumulated too much debt' through neoliberal structural adjustment, again resulting in intense resentment.

What happened to the global economy under these two policy regimes, the Keynesian and the neoliberal? The measure used by conventional economists to measure 'well-being' is rate of economic growth – let us, for a moment, accept this measure at face value – i.e.

'growth is good.' Economic growth in the OECD countries, the richest countries in the world, averaged 3.5 percent a year in the period 1961–80, basically during Keynesianism, and 2.0 percent a year in 1981–99 (basically during neoliberalism). In developing countries the equivalent figures were 3.2 percent and 0.7 percent (Pollin 2003: 133). In other words, Keynesianism vastly outperformed neoliberalism. At the same time as economic growth slowed under neoliberalism, global inequality increased. In 1960 the 20 percent of the world's people living in the richest countries had thirty times the income of the 20 percent of the world's people living in the poorest countries; in 1973 the figure was 44 to 1; and in 1997 the ratio was 74 to 1 (UNDP 1999: 36–8). According to the World Bank (2004: 246–7), 971 million people living in the 'high income' countries and making up 15.5 percent of the world's population now receive $27.7 trillion in income, or 80.4 percent of the global income of $34.5 trillion, while 2,310 million people in the 'low income' countries, making up 36.8 percent of the world's population, receive $1.04 trillion, or 3.0 percent of global income. Putting this a little differently, the 'average person' living in the high-income countries now gets 63.5 times as much as the 'average person' living in the poor countries. National poverty rates in the low-income countries are in the range of 45–70 percent of the population, while the percentage of people living on less than $2 a day varies from 50 to 90 percent, depending on the country.

Yet geographic inequality only begins this sorry tale. Class, ethnicity and gender distribute incomes extremely unequally *within* countries. Of the 80 percent of global income going to rich countries, 50 percent typically goes to the highest-income 20 percent of the people, while the lowest-income 20 percent get 5–9 percent, again depending on the country. At the other end of the world, in the low-income countries, the richest 20 percent typically get 50–85 percent of national income, while the poorest 20 percent typically get 3–5 percent … of the 3 percent of global income that these poor countries receive (ibid.). One of the great but under-mentioned facts about global incomes is this: *poverty results from inequality*. Poverty increases as the world becomes a more unequal place. So, what has been happening to class inequality under neoliberalism? Take the case of the leading capitalist society, the USA, 'neoliberal model for the rest of the world.' Between 1947 and 1973, under the Keynesian policy regime, every income category of people experienced real income growth, with the poorest families having the highest growth in incomes of all groups. After

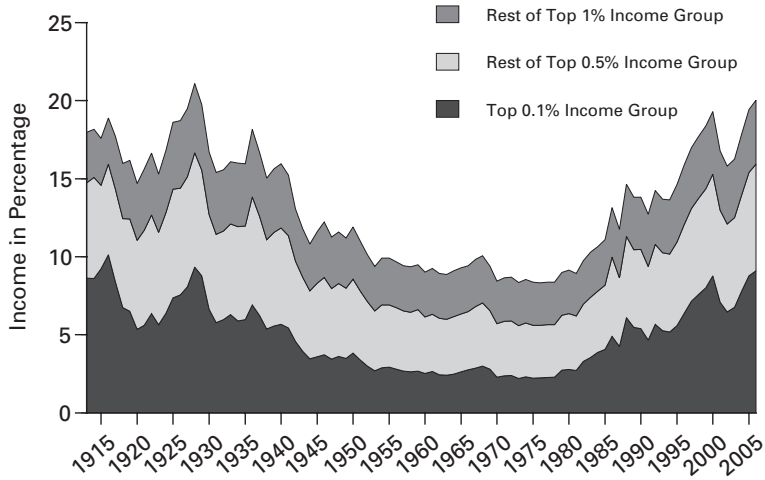

FIGURE 6.1 Percentage of income earned by three top brackets, United States, 1913–2005 *Source*: Statistics from Piketty et al. 2004

1973 average real income not only was stagnant, but that average reflected high-income growth for the top 20 percent of families, and significant income *decrease* for the poorest 20 percent, so that almost half of all families received lower real incomes by the mid-1990s than they had in 1973 (Leone 1996).

The key factor causing these secular changes in class incomes was an even greater divergence in the ownership of wealth, especially financial wealth – that is, bank accounts, ownership of stocks and bonds, and life insurance and mutual fund savings. Particularly important is ownership of stocks and mutual fund shares. Despite democratization (retirement savings invested in mutual funds, etc.) only 27 percent of US families own stocks. While 78 percent of the richest families own stocks and mutual funds, 3 percent of the poorest families do so. The equalizing trends in wealth ownership of the entire state interventionist period between the 1930s and the 1970s (New Deal, War Economy, Keynesianism) reversed sharply in the neoliberal 1980s, so that by 1989 the richest 1 percent of households owned almost half of the total financial wealth of the USA (Wolf 1996), a concentration of ownership that has only become more extreme since (Harvey 2005: 16–17). Within this rich 1 percent, the super-rich – that one thousandth of the population (145,000 people) making an average of $3 million a year – doubled its share of total national

income between 1980 and 2002, to 7.4 percent, while the share earned by the bottom 90 percent fell (see Figure 6.1). Or, putting this more starkly, the assets of the 200 richest people are greater in value than the assets of the 2.6 billion poorest people on earth.

Economic madness

This neoliberal policy regime helped to produce global finance capitalism. Since the late 1970s, income has deliberately been redirected toward people who *could not spend* it, no matter how hard they tried ($20 million apartments in financial centers that became real-estate price multipliers); they could only save and invest it. So under neoliberalism $1 trillion a year flows into the investment accounts of a few hundred thousand already very wealthy people (Johnston 2005). Financial institutions compete to use the investment funds over-accumulated by 'high net worth individuals' and by workers' savings in pension funds, insurance contributions, and so on. Corporations compete to attract investment capital not so much by offering high dividends, but by rapidly increasing the price of corporate stock. CEOs and corporate boards come and go, prosper or not, largely on the basis not so much of how effectively they run the corporation, but how much they can run up the price of the corporation's shares over a short period of time. Corporate capital experiences this competition for investment as an external compulsion originating in the dominant financial fraction of capital. CEOs who fail to deliver are subject to scrutiny by private equity firms that make their money by buying up 'non-performing' corporations, ruthlessly restructuring them (i.e. firing workers), and then selling to make a quick profit that yields high returns to investors. As this suggests, the reach of financial power (in all its aspects) has expanded outward, from its original, capitalist bases in the advanced industrial countries, onto a global playing field, where trillions of dollars range each day with ease and speed in search of the highest possible returns. Clearly, this global playground for capital is lined still with political and cultural boundaries. But increasingly, within the established, global investment space, countries are adjudicated merely as risk/benefit ratios and, by being included that way in the profit calculus, states are reduced in significance, except in acting as minders to the profit-seeking actions of global capital. This new version of finance capitalism is centered on the deployment of large accumulations of wealth by specialized institutions, such as investment banks and risk assessment firms,

concentrated in a few centers of financial power – the upper rank of 'global cities.'

Yet, even with ruthless profit raiding of corporations as modus operandi, the securities market is a relatively safe, stable investment outlet. This is because stock markets are, to some degree, regulated by states – in the USA by a government agency, the Securities and Exchange Commission, established in 1934, at a previous time of crisis. Investment management companies controlling collective assets in the form, for example, of mutual funds are also regulated in the USA under the Investment Company Act of 1940. Under neoliberalism, however, the super-rich have increasingly found ways of avoiding state regulation of investment. They do this partly by escaping national jurisdictions, as with the phantom corporate headquarters in places like the Cayman Islands. Global governance leaves this alone – the institutions they might try to regulate are more powerful than the IMF. The super-rich escape regulation at home by forming exotic investment vehicles. In the USA, investment funds open to small numbers (less than a hundred) of 'accredited investors,' and funds made up of 'qualified purchasers' (the qualification being over $5 million in investment assets), are not subject to governmental regulation, other than the registration of traders. So temporary investing in the equity market (the stock market), making a quick profit, and then selling competes with other, far more speculative, and lightly regulated hedge funds, private equity companies, sub-prime mortgage bundlers, futures, derivatives and currency traders, etc. In the context of globalization, 'emerging markets,' and exotic investment outlets, investment funds are expected to return at least 20 percent a year, doubling elite wealth every four to five years. So we live in societies where the dynamic of the leading fraction of capital is the pursuit, by any means possible, of more money for those who already have far too much. This reckless pursuit of money for the sake of more money is financial, global madness. It can result only in disaster.

For the price of high returns is … eternal risk. Any investment fund that does not generate high returns and, thereby, does not take extreme risk suffers disinvestment in highly competitive markets, where money changes hands in computer-quickened moments. So, there is a competitive compulsion to take increasingly daring risks in search of higher returns that temporarily attract investment. Speculation, risk and fear are structurally endemic to global financial capitalism. Indeed, 'fear itself' becomes the source of further speculation – buying

gold, or petroleum futures, for example. Speculation and gambling spread from Wall Street and the City of London into all sectors of society – house prices, state lotteries, casinos, church bingo nights, sweepstakes, buying Pokemon cards – everyone gambles, even little kids. The interlocking of speculations is the source of their intractability and the widening space of their effects. So the financial crisis of 2007/08 had the following component moments: vastly overpriced housing, particularly near booming financial centers; competition among financial institutions to offer easy credit to everyone; the bundling of home mortgages into tradable paper; very high levels of leveraging; the use of assets whose value can disappear in an instant to securitize other, even more risky, investments; interlocking bank failures or near-failures all over the world; the inability of governance to even think of managing all this. It is not just that crisis spreads from one area to another. Its more that crisis in one (such as the inevitable end to the housing price bubble) has exponential effects on the others (investment banks overextended into high-risk mortages) to the degree that losses accumulate that are beyond the rescuing powers of states and the governance institutions we have been looking at in this book. Hence the tendency for disaster to accumulate into catastrophe.

Civilization and global philanthropy

When speculation and gambling are normalized, the root source of value creation, labor performed on environmental resources, is lost to memory. Money appears (and disappears) from out of the speculative blue, rather than from knowable, seeable real activities. Unregulated financial speculation is the nearest we get to an economy driven by aggression and egoistic self-interest (see Freud 1966). Traders make more in a few seconds on the computer than 99 percent of the rest of us make through the hard, dedicated work of a lifetime. Workers are fired, homeowners dispossessed, but the fund manager does not witness these awful, terrible events, nor can he care. For plenty of others rush in where the ethical investor fears to tread. And if the intermediation of commodities in relations of production makes for an alienated society (Marx 1967: ch. 1), and the intermediation of images makes for a mesmerized society (Debord 2004), the intermediation of money and gambling in social relations makes for a mad global society. Even so, corruption and madness do not completely relieve global finance capitalism of the pangs of conscience. They just corrupt that 'conscience' and everything that emerges from its dubious morality.

In the Western, Calvinist tradition, philanthropy is the way rich people salve their consciences. In global finance capitalism an emotive, idealistic, moralistic veneer is added to this already exaggerated, philanthropic gesture. In the Fordist age of consumerism and advertising, people are attuned to image, suggestion and subjective exaggeration in all spheres of life, including the philanthropic. Image, media and spectacle play on popular concern, apparently to build support for grand action, but less obviously to channel what could mount into mass anger into safe and responsible, institutionally contained intervention. As we have seen, the symbolic turn of the millennium witnessed an escalation in sorrow, institutionalized in a global philanthropic complex that merges 'aid' with 'ending poverty' with 'development.' The geofinancial panopticon (O'Tuathail 1997) is mirrored in a geophilanthropic panopticon. The hegemonic capitalist countries, the IFIs (especially the World Bank), leading members of the global financial and industrial elite, famous academics, a dazzling array of pop stars … all the guilty parties want to 'end global poverty now.' At the IMF and World Bank, structural adjustment was renamed 'poverty reduction and growth.' The UN Millennium Declaration centered on halving extreme poverty by 2015. After mass, popular pressure, organized as Live 8 rock concerts, by singers Bono and Bob Geldof, the G7/G8 countries agreed to write off $40 billion owed to international agencies. In 2006, Warren Buffett, third-richest person in the world, pledged $31 billion to the Bill and Melinda Gates Foundation, started by the richest person in the world, aimed at ending global poverty. Over and over again, the UN says significant progress has been made toward achieving the goals of the Millennium Declaration, especially in the area of global poverty reduction. Even the WTO gets in on the anti-poverty crusade – so the Doha Round was said to need completing because more free trade would alleviate poverty in the poorest countries.

Can we accept these widely acclaimed acts of altruistic benevolence simply, in their own optimistic terms? Or is 'ending global poverty now … the world cannot wait' a civilizational gloss on the pursuit of more brutal, speculative self-interest? Rich countries look down on the poor and, in pitying them, devote themselves to 'ending global poverty' by declarative fiat or, when pressed, through safe means like education, funding anti-HIV/AIDs research, free mosquito nets, and so on. At the same time, ending global poverty is a disguise for extending the domain of global finance capital – it pacifies new spaces

of exploitation. In such ways, and more, are global finance capital, neoliberalism, global governance and the IMF and the World Bank's anti-poverty/debt relief policies linked.

The crisis of global governance

Even in this analysis, however, speculative global financial capitalism (madness), and its philanthropic gloss (civilization), is rendered insufficient by the onset of crisis. For it assumes that global capitalism has the time and the resources for acts of grace – the grand philanthropic gestures of the turn of the century, symbolized by the MDGs. Yet the scale and breadth of the financial crisis that began in 2007, and its intersection with global inflation in energy, food and raw materials, together with chaotic geopolitical conditions resulting from ill-conceived reactions to 9/11, all create a new miasma for which terms like stagflation prove insufficient. The new financial globalization allowed capital to escape the confines of what little remains of state regulation under neoliberalism to generate fantastic profit for the financiers. But the problem with escaping from regulation by the nation state is … who rides to the rescue at times of crisis? The answer in the past was the IFIs, particularly the IMF, the nearest we have to global economic regulators. The answer in the present and immediate future is the G7/8, although more realistically all the Gs are whizzing in divergent directions – G7 divided, G8 (Russia) unreliable, G4, G20, G90, etc. Even the biggest Gs, the USA and the EU, are probably insufficient given the size of global financial loss, the degree of debt, and the limits of state budgets.

But what of the IFI component of global governance? In retrospect we see the debt crises of the 1980s, and the regional financial crises of the 1990s, as preludes to the global financial crises of the 2000s. The response of the IFIs to the earlier symptoms of financial stress was more globalization – join the global neoliberal order, with our help, and your problems will disappear. The victims of this prescription resented it, the perpetrators (especially the IMF) were disgraced, the most aggressive proponents (especially the WTO) divided into squabbling blocs. Global governance IFI-style was already in crisis when, in 2007, global financial disorder set in. Hence global governance is riven by two intersecting contradictions. On the one hand, its monetary resources are hopelessly inadequate given the scale of global finance capital, the depth of its losses, and the multiplicity of its crises. On the other hand, confidence in its policy prescriptions

has long since eroded, so only a fool would lend the IFIs more money to solve the world's financial problems. The Bretton Woods period is over, its institutions are irrelevant, and the will to found a new global regulatory order is not there. So the World Bank sets a new tone that the other IFIs scramble to follow – Salvation Army to the world.

What is to be done?

Of course, global governance has faced crises before. Indeed, as Rajagopal (2000) argues, resistance by environmental and other social movements fed the proliferation and expansion of the IMF and the World Bank in the 1960s, 1970s and 1980s. And Broad (2006) adds that the Bank and the Fund are adept at paradigm maintenance. The present time, however, finds an already advanced process of destabilization of the hegemonic ideas of the Washington–Wall Street alliance within an overall crisis of global financial capitalism. A combination of crisis, destabilization and counter-hegemonic demonstrations has the global governors worried. Significant change seems at last to be realistically possible. What therefore is to be done about global governance in the post-September 11, post-financial-crisis era?

We have argued that the IMF and the World Bank, in league with the WTO and backed by the big corporations, especially the banks, impose economic policies on a hundred countries in the world which kill thousands of children every day in agony through malnutrition and preventable illnesses resulting from poverty and unemployment. This in the name of ending poverty for ever! So radical change has to deal with the beliefs and the mode of understanding that make such costly delusion possible on the part of (presumably) well-meaning IFI bureaucrats. Controversially, this means not only a critique of the rightist politics of neoliberalism, but a critique of the certainty that derives from a belief in the scientific validity of mainstream economics. We think that an objective economics likened to physics should be deconstructed, and replaced by one grounded in subjective judgment and likened to theories of culture – so markets are places not where atoms collide, but where representations contend. We suggest that a historical economics grounded more in empirical generalizations, with more attention to contexts and cases, would do more to end inequality and poverty than unrealistic mathematical elegance. Further, we think that the political and economic interests controlling global governance institutions and their policies, especially banking and the multinational corporations, should be further revealed to show that

policies damaging the poor result from considerations limited to the rich. We think that speculation should be replaced by planning as organizer of the economy. We find hope for the future in the construction of alternative economic models in Venezuela, Ecuador, Bolivia and Cuba. We think that the NGOs that watch and constantly criticize global governance should be supported and strengthened, and that thousands of demonstrators, well equipped with detailed knowledge, and fully prepared to discuss policy alternatives, should continue to greet every meeting where our world's future is discussed. Practically, we think that the IMF should revert to its original role as a place to deposit surpluses that can be withdrawn on demand, in hard currencies, as emergency loans. Failing this, the IMF should be disbanded. The WTO is a nasty organization run by directors and a secretariat that propagate rightist elitism in the guise of consumer populism. The WTO has either to be transformed into a fair trade organization, or it should be allowed to collapse in confusion, as it shows every sign of doing – either way, it has to go. And finally, we see some hope for the World Bank, were it to listen seriously to its many critics, and were it to undergo the changes that even its own conscience and many of its own staff suggest. The Bank's project lending did produce low-cost housing, clean water supplies and safe sewage disposal, where none existed before. The Bank's record on larger schemes, such as long-distance roads and high dams, reveals a conception of 'project' so limited that the consequences for those affected have to be disastrous – here the power of the bond-holders, and behind them that of the 'efficient' markets, has to be countered by the powers of the people. The Bank's association with the IMF after the mid-1970s, especially in the area of structural adjustment conditionality, tarnished its reputation, while half-hearted efforts at public participation have done little to improve its ethical position. The Bank's 'turn toward poverty' we find motivated more by paradigm maintenance than a real sense of global injustice. If the Bank aspires to end poverty, then the poor should be not sentimentalized, but included through their social movements in the process of planning their own development. For the Bank this means democratization, separation from what little remains of the IMF, and operation under an entirely different set of political-economic principles devoted to social justice.

In general we think that globalization has to be completely re-evaluated. This should be done in terms of the theories and policies that have directed it and the institutions that have managed it. The

potential for globalization to bring about a 'humanity appreciative of difference' has been made unrealizable by a real process of domination and the accumulation of hegemonic power. Rather than acting as agents of a more even, more equitable globalization, the institutions we have examined, the IMF, the World Bank and the WTO, have been captured by a neoliberal ideology that places them on the side of those who already have so much money they know not what to do with it. Globalization has to be directed into becoming something finer by a democratic alliance of social movements that opposes the alliance of the rich, the famous, and the gratuitously philanthropic. The idealistic critics are the realists at the present juncture, not the hard-headed expert insiders. There is lots of room, even in the present, limited structures of the institutions of global governance, for increasing popular participation and enhancing democratic decision-making. The idea is to widen the scope of this potential and to intensify its content. Only in so doing will global governance finally be transformed.

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FOREWORD

At the dawn of the third millennium, as the nation prepares for its second war in the Persian Gulf in little more than 10 years, the same debate rages in this country that has defined it for the last three centuries: What exactly does it mean to be an American? Is America a place or a state of mind?

The British may love their language, and the French may love their gold, but Americans love more than anything to argue over who they really are. And in all that time, and all that arguing—from the dueling essays of Jefferson and Hamilton, to the confused politics of the Reform Party and Pat Buchanan—the American story has ultimately never strayed very far from the plotline that has energized it from the start.

You may devote a lifetime to peeling back the onion skins of the American Experience, as so many scholars have done, and no matter where you stop you will always encounter the same basic question that frames our history: In a democracy, what are the limits to legitimate power?

At its core, that is the question that informs *The Iron Triangle: Inside the Secret World of the Carlyle Group*—just as it eventually seems to inform our understanding of everything that ever happens in American public life, from the XYZ Affair to the Pentagon Papers. It is why one generation of Americans enacts the Sherman Antitrust Act, and a later generation eviscerates it. At the start of the 1950s, a screenwriter named Ring Lardner, Jr. was imprisoned as a Communist sympathizer; a generation later he was lionized in Hollywood as the screenwriter of M*A*S*H.

Of such moments is the history of this country eventually told, as Americans engage in the ceaseless pursuit of midcourse corrections to get where we want to go as a nation without becoming a tyranny in the process. When Richard Nixon lamented the nation's seeming obsession with "wallowing in Watergate," he missed the key point: As a nation and a people, we really had no other choice.

Now, in the winter of 2003, with America's wrath once again poised to strike down Iraq, a palpable sense is abroad in the land—not shared by all, but shared by enough—that we have somehow drawn a line in the sand where we never really intended to stand. How did we get to this moment anyway? In the visible mechanism of political cause and effect, part of what's happening feels hidden from view. We see the cause, and we see the effect. But the assembly of gears that transmits the power seems off somewhere else, in another room.

It is the work of scholarship—and in particular, of that uniquely American kind of contemporary scholarship that we call investigative journalism—to enter those darkened rooms and switch on the light so that all may see what is actually taking place. When the work is done well, and the message is true, we find ourselves in a diorama we never imaged could exist. One thinks in that regard of Jacob A. Riis's *How the Other Half Lives,* or more recently, and on a different stage entirely, Wise and Ross's *Invisible Government.* At other times, the exposes connect invisible dots, and in fairly short order are deservedly consigned to the ash bin of history as conspiracy theory. (Want to find yourself standing alone at a cocktail party? Then try suggesting that you have it on good authority that the Trilateral Commission actually runs the world.)

Briody's scholarship will meet no such fate, for not only are the facts of *The Iron Triangle* accurate, but the picture they present is also *true.* And just as *Invisible Government* in 1964 helped bring depth to our understanding of some of the missing gears that soon drove America into the jungles and highlands of Indochina, so too does *The Iron Triangle* introduce us to the men (and they are mostly just that) whose role in the geopolitics of the Middle East is now only glimpsed fleetingly, and never by design.

In the foreign policy apparatus of Washington, the Carlyle Group inhabits one of the most darkened rooms of all—hiding in plain sight in offices a mere five minutes' walk down Pennsylvania Avenue from the White House. Into this room, Briody has wandered uninvited and flipped on the light, to reveal the entire spin-cycle apparatus of post-public-sector employment that keeps the top men of successive administrations still gainfully employed in the fields they know best (typically aerospace and defense) once the boss has vacated the White House and returned to private life.

In this room, you'll meet the crude and brashly entertaining original founder of the Carlyle Group, Stephen Norris, a one-time hotel executive for the Marriott Corporation, who figured out how to exploit a late-1980s tax break passed for some Eskimos whose businesses kept failing, and parlayed it into a gimmick for monetizing the value of failure itself, and then marketing it as tax loss carry-forwards.

From this gimmick sprang the Carlyle Group—named by Norris and some chums after an organizing meeting they'd held in New York's Carlyle Hotel, as if the Group were nothing more than a piece of faux Regency furniture in need of a credential.

In these pages, you'll meet the relentlessly over-achieving David Rubenstein, now no longer the boy wonder bullet-biter of the Carter White House, where he held the title of Deputy Domestic Policy Assistant at the age of 27, and was said to have eaten three squares a day, for the entire four years, on junk food from White House vending machines.

You'll also come face-to-face with hatchet-faced Frank Carlucci ("Spooky Frank"), a man with a shadowy past including allegations that he began his career in the CIA with a foiled attempt to assassinate Patrice Lumumba in the Eisenhower years—something that Spooky Frank denies. You'll see him rise to deputy director of the CIA late in the Carter years, then "retire" early in the first term of Ronald Reagan's administration to become head of Sears World Trade—a company with a business that consisted, intriguingly, of neither deals nor revenues. Then, drawn back to Washington by the Great Revolving Door of government, Carlucci took a seat on the National Security Council, once again for Ronald Reagan, then

hopped over to Defense, finally spinning back through the door and into the private sector. At the end of Reagan's second term, he was settling behind his desk at the Carlyle Group.

You'll meet such figures as George Bush, Sr.'s one-time secretary of state, James Baker, who also joined the team, and even the ex-president himself, now a senior advisor to the Group.

And, for the first time anywhere, you'll go behind the scenes to see what this group really does as a "business." How it nails down deals, whose arms get twisted, and why. On the light side, you'll encounter comic relief figures like Prince Alwaleed bin Talal, who has promoted himself around the world as a top member of the Saudi royal family but has proved to be a spectacularly inept investor, pouring vast sums of Saudi money into dot-com stocks at the top of the boom.

More darkly, you'll enter the astounding—and until now almost entirely hidden—world of the Vinnell Corporation, which has been training the Saudi Armed Forces in how to protect their country's oil fields since the mid-1970s. There are now an almost unbelievable 45,000 private mercenaries working for Vinnell and outfits like it in place in the country. Vinnell was a Carlyle Group subsidiary from 1992 to 1997.

What is one to make of all this? Certainly enough to want to know more, which is why a book such as *The Iron Triangle* is such an important contribution: It puts the subject in play. A half century ago, Douglas MacArthur, having been summoned back to Washington from Korea by his Commander in Chief, Harry Truman, and relieved of his command over a dispute regarding his conduct of the war, stood before a joint session of Congress and declared, in one of the most memorable moments in American life, that "old soldiers never die, they just fade away . . ." after which he retired to the penthouse suite of the Waldorf Astoria Hotel in New York and was rarely seen in public again. Today, he would more likely have retired to the Carlyle Group, where he'd find a reporter named Dan Briody dogging his every move.

—Christopher Byron

March 2003

TIME LINE

February 1975—Vinnell Corp., a construction contractor and future Carlyle company, signs a $77 million contract to train the Saudi Arabian National Guard. The news touches off a controversy that would dog Vinnell, and then later Carlyle, to the present day, even after Carlyle sold off Vinnell to TRW in the mid-1990s.

December 1986—Frank Carlucci is named national security advisor to President Ronald Reagan, succeeding John Poindexter, who resigned in disgrace following the Iran-Contra scandal. While waiting to assume his responsibilities as national security advisor, Carlucci is briefly embroiled in an arms scandal of his own, when the *Washington Post* reports that Sears World Trade was involved in clandestine international arms deals while Carlucci was chairman.

September 1987—After making millions brokering deals that exploited an obscure tax loophole, Stephen Norris and David Rubenstein form the Carlyle Group, named after the posh Carlyle Hotel on New York's Upper East Side.

November 1987—Frank Carlucci is named secretary of defense by President Ronald Reagan. During his short tenure, Carlucci worked extensively on restructuring the Pentagon's procurement system, a system he would later exploit as chairman of the Carlyle Group.

July 1988—BDM, soon to be a Carlyle company, is accused by rivals of currying favor with the Navy officer in charge of procurement, Melvyn Paisley, by hiring his wife. Paisley would go on to

become the highest profile conviction of Operation Ill Wind, the years-long investigation into corruption at the Pentagon.

September 1988—Fred Malek resigns as chairman of the Republican National Committee after reports that while a Nixon aide, he compiled figures on the number of Jews working in the Bureau of Labor and Statistics. He immediately signs on with Carlyle.

January 1989—Six days after his term as secretary of defense ended, Frank Carlucci joins the Carlyle Group.

July 1989—Marriott Corp. sells its In-Flite Services catering business to Marriott's upper management. Carlyle invests in the deal, renames the company Caterair, and loses millions when the airline catering business evaporates in the early 1990s.

February 1990—George W. Bush joins Caterair board at the behest of Fred Malek, a good friend of his father's. Bush would later drop his disastrous experience with Caterair from his resume when he runs for governor of Texas in 1994.

September 1990—Carlyle Group buys BDM Consulting, one of the largest and most successful defense consultancies in the world. Carlyle would use the $130 million purchase to evaluate future buyouts in the defense industry.

January 1991—After months of contentious negotiations, Carlyle snags a board seat at Harsco, a maker of military vehicles. The seat would eventually help Carlyle to obtain Harsco's defense business, later known as United Defense.

February 1991—Prince Alwaleed of Saudi Arabia buys $590 million of stock in Citicorp, America's largest bank. Carlyle brokers the deal and gains a reputation as the merchant bank of choice for wealthy Saudis.

March 1992—BDM, a Carlyle company, buys Vinnell, a privatized military training company that does extensive work with the Saudi Arabian National Guard.

August 1992—Carlyle wins a year-long struggle over control of LTV Corp.'s defense and aerospace division, paying $475 million in

conjunction with Loral Corp. and Northrop Corp. The deal instantly legitimizes Carlyle as a serious player in defense buyouts.

September 1992—George Soros, a future Carlyle investor, brings the British economy to its knees by speculating on the demise of the British pound. When the value of the pound cratered on Black Wednesday, September 16, 1992, Soros pocketed a cool billion.

February 1993—A month after the Bush administration cleans out its desks at the White House, Richard Darman, the outgoing director of the Office of Management and Budget, joins the Carlyle Group in a package deal with James Baker III.

March 1993—After spending 12 straight years in the White House in various capacities under Reagan and Bush, James Baker III takes his considerable talents to the Carlyle Group, lending the firm instant international recognition and credibility.

September 1993—Carlyle snags its highest profile investor to date when George Soros invests $100 million in Carlyle Partners II, a fund that would go on to become the biggest and most successful of all Carlyle's funds.

December 1994—A *Washington Post* article exposes a secret arms deal conducted by BDM, a Carlyle company. In the deal, BDM used the same arms broker from the Iran-Contra scandal to arrange the transfer of Russian military equipment to the United States.

January 1995—Co-founder Stephen Norris is forced out of the company, accused by his colleagues of erratic behavior and fiscal irresponsibility. Norris faults his former colleagues for waging a smear campaign against him, spreading rumors and undermining his credibility to the financial community.

March 1995—University of Texas Investment Management Company, UTIMCO, weeks after George W. Bush became governor of Texas, places a $10 million investment into the Carlyle Group, which up until 1994, employed the young Bush.

September 1995—Onex Food Services buys Caterair from Carlyle for $500 million, nearly $150 million less than Carlyle had originally paid for the company.

November 1995—A car bomb attack on Americans living in Saudi Arabia puts a spotlight on Vinnell, BDM, and the presence of the Carlyle Group in Saudi Arabia. Three spouses of BDM workers are injured in the attack.

September 1996—Carlyle closes Carlyle Partners II at a total of $1.33 billion, more than twice its original target for the fund, and 13 times as much as the company had ever raised for a single fund. The defense-oriented fund would go on to produce returns of better than 35 percent.

September 1997—Carlyle buys United Defense for $850 million, one of the company's largest buyouts ever. United Defense has plans to build the Army a 60-ton mobile howitzer called Crusader.

March 1998—John Major, former prime minister of the United Kingdom, joins Carlyle as European advisor. He would later become chairman of Carlyle Europe in May 2001.

April 1998—Carlyle closes another $1.1 billion fund, called Carlyle European Capital Partners, at double its initial target. The company was able to raise the money in just under a year.

May 1999—Former President George Herbert Walker Bush visits South Korea on behalf of Carlyle, cultivating business and political ties that result in Carlyle's investing more than $1 billion in South Korea's struggling economy.

July 1999—Former Connecticut State Treasurer Paul Silvester is forced to resign his new position at Park Strategies after the FBI begins an investigation into a series of investments he made with Connecticut State Pension funds before he left office. Among the investments is a $50 million placement with Carlyle Asia.

September 1999—Silvester pleads guilty to corruption. Court documents are sealed, and the identities of the private equity firms involved are kept secret by the state, awaiting Silvester's sentencing, which is ongoing.

January 2001—SBC Communications, a Carlyle client, wins FCC approval to offer long-distance phone service in Texas, Oklahoma, and Kansas, after the Justice Department had rejected the

company's request. The approval is given on the last day of FCC Chairman William Kennard's tenure. Three months later, Kennard is given a job at Carlyle.

February 2001—George W. Bush, a month into his presidency, reverses America's policy of diplomacy toward North Korea, angering North and South Koreans alike, and threatening Carlyle's extensive investments in the region.

June 2001—Former President George H. W. Bush urges his son to reconsider his stance on North Korea, reminding him, among other things, of the U.S. business interests in the Korean peninsula. George W. Bush subsequently reverses his policy toward North Korea.

July 2001—Former President George H. W. Bush personally calls Crown Prince Abdullah of Saudi Arabia, reassuring the heir to Saudi Arabia that his son is "going to do the right thing" and "his heart is in the right place." The call is in response to George W. Bush upsetting the Saudi prince with his policy toward the Israeli-Palestinian conflict. It also helps protect Carlyle's extensive business in the region.

September 11, 2001—America sustains a highly organized attack by terrorists, leveling the World Trade Center towers, and ripping a gash in the Pentagon building. The attacks would lead to a massive increase in defense spending. A week after the attacks, Anthrax-laced letters are found throughout the East Coast, leading to heightened fears, and unexpected new contracts for Carlyle companies.

October 2001—Carlyle is forced to liquidate its holdings from the bin Laden family as news reports of the company's association with terrorist Osama bin Laden's estranged family overwhelm the press.

December 2001—Carlyle takes United Defense public after newly approved defense spending temporarily secures the Crusader's future. The company earns $237 million in one day on the sale of shares, and on paper made more than $800 million.

April 2002—Cynthia McKinney, a Democratic congresswoman from Georgia calls for an investigation into the September 11 attacks, pointing out the President's extensive ties with the Carlyle Group, a company that stands to make millions from the aftermath of September 11.

May 2002—The Army is forced to investigate whether its own officials illegally lobbied Congress in support of the Crusader in the face of the program's cancellation.

August 2002—United Defense issues an official press release announcing the cancellation of the Crusader program. The same press release announces the awarding of a new contract for United Defense to build another gun for the Army, effectively replacing Crusader.

November 2002—Lou Gerstner, the man who engineered IBM's stunning turnaround during the 1990s, is hired as Carlyle's chairman. The move is characterized by many in the media to change Carlyle's image from a defense oriented buyout firm to a more traditional private equity company. Frank Carlucci stays on as Chairman Emeritus.

CAST OF CHARACTERS

(in Order of Appearance)

Stephen Norris—co-founder Carlyle Group.

Norris was the driving force behind the creation of the company. A mercurial executive, bent on hunting down big deals, Norris ultimately would be forced out of the firm by his fellow co-founders in an acrimonious conflict.

David Rubentstein—co-founder Carlyle Group.

Still the brains of the operation, Rubenstein is widely considered one of the most intelligent men in Washington, DC. His IQ is surpassed only by his tireless work ethic and extensive Rolodex. He is what holds Carlyle together.

Dan D'Aniello—co-founder Carlyle Group.

A former colleague of Norris at Marriott, D'Aniello was brought on board only after Norris personally guaranteed his salary. He is among the more enigmatic, behind-the-scenes members of Carlyle, often serving as a buffer between the more explosive executives.

William Conway—co-founder Carlyle Group.

The son of a quality control guru and former chief financial officer at MCI, Conway is reputed to be one of the finest financiers in the world. His conservative style and waste-not approach would eventually clash with Norris's larger-than-life personality, resulting in Norris being sent packing.

Frederic Malek—former Carlyle consultant.

This former Nixon aide and close friend of George Bush Sr. ran to Carlyle after a furor erupted in Washington over his involvement in

the documented anti-Semitic actions of former President Nixon. He would go on to introduce Carlyle to some big names in Washington, but would later be excommunicated from the firm.

William Barr—former Attorney General.

A one-time law partner of David Rubenstein's, Barr would help Carlyle, along with Rubenstein, funnel millions of dollars through a temporary tax loophole known as the *Great Eskimo Tax Scam,* taking Carlyle into the Big Leagues.

Arthur Miltenberger—then chief investment officer of the Mellon Foundation.

As an original investor in Carlyle Group, Miltenberger was among the first to see the potential of an investment bank based in Washington, DC. His early contributions would get Carlyle on its feet.

J. W. Marriott—chairman of Marriott Corp.

The hotel magnate was once the boss of Steve Norris, Fred Malek, and Dan D'Aniello. The influence of Marriott on Carlyle was a pervasive force, and his former employees still utter his name with the highest respect.

Dan Altobello—former chairman of Caterair.

Yet another former Marriott employee, Altobello had the dubious honor of presiding over one of Carlyle's worst investments ever in Caterair. Like many others, he would clash badly with Norris, and later sell off Caterair at a loss.

George W. Bush—president of the United States of America.

An early hire of Carlyle, Bush was placed on the board of Caterair in 1990 and served for four years, before leaving to run for governor of Texas. His early stint with Carlyle would become a source of controversy later during his presidency.

Frank Carlucci—chairman 1989–2002, currently chairman emeritus of Carlyle Group.

A lifelong public servant, former secretary of defense, former deputy director of the CIA, and more, Frank Carlucci would lead Carlyle into the murky world of defense buyouts in the late 1980s and early 1990s. It is Carlucci's close friendship with Secretary of

Defense Donald Rumsfeld that the press most often seizes on when criticizing Carlyle.

Patrice Lumumba—former president of Zaire.

Assassinated after only two months in power, Lumumba would later become the subject of the film *Lumumba,* directed by Raoul Peck. In the film, there was originally a scene showing Frank Carlucci plotting the murder of the erstwhile leader. The scene was edited at Carlucci's request before the film's release.

Mobuto Sese Seko—former president of Zaire.

Chosen by Americans to succeed Lumumba, Sese Seko led Zaire into decades of famine and war. He remains part of Carlucci's legacy from his time as second secretary to the U.S. Embassy in Zaire.

Raoul Peck—filmmaker.

It was Peck's accounting of the murder of Patrice Lumumba that caused an uproar from Frank Carlucci. At Carlucci's request, Peck edited the scene that showed Carlucci plotting the assassination, but Peck stands by the film's veracity.

Donald Rumsfeld—secretary of defense.

A former college roommate and wrestling teammate of Frank Carlucci, Rumsfeld and Carlucci are never far apart. The two followed each other through the executive ranks of government, worked for Sears Roebuck together, and remain very close friends to this day.

Caspar Weinberger—former secretary of defense.

As one of Carlucci's many mentors, Cap Weinberger helped legitimize Carlucci, grooming him to one day become secretary of defense.

Roderick Hills—former CEO of Sears World Trade.

As the CEO of Sears World Trade, Hills fought off allegations of the company being a front for CIA activity and eventually resigned amidst huge financial losses, leaving Carlucci to succeed him.

Earle Williams—former CEO of BDM.

In leading BDM, a highly successful defense consultancy, Earle Williams curried favor with countless Washington, DC insiders,

among them Frank Carlucci. Carlyle would go on to buy BDM and make a killing.

Melvyn Paisley—former Naval officer.

When in the Navy, Paisley was in charge of awarding Navy contracts, a task he did while accepting kickbacks from defense contractors. He would go on to work for BDM, then get convicted after pleading guilty in the Ill Wind investigation into corruption in the Pentagon.

Vicki Paisley—Melvyn's wife.

Also an employee at BDM, Vicki was thought to be the reason that Earle Williams received a highly coveted appointment to the Naval Advisory Board.

Phil Odeen—chairman of TRW.

Williams' successor as BDM CEO, Odeen would grow the company into a highly successful and diversified consultancy. He was also CEO when BDM employees were targeted in a vicious car bombing in Saudi Arabia.

M. W. Gambill—former CEO of defense contractor Harsco.

The CEO of one of Carlyle's early takeover targets, Gambill would fight the fledgling buyout firm for control of Harsco, eventually conceding only a seat on the company's board.

Norman Augustine—former CEO of defense contractor Martin Marietta.

Augustine would go toe-to-toe with Carlyle over the heavily disputed takeover of LTV, an aerospace company spun out of Ford. After a protracted battle, Augustine and Martin Marietta would eventually lose out to Carlyle.

Prince Alwaleed bin Talal—Saudi Arabian prince.

A billionaire international investor, the Prince played a central role in raising Carlyle's name recognition, both at home and in Saudi Arabia. The Prince would go on to become close friends with Steve Norris, and make enormous investments in American companies.

King Fahd—king of Saudi Arabia.

As the leader of Saudi Arabia, King Fahd hired Carlyle companies to protect him and his family, as well as to manage the Saudi Economic Offset Program, a government-run program that brings foreign investment into Saudi Arabia.

Faissel Fahad—San Francisco lawyer.

This friend of Prince Alwaleed was responsible for making the key connection between Carlyle and the Prince, which led to the $590 million investment in Citicorp.

Prince Sultan bin Abdulaziz—Saudi Arabian defense minister.

According to a financial advisor to Prince Alwaleed, Prince Sultan bin Abdulaziz used Prince Alwaleed bin Talal as a front to invest money on his behalf, among others, in U.S. companies, like Citicorp. Prince Alwaleed denies the allegation.

Henry Jackson—former U.S. senator.

Jackson saw early on the perils of letting private companies contract with foreign governments on military missions. His investigation into Vinnell's deal with Saudi Arabia revealed a contract fraught with controversy.

Richard Secord—retired Air Force general.

An ex-employee of Vinnell, but better known as one of the Iran-Contra fall guys, Secord drew unwanted attention to Vinnell when he was implicated in trading arms for hostages.

James Baker III—Carlyle managing director, senior counselor.

The former secretary of state under President George Bush Sr. led five different Republican presidential campaigns, and spent 12 straight years in the White House during the Reagan and Bush administrations. He took a position with Carlyle in 1993, and would later lead George W. Bush's successful battle for the presidency during the Florida recounts.

Richard Darman—Carlyle executive.

The former director of the Office of Management and Budget under Bush Sr., Darman wrangled his way into a position at Carlyle by including himself in a package deal with Baker.

Colin Powell—secretary of state.

A former Carlyle advisor, Powell's role in Carlyle's history is a bit of a mystery. Most believe that he merely advised the company while he was not in public office. One of his early mentors was Frank Carlucci, and the two remain close.

Michael Eisner—chairman of Walt Disney.

Eisner was involved with a deal between Prince Alwaleed and Euro Disney, in which Norris negotiated a huge investment from the Prince. Eisner was among the many that found Norris undisciplined.

Antonio Guizzetti—Italian business man.

After meeting Steve Norris in a sauna at a Washington area gym, Guizzetti led Norris and Baker on a wild tour of Italy in search of the perfect investment. Ultimately, the investment they had targeted fell apart when Norris resigned in the middle of negotiations.

Basil Al Rahim—former Carlyle employee.

In charge of raising capital in Middle East during the early 1990s, Al Rahim was the man who introduced Carlyle to members of the bin Laden family, a relationship that would later cause both parties discomfort.

George Soros—Carlyle investor.

This internationally respected investor and speculator helped legitimize Carlyle when he committed $100 million to the Carlyle Partners II fund. The sizeable investment was accompanied by Soros' public endorsement of Carlyle.

John Major—chairman Carlyle Europe.

The former prime minister of the United Kingdom, Major came on board with Carlyle during a fevered spate of highly political hirings by the company. Since then he has spent time stumping for Carlyle throughout the world.

Paul Silvester—former Connecticut state treasurer.

Silvester is awaiting sentencing after pleading guilty to corruption charges while working as the state treasurer of Connecticut. In his

final two months in office, after losing reelection, Silvester invested $800 million of the state's pension fund in several private equity firms for which he received kickbacks. One of the firms he invested in was Carlyle, which was investigated, but no charges were brought.

Wayne Berman—president of Park Strategies.

A consummate Washington insider, Berman is a major financial backer of George W. Bush, as well as the president of Park Strategies, the company that hired Silvester after he invested Connecticut's pension funds through his firm.

Denise Nappier—Connecticut state treasurer.

Stepping into the mess that Silvester left behind, Nappier required that all firms doing business with the Connecticut state pension fund disclose their finder's fee arrangements. After initially holding out, Carlyle disclosed a $1 million fee to Wayne Berman.

Thomas Hicks—founder of Hicks, Muse, Tate & Furst.

This Texas billionaire and George W. Bush backer was responsible for taking the University of Texas' asset management private and investing the school's money with various Republican-friendly firms, including Carlyle.

William Kennard—Carlyle managing director.

The former chairman of the Federal Communications Commission (FCC), Kennard approved a highly questionable bid by SBC Communications, a Carlyle client, to enter into long-distance markets days before he left office. Two months later, he landed a job with Carlyle.

Frank Yeary—Carlyle managing director.

A former investment banker at Salomon Smith Barney, Yeary used his extensive connections at SBC to get Carlyle business there.

Arthur Levitt—Carlyle senior advisor.

The former chairman of the Securities and Exchange Commission (SEC) was known for his policy that protected the individual

investor and railed against corporate malfeasance. The irony of his current position with Carlyle is less than subtle.

George Herbert Walker Bush—Carlyle advisor.

The former president of the United States of America has been the source of the majority of Carlyle's controversy. His visits with world business leaders everywhere from Saudi Arabia to South Korea and his repeated influence on American foreign policy make him an easy target for public advocacy groups, who accuse him of influence peddling and damaging conflicts of interest.

Park Tae-joon—Carlyle advisor.

This former prime minister of South Korea was instrumental in securing Carlyle's extensive business interests in the Korean Peninsula.

Michael Kim—Carlyle managing director.

The son-in-law of Park Tae-joon, Kim runs Carlyle's Korean operations, and spearheaded the successful buyout of one of Korea's few healthy banks, KorAm.

Crown Prince Abdullah—heir to the Saudi Arabian throne.

Upset with George W. Bush's pro-Israel policy, Prince Abdullah received a phone call from the president's father, George H. W. Bush, reassuring him that his son was okay, and that George W.'s "heart is in the right place."

Tom Fitton—president of Judicial Watch.

A died-in-the-wool Clinton hater, Fitton caused a stir in Washington when he came out publicly against George H. W. Bush's involvement with the Carlyle Group. His efforts to obtain documents from the federal government have produced some of the most tangible evidence of Carlyle's influence yet.

General Shinseki—U.S. Army chief of staff.

In favor of a more mobile and agile army, General Shinseki originally presented the argument that would ultimately kill United Defense's Crusader, a 42-ton howitzer on wheels.

Andrew Krepinevich—executive director of the Center for Strategic and Budgetary Assessments.

As a member of the Congressionally appointed 1997 National Defense Panel which analyzed military spending, Krepinevich came out against the further development of Crusader, citing the gun's weight and obsolescence as his reasons.

Milo Djukanovic—president of Montenegro.

In searching for support to pursue independence for his country, Djukanovic lobbied the American government to no avail. But he found an ally in Frank Carlucci, who met with Djukanovic and then lobbied his former understudy, Colin Powell, to consider Djkanovic's requests.

Frank Finelli—Carlyle employee.

A retired Army colonel, Finelli is perhaps the most mysterious of all Carlyle's employees. He was instrumental in working with lawmakers to push through incremental approvals of the Crusader program. He has been characterized as a "behind the scenes" type that "works in the dark."

Shafiq bin Laden—estranged half-brother of Osama bin Laden.

Shafiq is the representative to Carlyle for his family's investments with the company, and as such, was at the Carlyle annual investor conference in Washington, DC, on September 11, 2001.

Cynthia McKinney—former democratic representative from Georgia.

McKinney was an outspoken critic of Carlyle and was openly ridiculed for voicing her concerns that people close to the George W. Bush administration stood to gain financially from the ongoing war on terrorism.

Chris Ullman—Carlyle spokesperson.

Hired only after the ironies of Carlyle's bin Laden ties were discovered *after* September 11. Ullman has been a busy man, trying to hold back a barrage of negative criticism.

Paul Wolfowitz—deputy secretary of defense.

Recently profiled by the media as the man behind Bush's war fetish, Wolfowitz is also reported to be the man that killed the Crusader, not Rumsfeld. Regardless, United Defense felt no pain from the cancellation of the program when the company was awarded another contract to build a different gun the very same day.

Louis V. Gerstner Jr.—chairman of Carlyle, former IBM chief executive.

At IBM, Gerstner earned a reputation as a driven executive, directing Big Blue through an unforgettable turnaround, restoring the company's reputation as a global behemoth. It is anticipated that he will only spend 20 percent of his time on Carlyle, advising on two funds and mentoring senior managers.

PROLOGUE

MEET THE CARLYLE GROUP

A vast interlocking global network.

—Carlyle marketing material, circa 2001

It is hard to imagine a more concentrated display of wealth than Manhattan's Upper East Side, where building after building reeks of money, power, and prestige. Multimillion dollar homes share Madison Avenue sidewalks with lavish galleries, ritzy boutiques, upscale nannies, and purebreds. But even against this extravagant setting, the Carlyle Hotel stands out. Its tower rises unapologetically into the sky, lording over Central Park and dominating the skyline around it. The blue-blood interior with lush carpeting and hushed tones perfectly suits its high-end clientele. It is a place for those accustomed to success and comfortable with luxury. In a city full of opulent hotels, it is among royalty.

So it is altogether fitting that the Carlyle Group would assimilate the name of this regal residence when banding together in the summer of 1987. At the time, co-founders Stephen Norris and David Rubenstein met often at the hotel on 76th Street and Madison Avenue. They wanted the name of their company to sound like old money, and the Carlyle moniker fit the bill. But little did either co-founder know, the Carlyle Group would go on to become one of the most powerful and successful private equity firms in the world, with over $13 billion under management and more political connections than the White House switchboard. In its 15 years of existence, the Carlyle Group has become the corporate embodiment of

the hotel it was named after: a towering presence in a world of wealth, power, and politics.

Today, the Carlyle Group is a story of dealings inside the "Iron Triangle," the place where the world's mightiest military intersects with high-powered politics and big business. It is a company whose history includes ties to CIA cover-ups and secret arms deals, and an astounding trail of corporate cronyism. By making defense buyouts the cornerstone of its business strategy, Carlyle now finds itself the beneficiary of the largest increase in defense spending in history. Indeed the stars seem to have aligned perfectly for Carlyle, in just 15 short years. With the ascension of George W. Bush to the presidency, the White House is now full of ex-Carlyle employees, friends, and business partners. And with the newly fattened defense budget, Carlyle has been able to extract massive profits from its defense holdings, like United Defense, in the wake of the terrorist attacks on September 11, 2001. It may be tough times for America, but as Bette Midler might say, everything's coming up Carlyle.

While the company flew well under the radar screen for the first decade of its life, lately success has not come without scrutiny for the Carlyle Group. After all, it's hard to remain anonymous when your employee roster includes names like George Herbert Walker Bush, James Baker III, John Major, and Arthur Levitt. It's also difficult to avoid those pesky accusations of corporate impropriety, conflict of interest, and influence peddling when your chairman emeritus is former defense secretary Frank Carlucci, a man who has courted controversy his entire life and spent his years at Princeton University bunking with his close friend Donald Rumsfeld, the current secretary of defense. Even George W. Bush and Colin Powell put their time in with the Carlyle Group. After years of doing business with everyone from the Bushes to members of the bin Laden family, Carlyle executives have now found their fortunes being accompanied by the cries of conspiracy.

Some critics charge that the company practices nothing more than "access capitalism," trotting out big names that bring in big money. Some call it "The Ex-Presidents Club." Some worry that it is influencing domestic and foreign policy. And some, including former Georgia congresswoman Cynthia McKinney, even implied that President Bush allowed the events of September 11 to take place to

enable him to dictate policy that would benefit the Carlyle Group. But no matter how deep your suspicions run, the Carlyle Group warrants close examination. That a company like the Carlyle Group even exists is testament to the irresistible temptation for ex-politicians to cash in on their time as public servants, in ways that to some seem less than scrupulous.

The Carlyle Group has established a number of firsts in America, including:

- It is the first time a former president has toiled on behalf of a defense contractor.
- It is the first time that a former president advised his son, while holding office, on foreign policy decisions that directly impacted both of their financial fortunes.
- It is the first private-equity firm of its kind to be based in Washington, DC, rather than the traditional haunts of New York, or even Chicago.
- It is the first company to assemble a cast of characters that even *X-Files* writers couldn't have dreamed up. Besides the impressive domestic roster of political heavyweights, Fidel Ramos, former president of the Philippines is a senior advisor. Park Tae-joon, former prime minister of South Korea was also a senior advisor. Former Thai Premier Anan Panyarachun also worked for the company.

If the thought of all of these men working together outside the fishbowl of international politics makes you uneasy, you are not alone. Political watchdog groups, like the Center for Public Integrity and Judicial Watch, have long been howling over the potential for corruption at Carlyle. The company has been investigated by the FBI, excoriated by representatives, sued by political activists, and embarrassed by scandal. Yet the Carlyle machine hums along, doing what it does best: making gobs of money for investors. Watchdogs might as well be barking at the moon, because the scandal here is not what's illegal, but what's legal.

In a time when the ties between high-ranking politicians and billion-dollar businesses has the country on edge, bracing for the next corporate scandal, and waiting for the political shoe to drop, the

Carlyle Group has come to symbolize the extent to which many of these relationships continue unchecked. And when accusations of war-profiteering ring out, Carlyle is usually at the top of most people's list of guilty parties. Coincidence and circumstance only go so far in explaining the unbridled success of this company. Connections, cronyism, and cunning fill in the gaps. Far more disconcerting to the discriminating investor is the fact that Carlyle has become the model for a new generation of investment banking in which former politicians are brought in at high-level positions to butter up investors, foreign heads of state, and business partners. Why else would Los Angeles–based Metropolitan West Financial appoint Al Gore, with zero professional investment experience, its vice chairman? Investment banks are learning that the Carlyle model pays.

But it is Carlyle's particular style of investing that has raised eyebrows. Concentrating on heavily regulated industries like defense, telecommunications, energy, and health care, Carlyle is betting that it can predict future trends in government spending and policy, or influence them outright. And by hiring former secretaries of defense, ex-presidents, the former head of the Securities and Exchange Commission, and the former chairman of the Federal Communication Commission, they are in a position to do either.

Dwight D. Eisenhower, upon leaving the office of president in 1961, warned future generations against the dangers of a "military-industrial complex," and the "grave implications" of the "conjunction of an immense military establishment and a large arms industry." He went on to presciently say, "In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military industrial complex. The potential for the disastrous rise of misplaced power exists and will persist. We must never let the weight of this combination endanger our liberties or democratic process."

The wisdom of these comments has clearly been lost in the 40 years since Ike left office. The first step toward turning things around is understanding how we got here. No single company can illustrate that progression better than the Carlyle Group, a business founded on a tax scheme in 1987 that has grown up to be what its

own marketing literature once called "a vast interlocking global network." The company does business at the confluence of the war on terrorism and corporate responsibility. It is a world that few of us can even imagine, full of clandestine meetings, quid pro quo deals, bitter ironies, and petty jealousies. And the cast of characters includes some of the most famous and powerful men in the world. This is today's America. This is the Carlyle Group.

1

THE POLITICIAN, THE BUSINESSMAN, AND THE UNLUCKY ESKIMOS

It was a great scam.

—Stephen Norris, co-founder
Carlyle Group, May 20, 2002

Cast of Characters

Stephen Norris	Co-founder Carlyle Group.
David Rubenstein	Co-founder Carlyle Group.
Dan D'Aniello	Co-founder Carlyle Group.
William Conway	Co-founder Carlyle Group.
Frederic Malek	Former Nixon aide, close friend of George Bush Sr., and current CEO of Thayer Capital.
Jimmy Carter	Former president of the United States.
William Barr	Former attorney general and law partner of David Rubenstein.

Stephen Norris is getting excited now. Even today, recalling the events that led to the formation of the Carlyle Group, the company that would eventually come to represent Norris' legacy, gives the 53-year-old Washington dealmaker a thrill. Though they didn't know it at the time, co-founders Norris and David Rubenstein, a young staffer from the Carter administration, were embarking on the ride of a lifetime.

With a nose for the big deal, the cocksure Norris is, by his own admission, a difficult man to get along with. His time with the Carlyle Group, ending abruptly in January 1995, was marked by tension, competition, and conflicting egos. He is a man with casual disregard of those with whom he is conversing. His eyes flit around the room. He looks at everything but you. He talks freely, with no fear of consequence, and rarely pauses for a retort. He talks over you. Athletic, fit, handsome, and with a healthy taste for the good life, Norris speaks longingly, even boastfully, of his time with the Carlyle Group, fondly recalling his blockbuster deals with rich Saudi princes and Fortune 500 companies. He is, and always has been, a man that swings for the fences.

In late 1986, Norris, then an executive with Marriott's mergers and acquisitions group and a tax whiz, got wind of a little-known tax loophole that allowed Eskimo-owned companies in Alaska to sell their losses to profitable companies. The origin of the loophole dated back to 1971, when Alaskan natives arrived at a unique settlement with the federal government over ownership claims of Alaskan land. Typically, when Native Americans sued the U.S. government over the atrocities committed during the nation's "manifest destiny" era, the settlements revolved around land, otherwise known as reservations. The logic went that if the government could return some portion of the land they stole in claiming America for themselves, the irreparable cultural damage done to Native Americans in the process would somehow be forgotten. But the Eskimos weren't buying it. Unlike Native Americans in the lower 48 states, Alaska's natives eschewed the traditional award of land reservations. Instead, the Alaskans chose cash. Under a unique settlement, Alaskan natives were allowed to set up native-run corporations to invest and manage the money they had been awarded. In the end, the Eskimos and other native Alaskans ended up with $962 million to manage as they saw fit. They also managed to negotiate for 44 million acres

of land on which to run their businesses. It was the price paid to them for decades of oppression, and they took it.

Because of some bureaucratic foot-dragging and truly unfortunate timing, the newly formed corporations missed out on Alaska's boom time in the mid-1970s. Fishing, timber, and oil, three of the local industries most companies were set up around, experienced major downturns. Many of the companies fell prey to mismanagement, investing in foolish pursuits like tire manufacturers, concrete plants, and hotels. Even though they had chosen their own fate, the owners of the companies felt they had been set up to fail. More than 180 companies had been formed out of the settlement. Only one managed to consistently turn a profit. It was a total disaster.

The companies soon found themselves facing huge losses, and limited options for turning things around. In 1983, Alaskan Senator Ted Stevens worked to save his floundering constituency by incorporating a clause in the 1984 tax bill that allowed the Alaskan-owned companies to leverage their losses by selling them to profitable companies looking for a break on their taxes. Essentially, if an Alaskan company lost $10 million in a fiscal year, they would sell the losses for $7 million in much-needed cash. The buyer would then write the losses off against its profits, getting a $10 million tax credit for just $7 million. Everyone's happy, except, of course, the government. Norris smelled money. But he needed help from someone. Someone with exceptional connections. Someone that knew everybody, including some Alaskan Eskimos.

Someone like David Rubenstein.

Rubenstein: Carlyle's Beating Heart

Ask enough people about David Rubenstein, and you start to hear the same descriptors over and over: brilliant, driven, tireless.

Norris still maintains an objective respect for Rubenstein, with whom he joined forces in 1986. Rubenstein had been toiling as a Washington, DC, lawyer for six years with the mergers and acquisitions groups at Shaw, Pittman, Potts & Trowbridge and G. William Miller & Co. when Norris came calling. Norris, who often transitions seamlessly between utterly eloquent and outright crude, calls Rubenstein "indefatigable, "indomitable," and "f**king brilliant." Rubenstein would go on to become the very heart and soul of Carlyle, driving the company forward through clashing egos and countless near-scandals.

After graduating from the University of Chicago Law School in 1973, Rubenstein worked his way up the political ranks with blazing speed. At the tender age of 27, he became the deputy domestic policy assistant to President Jimmy Carter. He was the first person in the office in the morning, and the last to leave. One of the most widely circulated stories about Rubenstein is that he survived solely on vending machine fare during his time at the White House, a claim he does not refute. He strongly believed in the nobility of being a public servant. He was young, idealistic, and most of all, innocent.

In the spring of 1980, Rubenstein filed a memo to the president late one night. Before he left to go home—some thought that he was actually living in the White House due to his late hours—he remembered something he had intended to add to the memo, and went into the president's office to fetch the document. After shuffling through some papers in the president's inbox, he found the memo, amended it, and returned it to the stack. The next morning, President Carter questioned Rubenstein about his late-night foray into his office, asking him pointedly and repeatedly what he had seen while he was there. Rubenstein truthfully told the president that he simply got his memo, and then returned it, seeing nothing in the process. As it turns out, atop the stack of papers on Carter's desk, were the plans for the ill-fated rescue attempt of America's Iranian

hostages in April 1980. The story, related to me by Norris, demonstrates Rubenstein's early naiveté. It also foreshadows the paranoia that some say has grown inside him over the past 20 years in Washington, DC. "He sees conspiracies," says Norris.

After Carter lost to Reagan in 1981, Rubenstein was released into the world of high-priced beltway lobbyists. It was a business that insulted Rubenstein's renowned intelligence and underutilized his many talents. His distaste for the work was captured in a 1993 article in *New Republic,* where he was quoted as saying, "I found it demeaning, it was legalized bribery." His opinion of lobbying would change later in his career.

Rubenstein would soon be delivered from the tedium of Washington influence peddling, when Norris, while still working for Marriott, contacted him, looking for a way to cash in on what would come to be known within Carlyle as the Great Eskimo Tax Scam.

Norris' entire job at the time was to scour tax law and find ways to save Marriott millions. He hired Rubenstein and William Barr, the man who would go on to become attorney general from 1991 to 1993, from Shaw, Pittman, Potts & Trowbridge, a Washington law firm that had represented Marriott on the Hill in the past. Along with his relentless work ethic, Rubenstein had also garnered a reputation for his extensive Rolodex. When Norris asked him if he knew any native Alaskans, Rubenstein had no problem coming up with some names.

Marriott ended up paying Rubenstein and Barr a seven-figure fee for their help in saving them a bundle on their taxes in 1986. Norris, after reading the tax bill closely, decided there was a much greater opportunity here than just this one-shot deal. He figured if Rubenstein and Barr could make out so handsomely for their limited role in facilitating Marriott's tax relief, he could, too. Norris left Marriott and set up shop in Seattle to pursue the deals, all the while talking to investors about opening up a little business of his own.

Before long, Norris and Rubenstein were flying Eskimos into Washington, DC, buttering them up, and brokering deals between them and profitable American companies. Finding the loss-making Eskimos was easier than either of them had imagined, and the profitable counterparts couldn't get enough of the free money. Norris and Rubenstein took a 1 percent cut of the transactions and sent an estimated $1 billion through the loophole. A cottage industry had been born. After clearing close to $10 million, Norris and Rubenstein recognized the ongoing potential of the business, and decided to incorporate. For corporate representation, the two hired none other than Ron Astin of the venerable Houston law firm Vinson & Elkins. (Astin would later find himself testifying before Congress about offshore partnerships he had helped set up for Enron.) With the crew in place, liabilities limited, and money coming in the door, the boys were ready to make something of themselves. All they needed now was a name.

During this time, Norris and Rubenstein frequented the Carlyle Hotel in New York. Norris loved the place. It was the kind of over-the-top lavishness he couldn't get enough of. It had a high-roller feel to it. His hero, Andre Meyer, the legendary head of investment bank Lazard Freres, had lived there for years. Norris felt the name lent the company a silk-stocking air. After selling Rubenstein on the idea, the Carlyle Group was born.

That the Carlyle Group was formed out of a temporary tax loophole, which was eliminated a year later, is utterly appropriate. David Rubenstein, as dedicated a public servant as there ever was, saw fit to found his company on a scheme that denied the federal government close to $1 billion in taxes. It was the first of many ironies that would compromise Rubenstein's political roots as his career with Carlyle progressed. As with many of the Carlyle Group's future deals, the Great Eskimo Tax Scam was entirely legal. Whether it was ethical, is another question.

The tax loophole unwittingly encouraged Eskimo companies to overstate their losses, and the IRS was called in to investigate. A discrepancy between "hard" and "soft" losses arose. Corporate appraisers took liberties in estimating the loss in value of certain goods, like timber and oil. Suddenly everyone in Alaska had losses for sale. It was a bonanza for accountants. Though no charges were ever filed, the case portends the current corporate malfeasance in America, in which companies inflate revenues and earnings through marginally legal accounting.

It bears mentioning that in certain cases, the tax loophole actually did what it was intended to do. Some Alaskan companies took the capital they received and reinvested, saving themselves from certain bankruptcy. Finally, however, just before Carlyle could complete a $500 million deal with a company called Cook Inlet, the government had seen enough of its money wasted, and sewed up the hole. It was the end of a great scheme for Carlyle, and it would be the last easy money the company saw for half a decade.

Goin' Legit

After the tax loophole closed, Norris and Rubenstein briskly went about building an empire. They brought Dan D'Aniello over from Marriott, whose salary Norris personally guaranteed. They also signed up William Conway, a former chief financial officer at MCI Communications. Funding for what Rubenstein was pitching as a leveraged buy-out firm came mainly from Pittsburgh's wealthy Richard K. Mellon family and Ed Mathias at T. Rowe Price, the Baltimore-based investment bank. It only took $5 million to get them on their way.

It was the go-go 1980s, and big business was flying high. Leveraged buyouts were the name of the game. This particular brand of cut-throat business consisted of big banks borrowing billions,

acquiring huge positions in struggling companies, snatching them up on the cheap, and selling them off for parts or turning them around. Everyone was getting rich and Rubenstein was itching to get a piece of the action. He would later confess to a reporter that "I thought I had a pretty good IQ myself, and people were making a lot more money than me who I thought maybe weren't so smart."

The most important thing for buyout firms, otherwise known as private equity firms, is raising capital. The more money a given firm can raise, the more successful it can be. Like a mutual fund, a buyout fund collects money from a number of sources—wealthy individuals, institutional investors, pension funds—then invests it on their behalf. But instead of investing in stocks, buyout funds buy companies, with the intention of turning them around and selling them for a profit. Typically, the companies are bought with a mix of capital and debt, somewhat mitigating the risk of the buyer. Hence, the leveraged buyout, or LBO, nickname. The companies are then held in a portfolio, or fund, which usually has a target market or theme. It can be a dangerous form of investing, open only to the extremely wealthy. Minimum investments in a given fund are usually no less than $1 million, and returns are generally expected to be more than 25 percent, usually within 10 years, sometimes less. Downside can be that much and more. LBOs are not for the faint of heart.

The Carlyle Group based themselves in Washington, DC, instead of the more traditional buy-out firm haunts of New York or Chicago, a move that surprised many in the business. Arthur Miltenberger, then chief investment officer of the Mellon Foundation, would tell *Forbes* at the time, "I was intrigued by a merchant bank based in Washington, DC, because foreigners have to come to Washington." Upon incorporation, Carlyle hardly registered a blip on the radar of older, more established buyout firms like Kohlberg Kravis & Roberts and Fortsmann Little.

It was clear from the outset that what the Carlyle Group had to offer that was different from its more incumbent competitors was its access. Newspapers heralded the rise of a new breed of dealmaker: the access capitalist. Indeed, the Carlyle Group's first deals reflected the relationships that its founders had fostered. Carlyle took a $35 million stake in Consolidated Entertainment, a company that was part-owned by Gerald M. Rafshoon, a former Carter administration advisor. The company was planning a six-hour miniseries for HBO called "The Great Satan," a detailed account of Ayatollah Khomeini and the Iranian hostage crisis, a topic that Rubenstein knew all to well. But it soon became apparent that it takes more to succeed in the world of high finance than a political pedigree and a bunch of swell friends.

The company stumbled its way to a disastrous early record, overpaying for ill-advised investments, and getting beat out by more nimble competitors on the only deals that had potential. In 1987, Carlyle launched a takeover bid of the Mexican restaurant chain Chi-Chi's, only to be outbid by Foodmaker. Then again in 1988, Carlyle began accumulating shares of Fairchild Industries, a Virginia-based defense contractor, only to be out-bid by Banner Industries, which up until that point had been in partnership with Carlyle. It was a bruising introduction to the world of high finance. Though the company made about $10 million in stock profits on both deals combined, they were discovering the hard way how the leveraged buyout game was played.

Counting the Jews

Then in September 1988, the Carlyle Group would get an infusion of experience, and controversy, when Frederic V. Malek, a former personnel chief for President Nixon, signed on. Malek, nicknamed "The Ax" for his days as Nixon's strongman, managed

Norris and D'Aniello at Marriott in the early 1980s. Close friends with George H. W. Bush, Malek had just been rewarded for coordinating Bush's New Orleans convention with a position as deputy chairman of the Republican National Committee (RNC) in August 1988. But the excitement was to be short-lived. Less than a month after Malek's appointment, scandal erupted in Washington.

In early September 1988, the *Washington Post* reported that in July 1971, operating under instructions from President Nixon, Malek had compiled figures on the number of Jews working within the Bureau of Labor and Statistics (BLS). Nixon, then at the height of his paranoia, believed that a "Jewish cabal" within the Bureau was undermining him, releasing unfavorable and inaccurate data to the public to damage his approval ratings. Malek, in a memo dated July 27, 1971, reported that 13 of the top 35 BLS officials were indeed Jewish, and provided their names to Nixon. In the months following, Chief Economist Peter Henle and Director of Current Employee Analysis Harold Goldstein were reassigned to lower level positions within the BLS. At the time these events occurred, nothing was known of Nixon's anti-Semitic sentiments. It wasn't until 17 years later that the incident came back to haunt Malek, when *Washington Post* reporters uncovered the fateful memo while digging through old files from the Nixon administration.

After the news broke, Malek resigned as RNC chairman immediately and admitted to compiling the figures for the president, but not for reassigning the two prominent Jews. The damage had been done though. Malek knew that he would be labeled an anti-Semite. He knew the public had no tolerance for that kind of ethnically fueled politicking. He knew that he was in danger and he knew immediately where to go.

Norris called Malek the day the news hit the papers, and told him to calm down, and come over to the Carlyle offices on Pennsylvania Avenue. Malek had his motorcade sneak into the

garage, so as not to be seen by anyone. "I've never seen a man so upset in my life," Norris recalls. "He was literally shaking." Norris set Malek up with an office adjoining his own, and Carlyle gave him a draw, or a salary, which Malek would theoretically have to earn back. Malek was by far the best connected of the nascent company. He brought with him deep relationships with the Bush family, the Saudi Arabian royal family, and countless Washington insiders. Even with his freshly tainted reputation, he would go on to spearhead several big deals for the company, including an ill-fated buyout of Caterair, the Texas-based airline catering company that would hire George W. Bush. Though Malek's stay at Carlyle would amount to nothing more than time on the lam, hiding out while the furor over his anti-Semitic actions died down, he did manage to set Carlyle up with a handful of high-powered Republican connections. He would soon return to public life to lead President George H. W. Bush's reelection campaign in 1991. But after Bush lost to William Jefferson Clinton, Malek found that he was no longer welcome at Carlyle. "No one wanted him back, and it was very embarrassing for Fred not to have a place to land," says Norris. "And it was wrong." Malek still harbors resentment over what he feels was mistreatment. "His wife still hates me," says Norris.

Though brief, Malek's time with Carlyle would ultimately change the face of the company forever. "I brought a little more name recognition, a little more gray hair," recalled Malek in an interview for this book. He is quick to point out that he never joined the firm outright. "I was officing there, just a freelancer," he says. In the fall of 1988, Malek brought Carlyle in on yet another ill-conceived deal to acquire Coldwell Banker Commercial, the biggest commercial real estate broker in the United States at the time. To this day, he asserts his independence from Carlyle on that deal. "It was my deal, my capital, and they just participated in it," says Malek. This exclusive attitude toward Carlyle would eventually cause enough tension between Malek and Rubenstein, that

Carlyle didn't see the need to welcome him back after Bush lost the election. Rubenstein and Conway would often refer to Malek as a "self-centered freeloader." But it was Malek who demonstrated the power of political contacts in deal making, a lesson the boys at Carlyle would take very much to heart.

Ultimately, the Coldwell deal was a bust when the real estate market did not cash in on Japanese investments as was anticipated. About the same time, Malek was helping a well-known Texas native by the name of George W. Bush, the son of then President George Bush Sr., buy the Texas Rangers major league baseball franchise. Like other deals that Malek worked while he was "officing" at Carlyle, the same people who had brought Malek in from the cold found themselves excluded from the negotiations on the Rangers.

There was one deal that Malek would let Carlyle in on, however, that both parties wish had never happened. In a classic LBO, and one of the last major deals of the booming 1980s, Carlyle would facilitate a management-led buyout of Marriott's In-Flite airline catering business. The company would later go on to be nicknamed "Craterair" by Wall Street analysts, and would remain a black mark on Carlyle's record until the mid-1990s. Though the deal would be a major bust, it wasn't all bad. It would introduce the foundering company to a young Texas businessman known simply by his middle initial: W.

2

CRATERAIR

Coffee, tea, or bankruptcy?
—*Forbes,* September 26, 1994

Cast of Characters

J. W. Marriott	Chairman of Marriott Corp., former boss to Stephen Norris, Fred Malek, and Dan Altobello.
Dan Altobello	Former chairman of Caterair.
George W. Bush	President of the United States of America.
Stephen Norris	
Fred Malek	

To understand how Carlyle works today, it is crucial to be fully acquainted with the company's long and sordid history. Each deal the Carlyle Group made, be it a wild success or tragic failure, helped shape what the company has become. Some buyouts that Carlyle participated in helped them gain a better understanding of a new industry. Some introduced them to new people—the human collateral that would open up future opportunities. In engineering the Caterair deal, Fred Malek would accomplish both.

In the case of the Caterair buyout, Carlyle made up for the money they lost—like many of the company's early deals, Caterair was horrendously unsuccessful—by hiring the man that would eventually be the leader of the most powerful country in the world: George W. Bush. Caterair may have been a complete failure

by ordinary business standards, but the relationships cultivated therein were more than worth the stinging financial losses. In Washington, it's not what you know, but who you know, and knowing George W. Bush, then son of the nation's president, was a valuable connection indeed. But getting an in with the president's son wasn't easy, and it all started when the man known simply as "Mr. Marriott" got a hankering to sell one of his businesses.

J. W. Marriott is among the most highly regarded businessmen in the world. He has a proven track record of deft management and strong leadership. His former employees, years after they've left the company, continue to refer to him as "Mr. Marriott," out of sheer respect. He has been known to sense trends in the industry with uncanny prescience. So in 1989, when Mr. Marriott made it known that his company's airline catering division, then known as Marriott In-Flite Services, was on the block, one had to suspect that he knew something the rest of the world didn't know. Nevertheless, a group of zealous Marriott executives went ahead with plans to buy the stagnating division from Marriott Corp. with the help of the newest merchant bank on the block: Carlyle Group.

Originally formed in 1937, Marriott In-Flite had ceased to be a growth area for Marriott by the late 1980s, and Mr. Marriott wanted out. Dan Altobello, who headed the division within Marriott since 1982, decided that he would spearhead a management-led leveraged buyout of In-Flite, meaning the current employees of the division would raise the capital necessary to buy the business from Marriott. Altobello knew exactly who to call to structure the deal. In fact, he knew them quite well.

Norris, Malek, and D'Aniello, were all former Marriott executives and former co-workers of Altobello's, and together they all got to work immediately on putting together a deal. Norris' role was to work the deal such that Marriott's tax liabilities were limited. Malek was needed to help Altobello manage the new independent company (this was a special request of Mr. Marriott).

D'Aniello managed the relationship with Merrill Lynch, which would provide a $250 million bridge loan to complete the deal, the last such deal Merrill Lynch would ever partake in. Negotiations progressed, capital was raised, and then, $650 million later, in July 1989, Marriott In-Flite was sold to its employees and renamed Caterair. Carlyle retained a stake in the new company, as well as collecting a fee for structuring the deal. It would be the last major LBO of the 1980s, the decade of LBOs.

Caterair consisted of 150 different airline customers at 45 U.S. and 38 foreign airports. It had an army of 19,000 employees and revenues of $800 million in 1988. It was a very big deal. Malek and Altobello became co-chairmen and greeted the press with promises of expansion in international markets, particularly the Soviet bloc. But it was not to be.

Malek's Triangle Trade

At the same time he was working to complete the Caterair deal, Fred Malek was also putting together the largest buyout ever in the airline industry: a $3.65 billion buyout of Northwest Airlines, then the country's fourth largest carrier. Malek worked with Al Checchi and Gary Wilson, two more former Marriott executives, to buy out Northwest, and in June 1989, just days before the Caterair deal was finalized, Malek had successfully completed the Northwest deal. That Malek was working on two colossal deals simultaneously was disconcerting to the boys at Carlyle, particularly when they had cut out of the Northwest deal entirely. Just a year removed from his disgraceful exit from public life on the Bush campaign trail, and Malek had multiple irons in the fire. (He was also helping George W. Bush to buy the Texas Rangers at this time.) Controversy had slowed down Malek's political ambitions, but it did nothing to hinder his business pursuits. By October 1989, Malek had been named president and CEO of Northwest. The job

required that Malek assume responsibility for day-to-day operations at Northwest, meaning he could no longer devote the time necessary to Caterair, and the burden of running the company fell solely to Altobello.

But Malek was no fool. Though he was constantly distracted by his myriad responsibilities, he still had time to make some critical moves for Caterair. By 1990, Malek had decided that George W. Bush would make an excellent board member for Caterair. "I began spending all my time on the Northwest deal, and when we did the Caterair deal, I thought he (George W. Bush) would be a good guy to be on that board," Malek told me. "His office had been next to mine on [his father's] campaign, so I knew him real well. He was coming to Washington a lot anyway, and I thought he had a lot of business judgment and practical sense. I just thought he would be a good director." George W. Bush became a board member of Caterair in 1990, the year after the company was bought out. Up to that point, Bush had a decade's worth of experience in the oil industry, but nothing even resembling the service-oriented business of airline catering. But George W. Bush had far more valuable things to offer than direct business experience. His father was president of the United States at the time and one would think that had to be worth something, both to Malek personally and to Carlyle.

In effect what Malek had constructed was his own personal triangle trade. Caterair did a sizeable business with Northwest. Northwest needed some help from the Bush administration on some regulatory issues, after Congress began questioning the airline's near-monopoly status at certain hubs. Finally, George W. Bush needed to bolster his business resume, and Malek of course was close friends with his father. Between currying favor with the president and securing business for Caterair, Malek had killed two birds with one Bush. And that's how cronyism works.

Despite Malek's public statements about Bush being appointed because of his business acumen, one Caterair board member said the real reason that Bush was named to the board was to help

Malek out on with the regulatory issues he was facing at Northwest. The board member also says that Malek, Bush, and Altobello would often huddle together at Caterair board meetings, excluding the rest of the board. Bush's involvement in the day-to-day activities of Caterair was nominal at best. "We all coveted his custom Texas Ranger's boots, signed by Nolan Ryan," says the board member, recalling what George W. Bush added to the board. "He was really smart but not really engaged in Caterair's business." The point at which arrangements like Caterair's break down is when the few individuals who control the company are maneuvering so feverishly for their own personal gain, that the well-being of a company, and its 19,000 employees, is overlooked.

Business went on that way for a time until the airline catering industry hit a wall that Caterair was ill prepared to climb. War in the Gulf, higher oil prices, and a nationwide recession combined to devastate revenues in the airline industry. Airlines started shutting their doors, facing bankruptcy. In 1991, alone, Caterair lost two of its best customers when both Pan Am and Eastern Air Lines stopped flying because of financial insolvency.

Adding to Caterair's woes, airlines started aggressively cutting costs, and one of the first places they looked was their meal budget. By 1993, the nine major airlines had cut food costs by 8 percent. Peanuts and crackers took the place of hot meals. Low-cost airlines that rarely served meals at all, like Southwest, steadily gained popularity. The pullback vanquished profitability in the catering business, which was already operating on razor-thin margins. "They could not cut costs fast enough," Malek bitterly recalls of the airlines.

Norris' Self-Destruction

Caterair lost $185 million in fiscal 1993, down from a profit of $52 million the year before, and the company was in a dire position. At this point, dissension began to fester in the boardroom.

Norris wasn't making any friends at Caterair, riding management and looking for alternatives and exit strategies for the company's quickly evaporating business. He began taking matters into his own hands, looking for buyers and raising money from personal acquaintances. He even held meetings with potential acquirers, like Sodexho, a massive international facilities management company. Norris was pushing his own agenda, and his fellow board members didn't appreciate it. But they all had their own agendas as well. With so much disparate intent in the boardroom, it's no wonder the company failed.

Then Norris went too far. Carlyle had been attempting to negotiate a management fee at Caterair, a customary payment in a leveraged buyout, but something that Carlyle did not ask for until years after the deal had been done. The Caterair board was about to approve the fee, which would at least bring some dividends from the deal back to Carlyle. To do so, the board held a meeting to vote on it. When it came time to vote, the board asked those members of the board who were also on staff at Carlyle to leave the room, due to their obvious conflict of interests. Norris, who had been attending the meeting from Paris via speakerphone, unleashed an inexplicable tirade of obscenities aimed at the board, according to people who were in the room. Apparently indignant at having to hang up during the vote, a perfectly reasonable request, Norris refused. His fiery outburst incensed the other board members, and ended up costing Carlyle the management fee. Reminded of the incident, one Carlyle staffer explained Norris' actions like this: "That's just Steve. One minute he's a brilliant businessman, on the trail of a big deal. The next he's a maniac. Steve is incredibly erratic."

Norris then instructed one of his staffers at Carlyle to work up some numbers on how a sale to Sodexho might save the equity in Caterair. Norris had very little confidence in Altobello's ability to steer the company through these troubled waters. He felt that Altobello had already missed opportunities to exit the

business with their reputations and their bank accounts intact. Norris often criticized Altobello's ineptitude to colleagues and friends. So instead of bringing the paperwork to the company's CEO, he naively brought it to Malek, thinking he could confide in him. It didn't take long for Altobello to find out what was going on behind his back, and he went ballistic, according to Norris. Altobello told Norris he had no right to attempt a sale of "his" company. Norris was asked to leave the board, and it would signal the beginning of the end of his Carlyle career. But it would get even uglier.

Shortly after Norris left, in 1994, George W. Bush would also jump ship. In a move that would dog him throughout his Texas gubernatorial campaign, Bush quit the board in May, in the midst of Caterair's financial unraveling. Incumbent Governor Ann Richards attacked Bush's business record, questioning Bush's claims that he was a successful businessman. "Mr. Bush continues to insist that he's a successful businessman, but when you take a hard look at his record, it's clear that he's not what he says he is," said Chuck McDonald, Governor Richards' spokesperson. With layoffs and losses mounting at Caterair, it was hard to argue. Bush responded feebly in the *Dallas Morning News,* saying simply that "the airline food business is going from hot meals to peanuts, and this company is in the process of adjusting."

The roof was caving in fast now, the result of squabbling in the boardroom and difficult economic circumstances. *Forbes* ran a scathing expose of the company in September 1994, entitled "Coffee, tea, or bankruptcy?" In it, the magazine ridiculed Altobello for drawing more than half a million dollars in annual salary as his company went belly up. Competitors were beating Caterair to international markets, which were the only markets growing at this point. Finally, Caterair was unable to diversify into a number of the ancillary markets its competitors were exploring, because of a noncompete clause with Marriott the managers signed when they led the buyout five years earlier. It was now all too clear why

Mr. Marriott couldn't wait to unload the catering business. It was a lemon.

Adding injury to insult, Representative Harold Ford told newspapers that he nearly choked to death during a Northwest flight in 1992, catered by Caterair. The Democratic congressman from Tennessee claimed there were multiple unidentified objects in his steak and potatoes that tore up his mouth and throat. He filed a lawsuit for $18 million against Caterair. It was horribly embarrassing for the faltering company, and it would coincide with Caterair's last gasp.

In September 1995, Caterair completed a deal with Onex Food Services, the parent company of Sky Chefs, Inc. The value of the transaction was slightly more than $500 million, far less than the $650 million that was originally paid for the company, which had grown its operations in the six years it had been independent, and should have been worth much, much more. It was, by all accounts, a disastrous deal. Carlyle, Malek, and Altobello had all taken a bath on it.

By this time, Malek had been spurned by Carlyle upon his return from the unsuccessful Bush reelection campaign and had gone on to start up his own private equity concern—Thayer Capital. He offers this understated comment on Caterair's ruination: "What went wrong is that you had the Iraqi invasion of Kuwait and the explosion of oil prices, which led to reduced travel and higher oil prices for airlines. There was lower passenger count because people were afraid to travel, and now higher costs because of the huge spike in fuel. We were in a survival mode as the airlines uniformly and drastically cut food service. We had to find a way to come out of that as best we could, and we were able to do that by merging it into Sky Chefs. We got enough cash to pay off debts, and a little bit of equity. It was not a screaming home run."

The saga of Caterair serves as a microcosm of Carlyle's early years. The infighting, egos, petty jealousies, and conflicting

agendas of the Caterair board were the same problems that Carlyle would wrestle with for years. Until Norris left the company in 1995, Carlyle would struggle with achieving solidarity among its upper management and creating a unified identity. Caterair was the first of many examples of the fracturing within Carlyle in the first seven years of its existence. But Caterair wasn't all bad.

Caterair turned out to be a very expensive introduction to then-President Bush's son for Carlyle. From George W. Bush, to James Baker, to George H. W. Bush, the connections made through Caterair would bolster Carlyle's ability to hook high-profile politicians leaving office. In the end, they had Malek, the man to whom they coldly turned their backs, to thank for it.

But it wasn't until 1989, after the Reagan administration had cleared out its desks, that Malek's stamp was permanently impressed on Carlyle. Rubenstein asked Malek who he thought would be a good person to hire coming out of the Reagan White House. Malek thought immediately of Frank Carlucci, the outgoing secretary of defense, and the man who had succeeded him as deputy director of the Office of Management and Budget in 1972. Malek held a cocktail party at his house in Washington, spoke to Carlucci, and quickly sealed the deal. On January 26, Frank Carlucci became vice chairman of the Carlyle Group, and life at the young merchant bank would never be the same again.

3

MR. CLEAN

They used to call him "Spooky Frank Carlucci."
—Former Carlyle employee, July 2002

Cast of Characters

Frank Carlucci	Lifelong public servant, former secretary of defense, former deputy director of the CIA.
Patrice Lumumba	Former president of Zaire, assassinated after only two months in power.
Mobuto Sese Seko	Chosen by Americans to succeed Lumumba, led Zaire into decades of famine and war.
Donald Rumsfeld	Secretary of defense, former college roommate of Frank Carlucci.
Raoul Peck	Filmmaker.
Caspar Weinberger	Former secretary of defense, Carlucci's mentor.
Roderick Hills	Former CEO of Sears World Trade.

The hiring of Frank C. Carlucci brought more than just the instant name recognition of one of the most dedicated public servants of the last three decades. It brought baggage—boatloads of baggage. Over time, the pattern of Carlyle's hiring practices emerges to reveal a series of old friends helping one another out. Norris helps out Malek, who brings in Carlucci, who helps land James Baker III, who places a call to George Bush Sr. Each successive hire helped co-founders Rubenstein and Norris climb the

political ladder, which ultimately delivered Carlyle to its riches. But it was Carlucci that served as the foundation of Carlyle's political reputation. He was the first high-profile, well-publicized hire by Carlyle (Malek was kept quiet for fear of bad press). It was Carlucci that really got the ball rolling, despite his checkered past.

Depending on your political leanings, Carlucci's early curriculum vitae read either like a resume for president of the United States or a checklist of foreign policy snafus. From his days with the U.S. State Department in the explosive Congo to his clean up of the Iran-Contra affair, Carlucci has been everywhere, seen everything, and knows everyone. He has been called "Mr. Clean" for his ability to mop up politically damaging situations, and "Carlucci the Cutter," for his relentless budget trimming. It was this type of ultimate Washington insider that Carlyle was fishing for when they hooked him in the winter of 1989. And that's exactly what they got. Carlucci's tenure at the firm would result in an astonishing litany of high-powered hirings, from James Baker III to John Major to George H. W. Bush, himself. But it was Carlucci's dark political past, and the relationships fostered therein, that suddenly made Carlyle's future so bright.

Born in Scranton, Pennsylvania, in 1930 to the son of an immigrant stonecutter from Southern Italy, the diminutive, soft-spoken Carlucci attended Princeton University, where he roomed, wrestled, and recreated with close friend Donald Rumsfeld. He served two years in the U.S. Navy, took some classes at Harvard Business School, and signed up with the State Department as a Foreign Service officer in 1956. After two years as vice consul and economic officer to Johannesburg, South Africa, Carlucci was assigned to the volatile Congo (now known as Zaire) as second secretary in the U.S. Embassy. He was 30 years old.

The year was 1960, and the Congo was a dangerous place to be. The former Belgian colony received its independence in late June and was holding its first public election. But the mood was still uncertain, and the population was volatile. By July, Patrice

Lumumba and his nationalist party had assumed control of the sprawling country. Lumumba was rumored to be tight with communist factions in the Soviet Union, and the election results put the United States on edge. Even after Congo's new leadership had been established by democratic means, sporadic violence throughout the country was not uncommon.

While negotiating through tribal violence, which had been fomented by the Belgian colonial government for years, Carlucci's daughter was threatened at bayonet-point, and Carlucci himself was stabbed between the shoulder blades and arrested after a car he was riding in struck and killed a bicyclist. But Carlucci, who was once called "a tough little monkey" by his father, stayed on in the Congo, despite the life-threatening circumstances. Lumumba stayed in power only two months, replaced by Mobuto Sese Seko, America's handpicked successor, in the fall. But the threat of a Lumumba-led coup to recapture power remained. Uncomfortable with that prospect, the United States began planning an assassination attempt. A poisons expert was dispatched to the region to carry out the mission. An investigative committee led by Senator Frank Church would later reveal that President Eisenhower himself had ordered the assassination. Though many Americans suspected that their government engaged in this kind of murderous behavior during the Cold War, the Church report made it frighteningly real. And undeniably true.

Lumumba was eventually assassinated, though not by U.S. forces. Instead, rival factions within the Congo took his life during a scheduled prisoner transfer. Many still believe the United States was behind the assassination, sharing information on the time and place of the transfer with the executioners. The Church report ultimately cleared the CIA of involvement. That didn't stop filmmaker Raoul Peck, a native of the Congo who has dedicated his professional life to researching and telling the story of Patrice Lumumba, from including a scene in his docudrama *Lumumba* that shows a group of men plotting Lumumba's murder.

At one point during a vote on the means of assassination, an actor playing Carlucci is asked what he thinks. His response, intended to appear disingenuous, is, "My country's government is not in the habit of meddling in the democratic affairs of a sovereign nation. We'll respect your decision." Peck says his extensive research uncovered that Carlucci was involved in the plot at the highest level, and the scene was used to illustrate that point.

Carlucci would fight the filmmaker, and eventually have the scene edited (his name is bleeped out), saying it was a simple case of mistaken identity. "I was never as fat as that guy," he charmingly told reporters at the film's opening. "The scene is tendentious, false, libelous; it never happened, and it is a cheap shot." Peck says today that the film's distributor did not want to run the risk of a lawsuit, but Peck stands by the veracity of the film, and in particular, that scene.

Cold War Operative to Career Politician

Thus, began Frank Carlucci's rise through the ranks of the executive branch. Before being offered the number two job at the Office of Economic Opportunity (OEO) in 1969 under his old friend Donald Rumsfeld, he was accused of leading the overthrow of Joao Goulart in Brazil in 1964, Abeid Karume of Zanzibar in 1972, and Salvador Allende of Chile in 1973, according to the London *Times*. He was also accused by Italian communists of being behind the 1978 kidnapping of Aldo Moro, and subverting the revolutionary process in Portugal. "He has been a specialist in dirty work and coup attempts in the Third World," Ramon Meneses, spokesman for the Sandinista Front in Nicaragua would tell reporters later. Carlucci denied everything, and nothing was ever proven. But Carlucci had already earned a couple more nicknames—"Spooky Frank Carlucci," and "Creepy Carlucci"—and his reputation as a Cold War operative in charge of installing

pro-Western governments throughout the world would follow him throughout his career.

Carlucci went on to succeed Rumsfeld at the OEO, then followed it up with stints at the Office of Management and Budget (OMB) (where he was succeeded by Fred Malek), Department of Health, Education, and Welfare (HEW), and finally landed as the deputy director of the CIA in 1978, under Carter's administration. During his time at the CIA, Carlucci was accused by conservative senators of weakening the agency through budget cuts, a charge that worked against him when those same senators voted against his nomination as deputy secretary of defense under Reagan (though he was ultimately approved for the job). He also pushed for legislation that limits the public's right to learn of CIA activity through Freedom of Information Act (FOIA) requests, an important tool for Americans wanting to know more about the actions of their elected officials.

By February 1981, working under Caspar Weinberger in the defense department, Carlucci was cultivating a new reputation, that of a master bureaucrat, efficient manager, and loyal citizen. He was seen as a problem fixer, dispatched to hot spots around the world to ensure a positive outcome for the United States. He had a history of attracting, then defusing, controversy. His legacy in tact, his connections extensive, Carlucci left the public life in 1982 for his first real business endeavor: world trade.

Secret Arms Deals

In what would later become a model for the Carlyle Group, Carlucci signed on to work with the newly formed Sears World Trade, a subsidiary of Sears designed to post executives around the world and compete with Japanese *sogo shosha* (trading companies). These massive companies leveraged size and extensive resources to conduct international trade, like timber in Thailand

for paper in Paraguay, always buying low and selling high. Like the Carlyle Group five years later, Sears World Trade (SWT) curiously chose to base itself in Washington, DC, and hire exgovernment officials as its top executives.

Sears World Trade CEO Roderick Hills had been SEC chairman from 1975 to 1977, and knew Frank Carlucci from his time as counsel to President Gerald Ford, when Carlucci was working with Caspar Weinberger in HEW. Hills brought Carlucci on as president of Sears World Trade. Among the other former government officials that wound up at SWT were Curtis Hessler, former assistant secretary of the treasury, and Alan Woods, former deputy secretary of defense. The group had grand dreams of an international trading powerhouse. The end result was far from it.

The company hired more than 1,000 employees, which made it several times larger than comparable companies. And it lost money. A lot of money, very fast. Sears World Trade, lost $12 million in its first year. It lost $16.3 million in its second year. It racked up monstrous travel expenses en route to making precious few trades. The strategy was ill-defined, and by 1984, Hills would resign abruptly amid growing losses.

It was about this time when the press began speculating that company was a CIA cover up. It wasn't an illogical conclusion to draw. There was a conspicuous lack of deals. The numerous staff, many with political ties, in far-flung locations puzzled business analysts. The Washington, DC, address was very unusual. There was no income. And of course, Frank Carlucci was right in the middle of it all. Everything seemed to add up. But Hills dismissed the claims, telling the *Washington Post,* "People like to make fun of the fact that we hired high government officials," explains Hills. "We didn't do that."

Then in 1986, the press learned of covert arms deals that Sears World Trade had participated in over the previous three years. The news hit just as Carlucci, by then chairman of SWT,

was chosen by President Reagan to head up the National Security Council, called in to replace John Poindexter, who resigned amid the furor over the Iran-Contra affair. The irony was thick. A new national security advisor, another arms scandal.

Using a subsidiary of SWT, called the International Planning and Analysis Center, Carlucci consulted on the buying and selling of anti-aircraft missiles, radar, jets, and other military equipment for the United States and Canada. IPAC was loaded with exmilitary, and also provided consulting to Third World countries. But nobody within SWT even knew about it. Donald Rumsfeld, never to be found too far from Frank Carlucci, was a member of the SWT board, and was quoted as saying, "We received periodic reports on Sears World Trade as an entire company, but I don't personally remember the arms deals." Another board member reacted with astonishment when he heard the news. "You're kidding," he candidly exclaimed. It appeared to be at least a breach of the public's trust, not to mention shareholders. For a brief time, the news looked like it would be a devastating blow to Carlucci's future ambitions in politics. At a time when he was being called up to restore credibility to the National Security Council, he was being dogged by accusations of yet another controversial covert action. But like so many times before, and in what would come to be his trademark, the Teflon-coated Carlucci miraculously sidestepped the controversy, and the story died quietly. Carlucci, a master at handling the press, quickly scuttled the potentially damaging story by pointing out that IPAC never did any consulting on "lethal weapons." That was enough to pacify the press, and just like that, Carlucci was back in public office.

Carlucci did not walk away from his time in corporate America empty handed. In fact, he made a small fortune, despite the dismal performance of Sears World Trade. In the disclosure papers he filed upon reassuming government work, he claimed his total income in 1986 was $1.2 million, which included more than

$700,000 as a termination settlement from Sears World Trade. Not bad for steering a company into bankruptcy.

A Farewell to Arms?

In the National Security Council, Carlucci was finally back in his element. He made fast friends with Congress and quickly cleaned house as Reagan's National Security Advisor. He jettisoned the dead weight. He called Senators. He kept an open office. And he hired a young Army Lt. General by the name of Colin Powell as his new deputy. In short, he was a natural. "Frank has a tremendous advantage in that he is one of the few people in Washington who gets on very, very well with both Cap [Weinberger] and Secretary Schultz," said Kenneth Adelman, director of the Arms Control and Disarmament Agency at the time. In fact, Carlucci was well liked by just about everyone, which in DC politics can be as much a liability as it is an advantage. Carlucci is a man known to get things done without screaming and yelling. Norris says of Carlucci, "Frank doesn't like confrontation; he likes people to agree with him."

In November 1987, Carlucci would succeed Caspar Weinberger as secretary of defense for the final year and a half of the Reagan administration. He would spend much of his time refining the budgeting and weapons procurement process, experience that would serve him well in his future role with Carlyle. While in office, he would set up an advance procurement system that favored long-term contracts with various purveyors of military goods. When Carlucci left the office of secretary of defense to join Carlyle, he would have special knowledge of which defense contractors would later be cashing in on the long-term procurement system he had arranged. And he would take advantage of that knowledge.

The relationships he established while in office would prove invaluable. In 14 months as secretary of defense, Carlucci would travel overseas 13 times, to Europe, the Middle East, Asia, and Africa. He was charming and diplomatic, and he gained supporters throughout the world. Everybody loved Frank.

In another of the stunning ironies of Carlucci's career, he fought hard to decrease spending and eliminate unnecessary weapons programs, angering military contractors and the armed forces in the process. Just 10 years later, he would find himself caught up in the same situation, only this time he would be siding with the contractors, fighting to keep outdated weapons programs alive in his role as chairman of Carlyle Group.

Despite his controversy-ridden past, Carlucci was thriving both in and out of the public domain. "Frank was washed clean by Cap Weinberger by selecting him, Ronald Reagan by nominating him, and the Senate by confirming him," says Norris. By the time Carlucci took his place at the Carlyle Group, he would have accumulated a history of covert operations, controversial assignments, disastrous business dealings, and a string of connections so powerful that, despite his dismal track record in business, any company would bend over backwards to get him. As it turned out, that company was the Carlyle Group.

4

CARLUCCI'S CONNECTIONS

Being connected to Carlyle sure doesn't hurt.
—Phil Odeen, chairman of TRW, August 21, 2002

Cast of Characters

Earle Williams	Former CEO of BDM, a highly successful defense consultancy.
Melvyn Paisley	Former Naval officer in charge of awarding Navy contracts.
Vicki Paisley	Melvyn's wife and employee at BDM.
Phil Odeen	Williams' successor at BDM, currently chairman of TRW.
Frank Carlucci	

When a Pentagon official leaves office, there are federal restrictions that prohibit that person from working for a defense contractor for at least one year. It is known as a "cooling-off period." Designed to put enough time between active public servants and their subsequent private lives, the cooling-off period is widely regarded in Washington as a joke. It is nominal and rather ineffective. The reason it exists, however, is because of the extraordinary temptations that former Pentagon officials face both while they are in office, and the moment they leave, from the many defense contractors eager to get new business. Braddock, Dunn, McDonald (BDM) was one of those contractors. The company's

history, both as a part of Carlyle's portfolio and outside of it, clearly demonstrates the secretive and sometimes surreptitious world of defense contracting—the world in which Carlyle has chosen to do business.

In addition, Pentagon officials, like all public officials, are often in a position to capitalize on policy decisions they made while in office. Carlyle's acquisition of BDM, as with many of their other deals, reflects more on Carlucci's knowledge of the system he helped create and his network of friends than the company's ability to identify a good deal. They are connections he made while acting as secretary of defense, as well as his many other government roles. They are very valuable connections. And it was Carlucci's connections that got Carlyle off its losing streak after a series of disastrous deals, when BDM turned into a bonanza.

Carlucci had accepted his position with Carlyle almost immediately after leaving office, but had only worked peripherally on defense deals. By September 1990, just 18 months after Frank Carlucci had resigned his post as defense secretary, the man who had reengineered defense spending and procurement at the Pentagon was ready to bring his expertise to bear on the industry he had shaped. Though he had already been wheeling and dealing on behalf of Carlyle with regard to other defense properties, he was now legally able to accept an official position with a defense contractor, an important distinction that would attract defense companies to Carlyle. With Carlucci "cooled off," Carlyle's defense prospects were really heating up.

Defense spending was still anemic after the end of the Cold War and before the beginning of the Gulf War, and Ford Motor Company was looking to divest its defense holdings, namely Ford Aerospace. Carlyle fought hard to buy the entire unit, but it lacked the capital, a shortcoming that would often plague the company in the early going. In the end, the fledgling company lost Ford Aerospace to Loral, a much more established player in

defense. Loral bought Ford Aerospace for $715 million in cash. But thanks to Frank, Carlyle wasn't entirely cut out of the deal.

Carlucci's contacts would prove valuable early and often in his career at Carlyle. In particular, his close friendship with Earle Williams, president and chief executive of BDM International, a defense consulting subsidiary of Ford Aerospace, would deliver Carlyle with the firm's most lucrative defense buy out of the early 1990s.

BDM is one of the most successful defense consulting businesses in the history of the industry. When it was founded in 1959 in El Paso, Texas, the company was focused on doing weapons systems analysis, a geeky trade they plied mostly at offices in New Mexico. In 1962, they hired Earle Williams, a young engineer from Alabama, who over the next three decades, that included his promotion to CEO in 1972, came to embody the new spirit of the company, a hard-driving consultancy intent on expanding its business to all parts of the armed forces. In 1973, Williams and BDM put the harsh summers of Texas behind and moved to McLean, Virginia, just outside of Washington, DC, in order to be closer to the federal government with which it was now doing most of its business. He was moving them to where the money was.

It didn't take long for the company to learn the harsh lessons of doing business in Washington, when competitors stole contract after contract from under them because of tight political connections and well-timed campaign donations. It was a lesson that Williams learned the hard way, but one he would never forget.

Over the next two decades, the outspoken Williams would thoroughly insinuate himself into the DC power scene. Suddenly, Williams was everywhere on Capitol Hill, holding fund-raisers, heading civic activities, rubbing elbows with key politicians, and landing on highly coveted advisory boards. Among the close ties that Williams forged during this time was a friendship with Marcia Carlucci, the wife of Frank Carlucci. Williams' ability to work

the room was a style of doing business that Carlyle would learn much from. And, as it turned out, it was highly lucrative. "I didn't think there was anything unusual with what I was doing at the time," says Williams, who retains his Alabama drawl and speaks with the ease of a man who has long since fought his most meaningful battles. "I just figured if you want to know people, you go where they are. It doesn't take a rocket scientist to figure that out."

Williams got to know Frank through Marcia Carlucci, and also through his work with the Defense Department (DOD) when Carlucci was secretary of defense. "When [Carlucci] was in the DOD, we had a V.P. that was working in the DOD that was on leave from us . . . sort of," says Williams.

Williams' relentless gripping-and-grinning eventually paid off. In 1984, Williams was appointed to the Naval Research Advisory Board, which consulted the Navy on long-term strategic planning. BDM's competitors couldn't believe it. How did this man manage to convince the secretary of the Navy to place him on an advisory board that allowed access to confidential information and Navy officials? Particularly when the bulk of BDM's business was with the Army and Air Force, not the Navy? (In 1983, BDM did just $1.9 million worth of business with the Navy, an insignificant fraction of their overall business and an unregistered blip on the Navy's massive procurement budget.) The answers would soon be forthcoming and would demonstrate just how much Williams had learned about doing business in the Beltway.

In the spring of 1983, BDM hired a little-known market researcher by the name of Vicki Paisley for a yearly salary of $40,000. It turned out to be an excellent hire. Paisley's husband, Melvyn Paisley, was in charge of awarding Navy contracts. A year after the hiring of Vicki Paisley, Williams landed the coveted position on the Navy's advisory board. "Mel was instrumental in getting me on that board," recalls Williams, who says that Paisley approached him for the position, and Williams initially demurred. "I think

you've got the wrong man, we work mostly with the Air Force and the Army," Williams told Paisley. But Paisley wouldn't relent, and eventually succeeded in signing up Williams. It was a coup for Williams, and it paid off almost immediately. Between his appointment to the Naval Research Advisory Board in 1984 and the end of fiscal 1987, BDM had more than doubled its contracts with the Navy from $3.1 million to $6.6 million. Then, in the beginning of fiscal 1988, BDM was reporting to shareholders an expected $62 million in Navy contracts, according to a *Washington Post* article. The build up in Navy contracts had other defense contractors from around the world scratching their heads. Competitors accused Williams of hiring Vicki Paisley as a favor to Melvyn, who then brought in Williams to the advisory board, and subsequently awarded Navy contracts to BDM. The situation reeked of perceived impropriety, and the newspapers covered the entire story in great detail, but inexplicably no investigation was called for at the time.

Much of the new business BDM was garnering was in an area the Navy called *Black Projects,* or budgets that are kept secret because to publicize them would compromise national security. Lawmakers often complain about Black Projects, citing that many contracts are thusly classified, not because of national security concerns, but rather to avoid the required congressional review. Regardless, BDM was suddenly ratcheting up its Navy business year after year. When Melvyn Paisley left the Pentagon in 1987, he took a job alongside his wife, consulting for BDM. It was a good time to get in. The company was clearly growing fast, and in the midst of its good fortune, was bought in May 1988 by Ford Aerospace for an eye-popping $425 million. Times were good, and Earle Williams had finally showed the cutthroat defense contractors how business was done in the Beltway.

Then in the summer of 1988, Operation Ill Wind swept through the Pentagon, exposing a ring of corruption, bribery, and fraud that would eventually send dozens of officials to jail

for rigging the awarding of defense contracts. For years, various elements in the government had suspected widespread corruption in the Pentagon and the defense business. Several years of covert investigation proved those suspicions true. It was a crushing blow to the credibility of the Pentagon and the secretary of defense at the time, Frank Carlucci. Arrests, arraignments, and convictions rained down weekly on the Pentagon, armed forces officials, and the defense contractors with whom they all did business.

The most prominent official convicted in the seven-year investigation was none other than Melvyn Paisley, who pleaded guilty to conspiracy to defraud the government, bribery, and theft of government property. He was sentenced to four years in prison for taking kickbacks. The FBI investigated BDM and the connection between Williams, Paisley, and his wife. Documents from the Paisley home were confiscated, including at least a dozen relating to BDM. Williams was told that he would eventually need to testify in front of the grand jury, but the bureau was unable to bring a case against BDM, and, as Williams says, "Ill Wind just blew away."

Williams had this to say about his role in the investigation: "In hindsight, I understand why people would have thought we participated [in illegal activity]. When Vicki Paisley came to see me, I didn't know who she was, but she wanted the job. I was aware of a potential conflict, and I told her that it probably wouldn't be suitable. But she said she really wanted to work for me. I asked her why she was leaving her job at Computer Sciences Corp. (CSC). She said it was because Mel told her to because CSC was doing too much Navy business, and it looked bad. I guess that's ironic. When Ill Wind hit, we started to lose business, but I told our clients we hadn't done anything wrong. There was never any real involvement of BDM in Ill Wind, and I guess the FBI just eventually figured we were small potatoes."

But the damage had been done. Between the residue left from the scandal and the end of the Cold War, the value of BDM, now

a subsidiary of Ford Aerospace, plummeted. When Loral picked up Ford Aerospace in the fall of 1990, Williams was intent on not working for Bernie Schwartz, then the head of Loral, for personal reasons. Ironically, Williams convinced Schwartz that owning BDM would be a conflict of interest for Loral, since BDM had consulted the Pentagon on systems that Loral produced. The perceived conflict of interest inherent in hiring Vicki Paisley seven years prior hadn't weighed on Williams' conscience quite as much, apparently.

After Williams got in touch with his good friend Frank Carlucci, Conway negotiated the purchase, and $130 million later, BDM was the newest company in Carlyle's portfolio. That was less than a third of the $425 million Ford Aerospace had paid for the company just two years prior. Carlucci landed a job as chairman, Conway snagged a seat on the board, and Williams stayed on as president and CEO. It was a steal.

A New Friend

After a couple of years, Williams, age 62, aspired toward a career in government service and, in early 1992, announced his retirement from the $400,000-a-year CEO job at BDM. It was time for another friend of Frank. This time, Carlucci turned to an old buddy and tennis partner by the name of Phil Odeen, currently chairman of TRW. A vice chairman at Coopers Lybrand at the time, Odeen had known Carlucci for decades, having spent 13 years in the office of the secretary of defense early in his own career. Carlucci's wife had even worked with Odeen at Coopers. Odeen was also good friends with Williams, and so the circle was complete. Over a tennis match in the winter of 1992, Carlucci popped the question.

"He asked me if I had any interest in the job, and I had just been promoted to vice chairman at Coopers and moved to New

York," Odeen told me. "I said no thanks, but if you don't find the right person, give me a call." Carlucci called the very next morning and arranged a Sunday morning breakfast meeting in DC between Conway, Rubenstein, and Carlucci. Apparently, Carlucci had indeed found the right person, and it was Odeen. Within a week, Odeen had an offer, and by May, Odeen was the new president and CEO of BDM. "It all happened very fast," recalls Odeen.

Under Odeen's watch, BDM would transform itself from a business heavily reliant on defense contracting to a more diversified services company. "The Cold War was over, and defense budgets were coming down," explains Odeen. "Information and communications technology were more important than ships and tanks." Odeen did a bang-up job getting BDM into emerging enterprise resource planning (ERP) and warehouse automation markets. But it was still defense that buttered BDM's bread. And controversy in that arena was set to strike yet again.

On Christmas Eve, 1994, the *New York Times* reported that Frank Carlucci had again been involved in a clandestine arms deal, this time with the Soviets. With Carlucci as chairman, BDM, now a Carlyle portfolio company, had brokered a deal between the Pentagon and the former Soviet Republic of Belarus to secretly purchase an S-300, the Soviet's version of the Patriot missile defense system the United States had used so effectively during the Gulf War.

After the Cold War, the Russians were selling weapons to both allies and enemies of the United States. They needed the cash and no longer had much use for weapons, so the Russians opened up an arms bazaar. In another black budget project, BDM was hired in 1992 to acquire the S-300 for the Defense Intelligence Agency's Missile and Space Intelligence Center in Alabama. American forces wanted the weapons so they could take them apart, see how they work, and develop ways to defeat them.

For the deal, BDM used the infamous Canadian arms dealer Emmanuel Weigensberg, the same man that brokered the Iran-Contra arms shipments for the Reagan White House. The reason for the secrecy around the deal, says Odeen, was that the Russians were selling the same weapons to America's enemies and wouldn't want those customers to know the Russians were playing both sides of the fence. But others speculated that the Russians had been duped. That they never knew they were selling the S-300 to the Americans, and had they known, would never have gone through with the transaction. Hence, the need for a middleman like Weigensberg, to obfuscate the actual buyers. Odeen denies those accusations. "We did not do these deals openly or publicly, but they [the Russians] knew who they were selling to," says Odeen. "This was a decent business for us. We had the relationships, and we were essentially a broker."

But BDM's competitors didn't see it that way. Again, there were charges of favoritism, cronyism, and quid pro quo. Russian military officials were reportedly incensed by the transaction, claiming they had no knowledge of the ultimate buyer. Competitors griped about their inability to penetrate the relationship between BDM and the Pentagon.

They said that BDM's connections, particularly within Carlyle, were to blame. At the time, Pentagon spokesperson Kenneth Bacon told the *Times* that he was "concerned about any allegations of unfairness and will review them as appropriate." But BDM was cleared again. The company seemed to have acquired Carlucci's Houdini-esque ability to sidestep scandal.

As it turned out, BDM had in place something called a "basic ordering agreement," or an ongoing, open-ended, long-term contract with the Pentagon. The agreement did put BDM on an inside track with regards to foreign weapons procurement. "Otherwise, it can get very bureaucratic," says Odeen. As for Carlucci's potential involvement, having advocated long-term

contracts that protect vendors like BDM when he was secretary of defense, Odeen recites an exculpatory mantra heard over and over again throughout Carlyle's history. "I don't think Frank had anything to do with that at all," says Odeen. He adds, "But being connected to Carlyle sure doesn't hurt."

Indeed, BDM's connections to Carlyle have done nothing but help them. And the deal didn't work out too badly for Carlyle, either. First, Carlyle took the company public in 1994. Then in 1997, TRW paid $975 million for BDM, making Carlyle's $130 million investment just seven years earlier, look brilliant. Phil Odeen went on to become the chairman at TRW, which then became one of the largest defense contractors in the country. In the words of Fred Malek, *this* deal was a "screaming home run."

Carlyle also used BDM in doing due diligence on future defense deals. It was a perfect setup. Because BDM had so much consulting experience and had worked with most of the major contractors, Carlyle had built in proprietary knowledge of dozens of defense companies. And this is where the bulk of Carlyle's early deals would come from. Some were more successful than others, but with defense, Carlyle had found a calling. They had found a business that they understood, in which they had myriad connections, and could make loads of cash. They had found what would become their identity.

But with the acquisition of BDM, Carlyle was agreeing to do business in the shadowy world of defense contracting; a murky business with which Carlucci was well acquainted, but Norris and Rubenstein knew little about. The decision to go down this road would eventually make Carlyle one of the largest defense contractors in the country and would create the controversial behemoth it is today.

5

GETTING DEFENSIVE

It's like shooting fish in a barrel.

—Former Chrysler chairman Lee Iacocca,
Washington Post, March 31, 1985

Cast of Characters

M. W. Gambill	Former CEO of defense contractor Harsco.
Norman Augustine	Former CEO of defense contractor Martin Marietta.
William Conway	
Frank Carlucci	

Legendary former chairman of Chrysler, Lee Iacocca, had a habit of asking his contractors, many of whom also sold goods to the military, whether making money in defense was a sure thing. "They start chuckling, and they look around to see if the office is bugged," said Iacocca in an interview in the mid-1980s. "And they say, 'It's like shooting fish in a barrel.'"

No one knew this better than Frank Carlucci, who fresh off his 18-month stint as secretary of defense, was getting his feet wet in the world of high finance for the first time since his unsuccessful run with Sears World Trade. But this would be different than his earlier disasters. Carlucci was going to deal in the industry he knew best: defense. After the BDM deal was completed, the rest of the defense world knew Carlucci meant business.

In the years following the BDM acquisition, Carlyle would embark on a stunning series of defense dealings, fighting it out with the giants of defense contracting, and quite often having their hats handed to them. But many of the deals they did win were hugely successful, as well as controversial, and built them into the nation's eleventh largest defense contractor. The disconcerting pattern of doing business with questionable companies continued, however, and signaled Carlyle's willingness to dwell in the dark underworld of the defense industry. With BDM's consulting help, Carlyle made a run at the top defense players in the nation and, when it was all said and done, carved themselves a place at the top.

An Arsenal of Democracy

The government has a long history of overpaying for weapons, offering interest-free loans, waiving federal taxes, bailing out floundering defense contractors, and even paying generous termination fees to unsuccessful vendors. The Defense Department has bailed out more than 6,000 defense companies since 1958, under an act of Congress known as the Extraordinary Contractual Relief Act. It is all done in the interests of "national security." And it amounts to a government-subsidized industry, doing business over a safety net.

Carlucci had as much to do with the current state of defense spending as anybody. As deputy defense secretary under Weinberger, Carlucci developed a Pentagon policy of procurement that called for higher profits for the defense industry. It also lowered the risks within defense contracting, ensuring long-term and no-bid contracts, both moves intended to encourage private companies to enter the market. Privatization, the practice of taking government-run offices and departments and forming for-profit, private companies, was all the rage. The idea was to build

up a healthy and happy private defense industry that would carry the United States to victory in the Cold War. And juice the economy while we were at it.

It worked. The defense industry blossomed under Reagan's watch by creating, and the former president himself termed it, an "arsenal of Democracy." At one point in 1985, a *Washington Post* expose on the defense industry uncovered that the Pentagon was spending an average of $28 million an hour—24 hours a day, 7 days a week. The top 13 contractors had revenues of more than $122 billion. Those same contractors were also the ones consulting the government on which weapons to buy and when. And few of the defense contractors were paying taxes. The numbers were astounding. It was a great time to be in the defense business. But it wouldn't last.

Just nine months after Carlucci took his post at Carlyle, the defense business came to a screeching halt, marked by the felling of the Berlin Wall on November 10, 1989, and the subsequent end of the Cold War. The defense industry went into instant retreat. Secretary of Defense Richard Cheney announced a "peacetime dividend" and quickly slashed $180 billion off the defense budget. Because of the end of the Cold War, everyone knew that the budget cuts were imminent, but no one thought it would be so quick, and so severe. Values of defense companies plummeted. Contractors didn't know what had hit them. It was a perfect time to get into defense buyouts, when all the properties were cheap, and Carlucci knew it.

After the BDM buyout, Carlyle began bearing down on the defense market in earnest. The first object of its affection was a Pennsylvania-based industrial company that owned an undervalued defense division that made howitzers and other military equipment, Harsco Corp. The defense division that Harsco harbored would later become the now well-known United Defense (much more on that later). The only problem was, Harsco wasn't interested in selling. Harsco employees didn't want to sell the

company at such a low point, locking in their losses. As a result, they resisted Carlyle's overtures, which often happens in the fierce world of leveraged buyouts, as companies struggle to maintain their independence during hard times, while the vultures circle above.

Carlyle went to plan B. If they couldn't convince Harsco management to sell the company outright, they would start snatching up public shares. It was more time-consuming and generally more expensive to acquire a company this way, but the thinking is that by gaining a large position in stock, they could begin to exert some pressure on Harsco's management. So Carlyle began accumulating a large stock position in Harsco, about 6 percent of the total shares outstanding. If they didn't want to sell, Carlyle was going to put the screws to them, threatening to acquire a majority share in the company. Then, at 2:30 P.M. on Ground Hog Day 1990, Harsco CEO M. W. Gambill got the call from Frank Carlucci.

It is known as a courtesy call, making a CEO aware of an aggressor's increasing position in a public company, as if Gambill hadn't already noticed. Carlucci and the boys at Carlyle had their eye on Harsco's defense division, whose value had been decimated by the retreat in defense spending. But Harsco still wasn't interested. Carlyle quickly increased its position in the company, until it became the majority shareholder with nearly 7 percent of the company. It submitted a restructuring plan to the company that included a tempting $15-a-share dividend, an appeal to shareholders of the company, a move designed to outflank Harsco's management. Harsco still wouldn't budge, and the company rejected the proposal outright. It was a slap in the face to Carlyle, and symbolic of the company's early lack of clout. Carlucci's reputation alone was not enough to get potential buyout targets excited. The company had no track record, and Harsco could not be sure of its intentions. Would Carlyle just break the company up and sell it for parts? Or would they nurture it back to health, then sell it for a profit? There was no precedent by which

Harsco could judge Carlyle. And they would just as soon not do business with them.

Carlyle was not through, however. The company upped its stock position to 10 percent, and demanded two positions on Harsco's board, as negotiations became more contentious. Harsco, under significant pressure now, compromised, offering Carlyle one position on its board. But Harsco never sold the unit to Carlyle outright. Harsco had maintained its independence and fended off a hostile takeover. It cost Carlyle $63 million in stock to gain that one board seat, not to mention the time and labor costs of doing due diligence on Harsco. On the surface, it was a terrible deal. But six years later, when Carlyle used that board seat to steal United Defense away from General Dynamics, it would prove to be one of the best deals the company ever made.

More Ill Wind

Shortly after this failure, Carlyle turned its attention to another highly controversial acquisition target: Unisys Corp. Now known mostly for its mainframe computer and IT services business, Unisys was among many companies looking to divest itself of a money-losing defense division. But in June 1988, in the middle of Carlucci's tenure as defense secretary, Operation Ill Wind, the same investigation that had attempted to nail BDM, took down Unisys. The probe, led by Assistant U.S. Attorney Joseph Aronica, resulted in convictions against 45 individuals and $225 million in fines. It was a comprehensive web of corporate and political corruption in the military, exactly what Eisenhower had warned against 30 years earlier. And it was all uncovered during Carlucci's watch.

In September 1991, after the probe was complete, Unisys alone paid $190 million in fines for bribing public officials en route to hundreds of millions of dollars in contracts. The company pleaded

guilty to conspiracy, bribery, and illegally overbilling the government. Unisys had been disgraced and, as a result, was thoroughly devalued. Of all the companies implicated in Operation Ill Wind, Unisys probably took the worst hit. And now, Carlyle was looking to pick the defense division up on the cheap.

Ultimately though, much like with Harsco, Carlyle would fail. Unisys and Carlyle would flirt for the better part of a year before Unisys chose to take the division public instead. Carlyle was having trouble convincing potential buyout partners to get in bed with them, an obstacle that is not uncommon for young buyout firms. Each failed takeover attempt costs money, though. And the payoffs were not forthcoming. It was another devastating setback for the incipient company, but it would not prove fatal. Not even close.

The folks at Carlyle were learning on the job. They had taken a few lumps, but in the company's 1992 bidding war for the defense and aerospace division of LTV Corp., they would show off their newly acquired erudition. The saga of LTV would ultimately consume a full year, involve multiple court battles, and even require a presidential intervention before it was done. Rubenstein would call it the most difficult transaction he had ever been involved in. It was, in a word, wild.

The fun once again started with a call from Frank Carlucci, this time to his friend Norman Augustine, chairman of defense giant Martin Marietta and former assistant secretary of the Army. Together with Lockheed Corp., Martin Marietta had announced on February 3, 1992, the purchase of LTV's defense and aerospace division, which was in bankruptcy at the time, for $355 million. It was a steal and, for all intents and purposes, a done deal. But on March 27 of that year, Augustine took a call from Carlucci, who asked if Lockheed and Martin Marietta might be willing to cut Carlyle into the deal.

Augustine was shocked and confused. For the past few months, Carlyle had been putting together a competitive bid for the division, with its partner Thomson-CSF, the French defense contractor.

Why would Carlucci be asking in on his deal? Especially now, when it was practically done?

As it turned out, things weren't going so well between Carlyle and Thomson. Carlyle once again couldn't get the financing in order for its share of the deal, and Thomson wouldn't proceed without it. The fragile partnership the two had constructed was falling apart. Thomson chairman Alain Gomez was calling around, looking for other partners that had the capital, and could complete the deal. All of which led Carlucci to call his old friend Augustine.

Bill's Will

Conway and Rubenstein met with Augustine and offered $50 million to get in, money they said would be useful if Thomson were to succeed in finding another partner and make a new more competitive bid at the eleventh hour. Augustine turned them down flatly, apparently unconvinced that Thomson would ever reemerge as a real threat. It looked like it was over. Thomson officials had abandoned hope, and Augustine felt certain that LTV was his. But Bill Conway had other ideas.

A relentless businessman, Conway was largely responsible for building MCI Communications into a major player in the telecommunications industry as chief financial officer during the 1980s. He had an impeccable reputation in financial circles, often cited as one of the top handful of CFOs in the country. He was a fearsome manager in the Carlyle offices, building tight-knit groups of his favorite employees and largely ignoring the rest of the company. One former employee said, "You're either in with Bill or your out, and if you're out, he'll make your life miserable."

Conway is a conservative businessman from New England and a real company man. Many ex-employees credit him with cultivating an atmosphere of intimidation in the Carlyle offices, putting

employees in place by firing off companywide e-mails stating, "I'm sick and tired of people complaining about *their* offices and *their* office furniture. It's not *your* office or *your* furniture. It's *mine*." He was notoriously cheap and would often gripe loudly about there being too many employees at Carlyle, "sitting around *my* offices, drinking strawberry flavored water."

The way Carlyle was structured, the partners got very, very rich from big deals, and no one else saw a dime outside of their salary. Conway would inexplicably remind employees of this sore spot when he would close out a company meeting by proclaiming it was time to go out "and make me money." According to those who worked for him, he could be alternately brilliant, driven, and despotic. And he never gave up on a deal.

Two days before the bankruptcy judge was to award LTV's assets to Martin Marietta and Lockheed, Conway got the needed money together from Carlyle's old benefactor, the Mellon family, and called Thomson to make nice. With the money in hand, Thomson and Carlyle quickly resolved their differences, waltzed into bankruptcy court, and offered $400 million in cash for LTV aerospace, $45 million more than the Martin Marietta/Lockheed team had offered. Conway had pulled it off, against all odds. Augustine was floored, and defeated. Or so it seemed.

This war was just heating up. Augustine kicked it into overdrive, setting up meetings with Assistant Secretary of Defense Paul Wolfowitz, Deputy Secretary of Defense Don Atwood, and Assistant Secretary of the Army Stephen Conver. Augustine argued that selling LTV's defense and aerospace division to Thomson, a company partly owned by the French government, would be a breach of national security. Martin Marietta sent a raft of lobbyist to the Hill to persuade lawmakers to come out against the deal. And quickly the tide turned. Augustine was making progress in blocking the sale. Carlucci worked the phones, as well, getting assurances from several Pentagon officials that the

deal would go through, despite the concerns of lawmakers over foreign ownership.

In the final day of bankruptcy court, the bidding escalated rapidly. Augustine had created enough uncertainty over whether the U.S. regulatory agencies would approve the deal, that the game was once again wide open. Because LTV's creditors were concerned over regulatory approval of the deal, which wouldn't be known until months after the actual sale, Carlyle and Thomson were forced to increase their bid to $430 million, plus a $17 million nonrefundable deposit. In the event that the sale was denied by lawmakers under national security concerns, Carlyle would pay LTV $17 million for nothing. Martin Marietta and Lockheed upped their bid to $385 million and urged creditors to consider the likelihood that the Carlyle-Thomson deal would never get approved. Carlyle would eventually offer another $20 million, plus a $20 million nonrefundable deposit. That was enough, and the judge awarded LTV's missile division to Thomson and the aircraft division to Carlyle. The boys from Carlyle had finally done it. They had gone up against the best, and won.

Augustine said of the decision, "Even when it's over, it ain't really over;" words that would prove to be prescient. Sure enough, the Bush administration went on record opposing the sale, and Congress voted 93–4 that selling LTV to a French company would be "detrimental to the national security interests of the United States." Despite the assurances that Carlucci had gotten from the Pentagon, the sale never really had a chance in Congress. Thomson would eventually pull out of the running altogether, flinging the door open to renewed bidding, and getting Augustine back into the game. The race was on again.

This time Carlyle teamed up with Loral Corp. and Northrop, more formidable partners than Thomson, not to mention American companies, and finally outbid the Marietta-Lockheed team with a price of $475 million. They renamed the division Vought

Aircraft and managed to turn the flailing company around. Carlyle's contribution to the sale was $38 million, a stake that the company would then sell back to Northrop Grumman for $130 million in just two years. It was a lucrative deal. And it legitimized Carlyle's band of ex-politicians in the wheeling and dealing world of defense buyouts.

Finally, Carlyle was being viewed as a player. Though still accused of practicing access capitalism and suffering a number of brutal early setbacks, the LTV deal burnished their reputation as serious competitors, willing to do whatever it takes to make a deal happen. In conjunction with the BDM deal, Carlyle now had to be taken seriously around the Beltway. But there was another deal in the works that would really put Carlyle on the map—the world map.

6

AN ARABIAN WHITE KNIGHT

Politically, it could be considered a quid pro quo for the United States.

—Shafiqul Islam, senior fellow at the Council on Foreign Relations, *Washington Post,* February 22, 1991

Cast of Characters

Prince Alwaleed bin Talal bin Abdul Aziz Al Saud	Saudi Arabian prince, billionaire, international investor.
King Fahd	King of Saudi Arabia.
Faissel Fahad	San Francisco lawyer, friend of Prince Alwaleed.
Prince Sultan bin Abdulaziz	Saudi Arabian defense minister.
Stephen Norris	

The early part of 1991 was literally an explosive time in the world. Bombs were raining down over Baghdad in the latter stages of the Gulf War. Scud missiles were careening their way past U.S. defenses in Saudi Arabia. And the savings and loan crisis had the nation's economy in full retreat. But this rare and tragic confluence of events had set up one of the best business deals of the year, and possibly the decade. A deal that would put Carlyle on the front page of newspapers around the world.

Prince Alwaleed bin Talal bin Abdul Aziz Al Saud, more economically known as Prince Alwaleed bin Talal, was 35 in 1991 and

eager to invest his fortunes across the world. The nephew of Saudi Arabia's King Fahd bin Abdul Aziz Al Saud, the Prince was a glamorous, wealthy jet setter who had spent much of his formative years studying in the United States. After earning his bachelor's degree in business administration at tiny Menlo College in California in 1979, he went to Syracuse University in upstate New York to get his masters in social science. Upon returning to Saudi Arabia, the Prince immediately began building his investment portfolio, mostly in real estate and construction. At first, he wasn't so good at it, and he burned through a $30,000 gift from his father within months. At that time, he approached Citigroup in Riyadh, an American bank, to ask for a loan. They rejected him flatly. But he went on to accumulate millions, at least some of which came through acting as a liaison between foreign construction contractors and local businesses, though the source of much of the Prince's fortunes remains unknown. Through his gains, he formed the Kingdom Holding Company, an investment vehicle through which he could play with his millions. But the Prince was looking for more, much more. He was looking toward investing in America.

The timing was right. America and Saudi Arabia were cooperating on defeating Saddam Hussein's aggression in Kuwait. It was one of the first times the United States and Saudi Arabia had their political agendas in line. Saudi Arabia had committed more than a hundred thousand troops to the conflict in the gulf, and those soldiers were fighting beside American troops. Many saw this as the dawn of a new era of cooperation between the two nations, both politically and financially. And they were right.

Back at home in the United States, the mighty banks were gasping for air. Stocks were plummeting all around the financial sector, and bankruptcies were not uncommon. The fallout from the savings and loan crisis was littered along Wall Street. It was on this shaky ground that Citicorp, America's largest bank at the time, found itself in February 1991. The company's stock had collapsed,

losing half its value between the summer and winter of 1990. It was in desperate need of financing, a lot of financing. Citicorp was looking for as much as $1.5 billion to stay afloat, and they were hoping to raise it through the sale of stock. They were looking for a white knight.

A Saudi Savior

Enter the Prince. Prince Alwaleed was watching the events in the United States closely, as he always did, and he had decided it was time to put his money to work in America. Known for his eccentricities, the Prince would often drag a caravan of trucks out into the desert to relax. There, with the baking, barren desert glowing all around him, he would sit in a tent complex, entertain guests, and watch multiple satellite television hook ups, staying abreast of world news. A seasoned critic of American media, he had been following the saga of Citicorp from the beginning. He decided it was time to invest.

Working through his representative in the United States, San Francisco lawyer Faissel Fahad, the Prince was put in touch with a prominent DC-based law firm. Because of the tricky political nature of a deal involving a major U.S. bank and a foreign investor, the firm felt they needed an advisor that offered more than just traditional investment banking advice. They decided they needed the Carlyle Group, to help them navigate the choppy waters of federal approval for the deal. After all, Carlyle had the government connections, they were based in DC, and a sensitive deal like this was going to need a delicate political touch. They called Norris.

The Prince had loads of cash, and Citicorp needed it. But at the time, Treasury Secretary Nicholas Brady had been pushing reform in the banking industry, to allow banks more flexibility in the types of business they could enter. It was intended to diversify

banks from the disastrous savings and loan business, and strengthen the industry by giving it more options. But there was concern that opponents to the legislation would use the fear of foreign ownership in American banks as a sticking point to hold up the reform. A deal between a wealthy Saudi Prince and the nation's largest bank was all reform opponents needed to prove their case. It was, to say the least, a very sensitive time in the banking industry. Norris and the Prince knew this, and the two worked hard to structure a deal with Citicorp that would allay any and all concerns, but still get the much-needed capital into the hands of Citicorp.

Norris and the Prince spoke often, sometimes two or three times a day, for hours on end. One conversation was temporarily interrupted while the Prince watched the American Patriot Defense system shoot down an Iraqi Scud missile outside his window. Unphased by the attack, the Prince and Norris picked up the conversation where they had left off. "It was a crazy time," remembers Norris. "The Prince and I were extremely close. I have a passport full of Saudi stamps. I don't even know how many times I went over there."

The negotiations were cordial but intense. During the dealmaking process, Norris asked Citicorp for a board seat in return for the Prince's investment. It was a pure red herring. A shrewd negotiating tactic, designed to be dropped in a show of concession, which it later was. Neither the Prince nor Norris thought they would get it. In fact, they knew it would make the Federal Reserve Board's approval of the deal nearly impossible. But it worked to perfection.

After months of preparation, they got the deal preapproved by the Federal Reserve Board (Fed), by conceding measures they never intended to secure and assuring members that the Prince would be a passive investor. The thinking at the Fed was that everyone wanted the Prince to invest his money to save Citicorp, they just didn't want him to exercise any control over his

investment. It was a lot to ask, but Norris and the Prince had expected it. The Fed also spent months researching where the Prince's money was coming from. Rumors that Prince was acting as a front for other investors ran rampant. There was concern about Middle Eastern investors using the Prince to launder their money. But finally, the Fed relented, and the deal went through.

On February 21, 1991, a mammoth deal was announced. The Prince would be purchasing $590 million worth of stock in Citicorp, and bailing out the bank that once turned him away when he needed a loan back in his home country. The shares were nonvoting preferred stock, which meant that the Prince could not vote his shares in proxy battles. But, he would be allowed to convert the shares to common stock at an exercise price of $16 a share in just eight months. He already owned 4.9 percent of the common stock, which he had acquired over time in the fall of 1990. That meant that if he were to convert his shares in October 1991, he would hold almost 15 percent of the common shares. In other words, he would be one of the company's largest shareholders.

Media Misteps

The stock jumped up 8 percent in the week following the announcement, and the press was all over the news. Who was Prince Alwaleed? How did he get so much money? Who is the Carlyle Group? Would the Prince be seeking a board seat in return for his investment? Is this a new beginning for financial cooperation between Saudi Arabia and the United States?

There with the answers to all of these pressing questions, in all his glory, was Stephen L. Norris, the co-founder of the Carlyle Group and the man who had engineered the biggest deal of the year. He was quoted everywhere, and figured prominently in a *BusinessWeek* profile of the deal. Norris told the press that the Prince would not be asking for a board seat. But that he didn't

plan to be completely passive either. After all, who invests $590 million of his own money and doesn't expect his voice to be heard on important decisions? No, Prince Alwaleed would be an "active" investor, said Norris.

Norris' statements proved to be well off the mark, and they set off the alarm bells at the Federal Reserve Board, the same board that had already been promised Alwaleed would remain a passive investor. Originally, the Fed had been assured that Alwaleed would not attempt to "influence management" for at least five years, though he would be allowed to speak his views to the board of directors, says Norris today. That was the deal. But Norris' statements to the press after the deal appeared to contradict that agreement, and the Fed wanted some answers.

The Prince's people feverishly worked the phones that next day, desperately trying to convince the Fed that Norris was out of line, not expressing himself clearly, and that the Prince had every intention to remain passive. In the middle of all of this, a 1988 article in *Forbes* surfaced, in which Alwaleed is quoted as saying the role of the passive investor is not for him. "I want my voice to be heard . . . I would love to be a corporate raider," he said. Suddenly, the whole reason that the Prince had chosen Carlyle in the first place—to help him traverse the rocky regulatory terrain—had blown up in his face.

In addition, the Prince took grave offense at what he perceived as Norris taking credit for the deal in the press. The Prince, not unreasonably, wanted to be seen as the savior of Citicorp. Instead, Carlyle was getting all the credit. Norris' Carlyle partners also felt he was becoming too personally involved in the success of a client, too public. The fiasco that resulted began the long, drawn-out process of Norris' excommunication from the firm.

Ultimately, and after much cajoling, the Fed allowed the deal to go through. But they forced the Prince to sell the 4.9 percent of common shares he had previously accumulated, and mandated that he not own more than 9.9 percent of the overall stock.

The move cost the Prince millions in future profits. It was a public sign from the Fed that they were going to remain extremely vigilant. With his newly acquired shares of Citicorp, Alwaleed had also bought himself a very high profile in the United States. His moves would be scrutinized by regulators and investors alike. The rumors that Alwaleed was investing money on behalf of Middle Eastern investors that don't want their identities revealed continued to dog him. The accusations were adamantly denied by Alwaleed—and are still denied to this day. (Those who know him say the Prince sees himself as a link between the Arab world and America—a Saudi with a soft spot for true capitalism.)

A Source Emerges

Then, in the Spring of 1991 shortly after the Citicorp investment, the Bank of Credit and Commerce International (BCCI) scandal ripped through the banking world like a missile. The fifth largest private bank in the world, as it turned out, was nothing but a fraud-ridden front, laundering money for drug lords and terrorists throughout the Middle East. BCCI was also trying to gain control of American banks. It was a scandal of epic proportions that brought down dozens of high-profile members of the international banking community. It was the largest bank fraud case ever. And it didn't bode well for the Citicorp deal.

After BCCI, the media speculated that Alwaleed might be up to the same thing. In an interview with CNBC 10 years later, Alwaleed described the situation like this, "We had Arabs involved with BCCI at that time. And they had a big scandal there, unfortunately. They (the Fed) looked at what I had there, we had a big discussion, long discussions, they could not find anything wrong with it at all. But I got the message that they were in a difficult position."

The Fed was indeed in a difficult position in trying to save Citicorp—the nation's largest bank. According to one person involved in the Citicorp negotiations, the Fed suspected that the money Alwaleed was investing was not his own, and officials there "looked the other way." The source says that the lack of due diligence in adhering to the rules that require transparency of foreign investors facilitated the Fed's goal of saving Citicorp. A source close to Alwaleed now says that at least some of the money belonged to Prince Sultan bin Abdulaziz, Saudi Arabia's defense minister. The defense minister could not be reached for comment, and the Prince maintains that all of the money he invested was his. Since the Citicorp flap, Alwaleed has regularly, and voluntarily, disclosed selected investments to the public, even though he is under no obligation to do so. But he only discloses what he wants to.

Despite its controversial nature, the Citicorp deal put both Carlyle and Alwaleed on the map. Many believed the deal was the financial embodiment of the political accord between the United States and Saudi Arabia. In a *Washington Post* article at the time of the deal, Shafiqul Islam, senior fellow at the Council on Foreign Relations in New York, said "here the profit motive and the political motive seem to coincide. Right now, the Saudis are our good friends, and Citicorp does need the money." Politically, it could be considered as a quid pro quo for the United States "helping them" in the Gulf War. It was a rare time when the United States and Saudi Arabia were both politically and financially aligned, and it opened a brief window of opportunity for Carlyle and the Prince. But it wouldn't always be that way.

Surprisingly, considering the magnitude of the deal, Norris and Carlyle walked away with a mere $50,000 of the Prince's money (they were paid more handsomely by Citicorp, though they won't disclose how much). And the Prince? After a nervous year during which the Prince's investments were underwater—a time when Rubenstein routinely fretted over Citicorp's languishing

stock—today's estimates fall somewhere between an $8 billion and $12 billion profit on the deal. It made all the trouble seem worth it. And it set Carlyle up for a future with the Prince, including another major bailout by Alwaleed of Euro Disney (an investment that hasn't turned out so well). But more importantly, the deal gave Carlyle access to Saudi Arabia, a country of unimaginable wealth if one knew where to look. "The deal gave us an enormously high profile in Saudi Arabia," recalls Norris. And with the Prince on its side, Carlyle had the world's best tour guide to pry open the treasures of Saudi Arabia.

7

VINNELL'S EXECUTIVE MERCENARIES

We train people to pull triggers.

—A potential Vinnell employee, *Newsweek,*
February 24, 1975

Cast of Characters

Henry Jackson Former U.S. senator.

Richard Secord Retired Air Force general, ex-employee of Vinnell, Iran-Contra fall guy.

After its early buyout misadventures, Carlyle had finally tasted fortune in both the BDM deal and its work with the Prince. In 1992, the time came to combine their newfound successes, when BDM, by then already under Carlyle's ownership, bought a little known company of ambiguous ownership named Vinnell. The deal would marry Carlyle's burgeoning expertise in defense with its incipient relationships in the Middle East. And it would forever strengthen the political ties between two of the world's most powerful countries.

Vinnell is the clearest example of Carlyle's business inside the Iron Triangle. It combines all of the necessary elements of the military, government, and big business, in one neat, utterly secretive package. Vinnell defines the term *war profiteer,* a private

company that trains foreign militaries in times of need, and would ultimately make Carlyle an insidious force inside the Kingdom of Saudi Arabia. Vinnell is yet another company with a highly controversial past that Carlyle snapped up, only to heighten its questionable legacy. Vinnell's history, before, during, and after Carlyle owned it, is a litany of covert operations, mercenary missions, and cover-ups: right up Carlyle's alley. Carlyle, it seemed, was building an entire portfolio of controversy, and Vinnell was the early centerpiece.

The relationship between the United States and Saudi Arabia has grown increasingly complex and co-dependent in recent years: the United States gorging itself on Saudi Arabia's cheap oil, and the Saudi's relying on American military support of the royal family. This give-and-take relationship has made navigating the post-September 11 political waters very tricky. Despite a near total lack of cooperation in the bombing campaign of Afghanistan and the investigation into September 11, Saudi Arabia remains the United States' chief ally in the Gulf. In response to Saudi Arabia's obstruction, senators have come out with strong rhetoric toward the Saudis, calling the regime corrupt. Some have accused them of sponsoring terror, or at least doing nothing to abate it. Others have recommended an end to the alliance between the two nations. But the relationship, however tenuous, holds. Like the oil that trades hands between the two countries, the United States holds Saudi Arabia in a slippery, combustible embrace.

Saudi Arabia's military dependence on the United States can be traced back to a Vinnell deal in 1975 that would alter the nature of the alliance forever. Of all the military ties the United States has fostered with Saudi Arabia over the last three decades, perhaps no one company has done as much to inject the American military machine into everyday life in Saudi Arabia than Vinnell. It was, and still is, an integral part of the Saudi military makeup.

A Company with No Past

Until Carlyle, through BDM, purchased Vinnell in 1992, the company virtually didn't exist to the public. Even though Vinnell claims to have been around since the days of the Great Depression, documentation of its history is nearly impossible to find. No publicity, no press releases, no news clippings. To this day, no one knows who the original owners were. Reports indicate that Vinnell, at one time a heavy construction company in Los Angeles, built Dodger Stadium. Then the company built some airstrips in Vietnam. But it wasn't until 1975 that the company mistakenly flew temporarily above the radar and into the public's view.

In February 1975, the Associated Press broke a story that sent shock waves through Washington. A private American firm was hired by the Pentagon to train Saudi troops to protect oil fields from potential aggression in the Middle East. The news came just two years after the United States had pulled its final remaining troops out of Vietnam, and Americans saw the action as yet another ill-conceived involvement in a foreign nation's affairs. Only this time, it wasn't enlisted soldiers, working for the American Armed Forces. It was soldiers of fortune, civilians with guns.

The $77 million contract, brokered through the Defense Department, stipulated that Vinnell would hire 1,000 former Special Forces personnel, most of whom had recently served in Vietnam, to work with the Saudi National Guard, the 26,000 men sworn to protect the royal family. Never before had a private company, employing civilians, been deployed overseas to train a foreign government in battle tactics. But it would not be the last time.

The news caused instant outrage on Capitol Hill. Congressmen accused the Pentagon of hiring "mercenaries" to develop the military of a country the United States may one day have to invade. At the time, U.S. oil companies complained incessantly to congressmen that Saudi Arabia and the Middle East were

strangling the United States by manipulating the exportation of oil. Henry Kissinger himself had threatened an invasion of Saudi Arabia if the situation did not improve. With tensions rising between the two nations, the Vinnell deal left lawmakers scratching their heads. Senator Henry Jackson, of Washington, demanded a congressional inquiry and was quoted as saying he was "completely baffled," by the deal, adding that to his knowledge, the only threat to Saudi Arabia's oil fields had come from the United States itself. And we certainly weren't going to train the Saudi National Guard how to defend themselves against us, were we?

U.S. companies had regularly scored contracts for training foreign nations in the use of American-made military equipment. But training men in battlefield tactics and combat was considered off limits. It was viewed by many as a way for the government to get around laws that prohibit the United States from getting involved militarily in certain nations, an issue that was particularly raw following America's disastrous foray into Vietnam. It was a quiet, though expensive, way to further America's agenda abroad without committing its own troops.

The type of men Vinnell was recruiting for the job led to consternation from others in the military training industry. This was not your typical service contract. The head of one security company at the time of the deal told *Forbes* that "the whole thing stinks. You're talking about professional killers, very senior Special Forces guys on this Vinnell contract. These aren't personnel specialists. They've got tremendous combat reputations. What kind of control does Vinnell have over them once they get over there?"

In the same article, William L. Hilger, corporate secretary for Vinnell at the time of the deal, told *Forbes,* "This isn't anything new for us. We've done all this sort of stuff with the Chinese Nationalists, the South Koreans, the South Vietnamese . . . We teach them to rebuild their ordnance equipment, repair their vehicles for

them, operate and maintain their airbases, their drydocks, install and operate their power system, everything."

The Pentagon, embarrassed by the press leak of the deal, went into defense mode, assuring Americans that the Vinnell personnel would not be instructing the Saudi National Guard in ground tactics and maneuvers (Vinnell employees were seen fighting with Saudi troops in the Gulf War 15 years later). Defense Department spokesmen explained that the United States was trying to wean foreign governments off of U.S. military manpower, steering them toward private companies instead, which frees up active troops for more pressing action. It was the beginning of privatization in the defense industry, a trend that would burgeon over the following two decades and make Carlyle very rich. The Vinnell contract was characterized as a one-time training mission, a quick in-and-out. Twenty-seven years later, Vinnell is still well entrenched in Saudi Arabia, though Carlyle sold the company in 1997.

At the time, Vinnell spokespeople played down the significance of the announcement, defending themselves against claims that they were nothing but a ragtag group of mercenaries. One former U.S. Army officer, while waiting in line to apply for a position in Saudi Arabia (Vinnell had to hire on most of the men for the job due to a lack of experience in this type of work), told *Newsweek* "We're not mercenaries because we're not pulling the triggers. We train people to pull triggers." Hundreds of young men applied for the positions, which were advertised in local newspapers. It was a truly frightening trend for Americans to watch evolve.

Senator Henry Jackson finally got his congressional investigation into the Vinnell deal. And the results were difficult to fathom. The probe yielded a stunning contract clause that barred Jews from working on the contract. Because of the sensitivities between Arabs and Jews, which ran very high in the mid-1970s, Vinnell had agreed to the obviously anti-Semitic clause. The investigation also turned up a suspicious $4.5 million agent's fee that investigators thought was a kickback to the royal family. But

in the end, the anti-Semitic clause was dropped, and no charges were filed. Vinnell was free to go ahead with the highly controversial, highly profitable, contract in Saudi Arabia.

Going Dark

Then Vinnell disappeared again. Like a shadow at night, the company seemed to have the disconcerting ability to disappear when it needed to, just go dark. It wasn't until the Iran-Contra affair that Vinnell resurfaced temporarily. Richard Secord, a retired Air Force general who worked for Vinnell in the mid-1980s, was implicated as Oliver North's accomplice in the well-known arms-for-hostages scandal. As part of the voluminous press coverage of the scandal, Secord's background was thoroughly investigated, and it was found that he had previously worked for Vinnell. But Vinnell managed to successfully distance itself from the investigation and from Secord, who would eventually plead guilty to lying to Congress for his involvement with Iran-Contra. But his involvement with Vinnell put the quiet company in the spotlight once again.

In a brief, confusing, and rare public reference to the company, a *Time* magazine article in 1987 picked up the scent of Vinnell when it reported that two Vinnell employees may have been tangentially involved in a failed attempt to overthrow Granada's leftist Prime Minister Maurice Bishop. It was a bizarre revelation and few in the media knew what to make of it. What were these guys doing? And does this mean Vinnell was involved with plots of regime change? The story caused a few ripples of concern, no follow-up, and then once again the company dropped off the radar. How was such an intriguing company keeping so quiet? Why did the press never seem to follow up on these strange tales?

By the time Carlyle picked up Vinnell, via BDM, in March 1992, the company had built the Saudi National Guard up to

about 70,000 troops from the original 26,000. It had also paved the way for the cooperation between the United States and Saudi Arabia in the Gulf War. Many of its employees fought right alongside the Saudis, something the Pentagon had promised would never happen, in defending Saudi Arabia from Iraq's aggression. "During the Gulf War, when a lot of companies sent their people home, BDM (and Vinnell) did not," says Phil Odeen, then chairman of BDM. "We kept our people there during war, and we got high marks from the Saudi's for that. I'm sure there were a lot of nervous people, but that was a big factor in our continued success in Saudi Arabia."

The U.S. military presence in Saudi Arabia was growing steadily after the war. The Air Force was setting up shop indefinitely in Riyadh. BDM was increasing its business. By the mid-1990s, there were about 5,000 U.S. military personnel in Saudi Arabia, and close to 2,000 BDM and Vinnell employees. But while the royal family welcomed the presence of the American military machine in its backyard, many Saudi nationals did not. It is a dichotomy that exists to this day, in which the royal family's concerns do not mirror those of the general population of Saudi Arabia. And Vinnell's presence in Saudi Arabia was exacerbating that problem. Both the royal family and Vinnell tried to keep their dealings as quiet as possible. But with so many non-Arab employees working in and around Riyadh, the secret got out. Tensions steadily rose, and then, disaster struck.

Hate Boils Over

In November 1995, a car bomb ripped through the Riyadh offices of BDM and Vinnell, killing seven people, including five Americans. Three spouses of Vinnell employees were injured in the blast. The offices that were targeted were those supporting Vinnell's National Guard contract. "One of them got cut up badly,"

remembers Odeen. Unlike a U.S. embassy, a typical target for this kind of terrorism, the building that housed Vinnell's people were purposely nondescript. The workers kept as low a profile as possible. Vinnell's employees knew they were an unwelcome presence to the majority of the population. "There was a fair amount of security concern," recalls Odeen. "You didn't drive around with an American flag in your car." But it didn't matter. The radicals responsible for the explosion knew enough to attack the Americans where they worked. Vinnell was fooling nobody.

The bombing set off a feeding frenzy by the national media. It was as though the Vinnell story was brand new, and everyone had questions. What were these people doing in Saudi Arabia? How did the Saudis know they were there? Why were they targets? The answers would turn out to be far more sinister than anyone suspected.

According to one former board member of Vinnell, who wishes to remain anonymous, Vinnell had been a cover for the CIA for decades. Dating all the way back to 1975, the company was gathering intelligence on behalf of the U.S. government, by infiltrating the Saudi National Guard under the specious guise of military trainers. The board member also says that though the company was supposed to be nothing more than a front for covert intelligence gathering, the darn thing started making money. The board member likened the operation to the Hollywood movie *Swordfish* starring John Travolta, in which secret operatives from the government end up making a fortune off of companies designed to be fronts for the Drug Enforcement Agency.

According to this board member, even after BDM purchased Vinnell in 1992, there was very little anyone on the board did in terms of overseeing of Vinnell. Board members met regularly, but rarely was anything acted upon. The company that seemed to run itself was, in fact, being run by someone else.

If true, the company's murky history starts to make more sense. The ambiguous ownership. The fits of secrecy. The peripheral

involvement in Iran-Contra and Granada. And finally, the targeting of Vinnell by Saudi nationals. For his part, Odeen demurs when presented with this revelation. "I know nothing about it being a CIA front," says Odeen. "I knew it to be a first-rate training organization." But first-hand sources, one of whom sat side by side with Odeen on the Vinnell board, say otherwise.

Today, Vinnell continues to do its work in Saudi Arabia, since 1997 as a subsidiary of TRW. Whether it is a front for CIA activity is unclear. The company is among many that have come under political attack in the wake of September 11, and has been held up as an example of why it is so difficult for the United States to cut ties with the Saudis during the War on Terrorism. William Hartung, a foreign policy expert at the World Policy Institute, in referring to Saudi Arabia's stonewalling of the United States following September 11, was quoted as saying "If there weren't all these other arrangements—arms deals and oil deals and consultancies—I don't think the United States would stand for this lack of cooperation." And it's not just Vinnell. The company led a tidal wave of private American military into Saudi Arabia. Today, it is estimated that between 35,000 and 45,000 employees for outfits like Vinnell are living and working in Saudi Arabia. It is becoming nearly impossible to distinguish America's real military from America's soldiers for hire.

Carlyle has certainly had more pedestrian investments than Vinnell, but it's had more controversial ones as well. It's safe to say, that after the purchase of Vinnell, Carlyle entered new territory that separated the company from other buyout giants like Kohlberg Kravis Roberts and Co. Alleged CIA cover ups, car bombs, purported executive mercenaries may sound like a Hollywood movie script or a far-fetched work of fiction, but it's all in a day's work for Carlyle.

8

OUT OF THE SHADOWS

A Republican administration in exile.

—*Time* magazine, March 22, 1993

Cast of Characters

James Baker III	Carlyle executive, former secretary of state under President George Bush Sr.
Richard Darman	Carlyle executive, former director of the Office of Management and Budget under President George Bush Sr.
Colin Powell	Former Carlyle advisor, secretary of state under President George W. Bush.
Michael Eisner	Chairman of Walt Disney.
Antonio Guizzetti	Italian business man, friend of Steve Norris.
Basil Al Rahim	Former Carlyle employee in charge of raising capital in Middle East.
Stephen Norris	
William Conway	

By the beginning of 1993, Carlyle was a somewhat seasoned, if not terribly successful, private equity firm. Six years and a dozen or so buyouts after Rubenstein and Norris joined forces at the Carlyle Hotel in New York, the firm had made some huge deals happen. It had also participated in some major flops. The company had stakes in 10 companies valued at around $2 billion.

But the bottom line was that the Carlyle was not making the gobs of money its co-founders had hoped it would. And the time had come to kick it into gear.

In 1993, Carlyle began a rapid transformation, from an eager young private equity firm into an international political and financial powerhouse. They brought in the high-priced, high-profile talent that would ultimately define the company. They shed some of their old, bad habits, one of which happened to be Steve Norris, the co-founder of the company. And the result was nothing short of astounding. The moves the company made between 1993 and 1995 would cause some growing pains within the firm, but would also lay the groundwork for the new Carlyle—the company kicked off the training wheels and began to tear around the international business community. All of which began with a very important hire, and ended with a tragic but inevitable firing.

To this point, the company was still operating without a chairman. Carlucci had settled nicely into his role as vice chairman. Aside from opening the doors of defense to the Carlyle Group, he was now residing on the boards of an astounding 32 companies, not all of them owned by Carlyle. He was ridiculously well connected. His time was precious, and he was not highly involved in Carlyle's day-to-day deal making. While Carlucci was a serviceable figurehead, he was a bit detached, and didn't exactly reek of credibility. In referring to Carlucci's status value and lack of business acumen, Rubenstein was often overheard around the office saying, "we all know what Frank is . . ." Carlucci was invaluable in Carlyle's dealings in defense. But he was not the marquee name the company needed to really go global. Carlyle needed someone who could help raise money. Someone that would make the world stand up and take notice. Someone universally admired and respected. Someone like James A. Baker III.

A Trophy Hire

Baker, like Carlucci and Rumsfeld, attended Princeton University, and graduated in 1952. (The more you research the backgrounds of the key figures in Carlyle, the more you end up at the same place: Princeton.) He then spent almost 20 years toiling with Houston law firm, Andrews and Kurth. But in 1975, he would enter American politics when he became the Undersecretary of Commerce for then President Ford. He would not leave politics again for the next 18 years. During that time, he would lead presidential campaigns for Ford, Reagan, and Bush. He would serve as Reagan's White House Chief of Staff from 1981 to 1985, then secretary of the Treasury from 1985 to 1988. After leading George H. W. Bush to victory in the 1988 presidential election, he would be rewarded by becoming the nation's sixty-first secretary of state, a post he would hold from January 1989 to August 1992. For the last few months of Bush's time in office, Baker again became White House chief of staff, until January 1993, when after failing to get his boss reelected, he resignedly cleaned out his office to make way for the incoming President Clinton, ushering in eight long years of Democrats in the White House.

All told, Baker had been camped in the White House for 12 years straight. He was, and still is, a consummate statesman, and a steadfast Republican. Carlyle, with its offices at 1001 Pennsylvania Avenue, just a few blocks from the White House, with a distinctly Republican flavor, made a compelling offer to Baker. It's not as if Baker had a paucity of offers either. Publishers urged him to write his memoirs. Rice University, in Baker's hometown of Houston, wanted him to run a foundation. Enron made overtures. So when the boys from Carlyle knocked on his door, they weren't sure what to expect.

Rubenstein, Conway, and Norris went to the White House to make their pitch during the White House transition, and in the

waiting room, they ran into David Rockefeller, the next in line to see the man of the hour. They knew then that the competition for Baker's services was going to be stiff. After an hour-long meeting with Baker, however, they felt considerably better about their chances of landing the outgoing administration's biggest fish (aside from the president himself, of course). Baker was intrigued by the offer, and he invited Richard Darman, Bush's outgoing budget director, to get involved. Darman convinced Rubenstein that if Carlyle wanted Baker, they were going to have to take him, too. He made it a package deal.

On February 24, 1993, the news release hit the wire that Richard Darman, former director of the Office of Management and Budget, was joining the Carlyle Group as a managing director. Darman was a former executive at Shearson Lehman Hutton, Inc., and combined with his years of government service, would make an excellent investment advisor in sectors heavily affected by government regulation, like energy, transportation, and insurance. Two weeks later, days after accepting another job consulting with Enron on overseas projects, James Baker became a partner at the Carlyle Group. Carlyle had officially appeared on the radar screen.

Suddenly, every media outlet wanted to find out more about this quiet little merchant bank called the Carlyle Group, and it seemed that every writer had the same idea. Ten days after Baker was hired, *Time* magazine ran a story entitled "Peddling Power for Profit." In it, the magazine referred to Carlyle as a "Republican administration in exile," and reported that Colin Powell was also considering a job offer from the group. Powell and Carlucci were very close from their days together on Reagan's National Security Council. Then the *New Republic* wrote a scathing cover story later that year entitled "The Access Capitalists," which portrayed Rubenstein as a nervous, paranoid wreck, obsessed with the media's portrayal of Carlyle. His fears proved warranted. In a *New Republic* article, writer Michael Lewis called the company a

"salon des refuses for the influence peddling class." It went on to say, "[Carlyle] offers a neat solution for people who don't have a lot to sell besides their access, but who don't want to appear to be selling their access." It was not the kind of public relations coup Rubenstein was looking for when he went combing through the remains of the former Republican White House. The stinging accusations and acrid characterizations first levied in these articles would follow the company to this day.

Baker's hiring caused some waves inside Carlyle as well. Rubenstein and Norris, who were running the firm at this point, were concerned that Carlucci would want out when Baker came on board. After all, it would be hard to argue that Carlucci would be of more value to the company than Baker. It seemed reasonable to assume that Baker might be Carlucci's boss. It wasn't clear which one was going to be more senior. So in a preemptive case of ego-stroking, the firm decided to bring Baker in as a partner and promote Carlucci to chairman. But former employees agree that the new title was purely for outside appearances. One former employee would say of Carlucci, "Frank was a good guy to have around, even though he was rarely there. But when we had a tough problem to tackle, no one said, 'Hey, let's go show this to Frank and see what he comes up with.' " Carlucci and Baker also clashed over politics. When he was in the Carlyle offices, Carlucci was often overheard badmouthing former President Reagan, the man who appointed him national security advisor and secretary of defense, saving him from the nightmare that was Sears World Trade. Baker, a devoted Reaganite, didn't take lightly to Carlucci's disrespect. And Norris, a huge Reagan fan, would often remind Carlucci that it was Reagan who "made you who you are," a jab that went unappreciated by Carlucci. But Carlucci and Baker's differences were miniscule compared to the other clashes to come in Carlyle's testosterone-laden executive ranks.

Darman and Rubenstein's personalities clashed badly early on. Rubenstein phoned Norris in Paris one day to say he had

reached the end of his rope and that something had to be done. It was a classic style clash. The two eventually had to work out an arrangement limiting Darman's role in management in order to get along. The tensions inside the company were growing along with the company itself. As with any company that achieves success, Carlyle was finding itself at a crossroad between the past and the future, and the strain was weighing on its executives. Power struggles were common, and not the least bit private. The entire office saw management openly sniping at one another. But no one could have understood the severity of the split that had opened up between fellow co-founders Steve Norris and Bill Conway. And this was the battle that would be the turning point in Carlyle's history, the winner defining how business would be done going forward, the loser left to carve out another future, away from Carlyle.

A Chasm of Character

Norris' relationship with Conway had almost completely deteriorated by the mid-1990s. There were major differences of opinion on business issues. But this particular feud got increasingly personal over the years. Two men could not have had more wildly disparate styles. Norris loved "elephant hunting," wheeling and dealing, striking out occasionally, but all the while looking for the deal of the century, the one that would make them all rich beyond their dreams. He spent money lavishly, spoke out of turn, and followed his own instincts. Some call him mercurial, a term he dismisses by claiming not to know the definition. Some call him a loose cannon. But no one denies the important impact that Norris had on Carlyle. "In the beginning, it was all Steve," recalls one employee. "David and Steve. Steve and David. That was all anybody knew. Between the two of them, they got it all done."

Conway, on the other hand, was conservative to a fault. He deplored wastefulness and railed against unnecessary expenses. He was a button-down businessman from New England. His father wrote the book on quality . . . literally. William E. Conway Sr., a world-renowned quality consultant, first wrote *The Quality Secret: The Right Way to Manage* in 1996, and followed it up with *Winning the War on Waste: Changing the Way We Work* in 1997. Conway's father was also the first American CEO to embrace the teachings of Total Quality Management (TQM), a corporate trend that would sweep through American business as capriciously as the Macarena affected American dance. Knowing this, it is not difficult to understand why Conway found Norris' footloose style of deal making deeply offensive. And why Norris felt threatened by Conway's staid approach to business. If you didn't know any better, you'd have thought Conway was playing the role of controlling father to Norris' troubled adolescent in Carlyle's internal drama.

The rift between the two was damaging morale at the Carlyle offices. Without solidarity at the top, there was little to keep the younger MBA types from fracturing and feeling put upon. One former employee remembers the office at the time like this: "It was not a place where you sensed joy or even teamwork. There was no camaraderie. It was a tough place to be, where most of the economics went to the senior guys, and they didn't even like each other. It was hard for the younger guys to see how they were ever going to make money. A huge amount of the firm was going to a bunch of guys who didn't even do deals." Things got even worse, and even pettier.

Norris recalls a painting he bought for about $5,000 for his wife at the time that hung in his living room. Later when the Norrises hosted a cocktail party at their home, Conway and his wife saw the painting and were beside themselves. Apparently, Conway's wife had intended to buy the same painting. According to Norris, the rivalry between the two had grown so fierce, that the

Conways were convinced that Norris had bought the painting just to stick it to them. Norris claims he had no idea the Conways had designs on the painting. The petty jealousies and name calling of the super rich can be astonishing to the rest of us.

By 1993, it had become appallingly clear that Norris' time with the firm was going to end badly. Conway had begun to manage Carlyle's defense buyout business, taking over the day-to-day dealmaking responsibilities that Carlucci had helped put in place. By this time, Norris was spending a great deal of time and money setting up shop in Paris as he worked a deal between the Prince Alwaleed and Euro Disney, an operation badly in need of some financing. Norris wasn't afraid to enjoy his successes, and when he was in Paris on business, he stayed at the Ritz Carlton. He also availed himself of some free time while traveling on business. He didn't dwell on the minutia of high finance. He likes to tell a story that illustrates the difference in work ethics between himself and David Rubenstein. Bill Conway came in to the Carlyle offices one weekend to pick up some work. Rubenstein was there, huddled over his desk, feverishly writing a memo, with Norris relaxing on his couch. Conway asked Rubenstein what he was doing, and David said, "writing a memo." Norris and Conway teased him, until Rubenstein asked Conway what he liked to do to relax, to which Conway replied, "play golf." Rubenstein then said, "Think of this as me playing golf." Suffice to say given Norris' position on the couch, he didn't write memos to relax.

While Norris was negotiating with Michael Eisner and crew for the Prince's eventual $360 million investment into Euro Disney, he was racking up healthy expense reports. One day, in the midst of heated negotiations, he decided to go shopping. "I could see that it wasn't going anywhere," Norris says of the negotiations. "If I wasn't available, nobody could talk to anybody, and tempers would calm down, and we could reach a compromise." It was a decision for which Conway could never forgive him. Carlyle eventually did get the deal done, but the folks back in Washington

objected to the amount of money it was costing them and Norris' laissez-faire attitude in Paris. Norris claims that he could have spent less money, but not much less. However, in talking about this contentious time in the company's history, he lets slip, "I was in my suite at the Ritz . . . well, my room at the Ritz . . . I was accused of having a suite, but I really didn't."

By this time, Norris alienated the Prince by turning down a job offer from him, pissed off Michael Eisner during the Disney negotiations, and ran up a monster expense tab in Paris. His partners were losing patience. "He has no discipline," says Stan Anderson, a partner at McDermott Will & Emery in Washington, who worked with Carlyle, especially Baker, on a few early deals. "On a bike trip in Europe, Eisner lambasted him for bringing an undisciplined approach to the negotiations," says Anderson. "He was basically living in Paris, and he was living too large."

Norris' Last Stand

The final straw for Norris came when he drummed up a potential piece of business with a man he met in a sauna. (Norris and saunas seem to have a long history at Carlyle—rumors abound at Carlyle about Norris' alleged sexual exploits with a female employee in the Carlyle office's sauna, an adventure that allegedly ended badly when it triggered the fire alarm and evacuated the building—a rumor that Norris flatly denies but other former employees swear is true.) After a workout, Norris started up a conversation with an Italian businessman in the steam room of their fitness club. The man was Antonio Guizzetti, the Washington, DC, representative of ENI, a massive Italian oil exploration firm. Norris smelled a deal. "He wanted to internationalize Carlyle," recalls Guizzetti. "To that point, Carlyle International didn't exist."

Norris and Guizzetti struck up a friendship. It was classic Norris, always looking for deals, even in the sauna. The two tried all

sorts of deals at first. They met with Italian designer Giorgio Armani. They met with Paolo Bulgari, of Bulgari Jewelers and nearly cinched a deal to buy 10 percent of the company for only $5 million. ("If we had finalized the deal with the Bulgaris we would be multimillionaires right now," laments Guizzetti.) But in the end, the deal they decided to pursue was a buyout of IP, the retail unit of Italian oil company AGIP, a subsidiary of ENI. AGIP had built up too large a market share in Italy with IP, and the European Union was uncomfortable with the potential for monopoly, so the company was looking to sell off the retail chain of gas stations. Because the deal would have major political implications within Italy and the United States, Carlyle assigned a career diplomat to assist Norris. They called in Baker.

Guizzetti, Norris, and Baker traveled around Italy meeting with ENI's top executives as well as high-ranking politicians. They secured time with then Prime Minister Carlo Azeglio Ciampi's general secretary. The met multiple times with Paolo Savona, the minister of industry privatization. Guizzetti said traveling with Baker was like traveling with royalty. "We flew in a private jet and had meetings with everybody," gushes Guizzetti. "Traveling with James Baker in Italy guaranteed that the deal was serious."

The deal was serious, and Norris began rounding up financing. Through a new Carlyle colleague named Basil Al Rahim, who had been traveling throughout the Middle East to raise money, Carlyle was put in touch with an extremely wealthy family in Saudi Arabia that wanted in on the deal. The family had amassed a fortune through construction contracts and was looking to diversify. The name of the family was bin Laden. And the relationship Al Rahim established with the estranged family of Osama bin Laden would go on to be a long-term and very lucrative partnership. But not this time.

With financing in place, regulatory issues cleared with the help of Baker, and AGIP ready to sell, Norris was suddenly asked to leave Carlyle in January 1995. The public face on the resignation

was that Norris no longer wanted to be bothered with managing money, when his real passion was for cutting deals. Rubenstein was quoted in the *Washington Post* saying "Steve is one of the most creative deal-doers in the country. He wants to do different types of deals from what we want to do." According to Norris, the reality was far more contentious and personal. Conway's cautious conservativism had won out, and Norris was to be part of Carlyle's past, not its future.

Without Norris, the IP deal fell apart. Carlyle backed out of the transaction at the eleventh hour, claiming that one of AGIP's oil refineries processed oil from Libya, a nation embargoed by the United States for sponsoring terrorism. Norris says that Baker's law firm, Baker Botts, had already told Carlyle there were no legal problems with owning the refinery. But Carlyle wanted out anyway, apparently preferring to distance itself from deals that were initiated by Norris. "We were very, very close to the deal," recalls Guizzetti. "Then suddenly Carlyle changed, and the reason they gave about Libya being a terrorist state was stupid. It was the departure of Steve [Norris] that killed the deal."

Norris went on to start up a series of independent investment houses on his own and met with tepid success. Many people in the private equity world say that Carlyle made it very difficult for Norris to succeed after he left. "They badmouthed him all over Europe," says one banker. "It made it impossible for him to raise money." A number of bizarre rumors had begun to crop up around the Beltway, like the one about the sauna, about Norris' relationships and spending habits. To this day, Norris is baffled by the animosity he curried while at Carlyle, and questions his actions often. "I've certainly made my share of mistakes while I was there, but if I had to do it over again, I don't think I would have changed anything," he says. He blames Carlyle, particularly Conway, for waging what he terms a "scorched earth" campaign against him after he left, sullying his name and attacking his character. What is undeniable is that Norris has been completely

written out of the firm's history. Deals that he said he did are now attributed to Rubenstein, Conway, or Carlucci. He is no longer mentioned in any of the company's literature. He is persona nongrata. It's as if he never existed. Poof.

"They had to discredit me," says Norris today, while waiting for his girlfriend at the Four Seasons in Washington, DC, the hotel chain that he'd helped the Prince invest in years earlier. "I should have been a hell of a lot smarter. But one of my biggest weaknesses is that I tend to be too trusting. I thought I had some partners around me that, though we all had different approaches, would pull together. That just didn't turn out to be the case."

With Norris out of the picture, and Baker in place, Carlyle was now looking toward its future. Baker's marquee value put the company in a position to start raising massive amounts of capital, a problem that had plagued them in the early stages. And now they would be able to take their dog-and-pony show on the road, raising international funds off the strength of Baker's name. The company now had enough heavy hitters to pry open wallets from South Korea to Saudi Arabia. While Baker was still having a little difficulty weaning himself from politics—on a fund-raising trip to Japan in 1994, Baker could not pull himself from the television set as he watched that year's election results come in—he would prove to be an invaluable addition to the firm. He would help attract money from some of the wealthiest people in the world. A trend that in turn would make Carlyle itself one of the biggest investors in the world.

9

BREAKING THE BANK

When you make $50 million, you have a different perspective on life.
—David Rubenstein, *New Republic,* October 18, 1993

Cast of Characters

George Soros	Internationally respected investor and speculator, Carlyle investor.
John Major	Former prime minister of the United Kingdom, Carlyle partner.
David Rubenstein	

Private equity firms are often judged on the amount of money they have under management. It is generally considered a measure of success, an indication of investors' trust and confidence. In this business, size matters. And though Carlyle had done some decent deals, they were not considered a major private equity player. They didn't have any funds of $1 billion or more, a basic earmark of a successful firm. In fact, their largest fund was a meager $100 million. They still struggled to raise enough capital to fund the deals they did identify, and even those were cobbled together using smoke and mirrors. They often took on too much debt when acquiring companies, and that would inevitably make exiting the investment more difficult. What they needed was more fund raising. They needed money in the bank. Enough

money that they could stop worrying about money. The kind of money that only the elite firms could raise. They were about to get it. But like Carlyle's portfolio of acquired companies, its list of investors carried conflict and controversy. Soliciting money from just about anyone who had it, the company put together some powerful and unlikely bedfellows. And the little merchant bank from Washington, DC, began to grow in both stature and intrigue.

Considering Carlyle's questionable investing record by the mid-1990s, it is truly remarkable that the firm was able to attract the type of talent it had. Midway through the 1990s, the company had yet to cash in on anything but a few defense buyouts. Carlyle was getting pigeon holed as a defense company, and fast. Business press was criticizing it for being a bunch of tax-scamming crony capitalists, trading in on their time in government, and hitting up old friends for business. They had made a little money, but they certainly weren't lighting up the scoreboard. One magazine reported that Conway's wife was pestering him about seeing some profits they could take to the supermarket. Then everything started to change.

With Baker on board, Rubenstein turned his focus to raising money. Truckloads of money. Rubenstein began work on a fund that would eventually be called Carlyle Partners II, designed to focus on aerospace, defense, healthcare, telecommunications, and insurance. The idea was to parlay the newly acquired political expertise that Carlyle had gained through the hiring of Darman and Baker, and invest in industries that are heavily dependent on federal regulation. This way, Carlyle could cash in on its ex-politicos in two ways: first, to help them raise money by giving speeches at home and abroad, packing the house with high net worth individuals; and, two, to leverage their relationships with lawmakers to gain insight on the direction of policies that affect their target industries. It was a brilliant strategy that was about to make all of them very, very rich.

Soros' Millions

The goal for the fund was $500 million, a relatively modest sum in private equity circles, but five times as much as Carlyle had ever raised. Until this time, Carlyle's strategy was to first identify a deal, then round up the investors needed to make it happen. There was often a great deal of leverage involved, and the debt loads on some of the deals caused ongoing problems for Carlyle. This time would be different. After rounding up almost $150 million from some banks, pension funds, and Richard K. Mellon & Sons (an original investor in Carlyle), the company was going after an investor that could contribute both money and fame and get them over the hump. They were going after George Soros.

The Hungarian-American Soros already had the reputation of being the most prescient and successful investor in the world. His Quantum Fund was admired around the world. His investment record was unassailable. But on September 16, 1992, he cemented his place in finance history by shorting the British pound, and nearly bringing down the British banking system. That day came to be known as Black Wednesday.

Shorting is a way of betting that a stock or currency will lose value, usually over a relatively short amount of time. The investor borrows the stock or currency, then sells it, expecting to buy it back after the value decreases, thus pocketing the difference. It's a very risky investment strategy, because should the stock or currency increase in value during that time, the short investor may be forced to buy back the stock with money they may or may not have, resulting in huge losses. People who short are universally reviled in investing circles, because they want companies and currencies to fail and thus lose value. Often times, they take an active role in making that happen, circulating rumors and various untruths that will undermine the stock. It can be a rather dirty business.

In 1992, Britain was in the midst of a tough recession, and the British pound was struggling to maintain its value against

other currencies. Then prime minister John Major had announced a comprehensive plan to restore confidence in the pound. Publicly, he called it his "over-riding objective." But Soros had other ideas.

Soros placed a $10 billion bet against the pound, enough to cause the value of the currency to bottom out on its own when the public saw that such an important and knowledgeable investor had lost confidence in the currency. In essence, Soros was betting against Major and his ability to prop up the sagging pound. It has been called the highest stakes poker game in history. Currency speculators were either to believe in Major's ability to save the pound or Soros' intent to eviscerate it. Soros won. On Black Wednesday, the pound crashed, crippling the British economy and embarrassing the prime minister. Soros made a profit of $950 million. He would later be known in England as the man who made a billion off the pound's collapse. Needless to say, George Soros wasn't exactly a popular bloke in the United Kingdom.

So when Soros agreed to become a limited partner in Carlyle's new fund exactly one year after Black Wednesday, he was bringing far more than just $100 million. He was bringing added credibility and a reputation for making gobs of money. George Soros didn't make bad investments, so the Carlyle Group must be for real. Soros was also jump starting a fund that would go on to be the most successful in Carlyle's history. It is unusual for a private equity firm to issue a press release announcing an investment into a fund. Usually contributions to private equity funds are decidedly low-key events, meant to be kept private. Most investors prefer it that way. But it's different when the investor is George Soros. Carlyle needed to capitalize on their newfound fortune. So an announcement went out hailing a new dawn at Carlyle. Rubenstein would publicly characterize the investment as "more of a partnership than just a passive relationship." Indeed, Soros helped to market the fund, and his anchor investment brought the total

money raised to half the anticipated $500 million. But as it turned out, reaching the stated goal of $500 million would not be a problem for Carlyle, now that they could throw Soros' name around at meetings.

Suddenly, raising money was surprisingly easy. Investments were pouring in from the likes of American Airlines, Gannett, Citibank, and others. By the winter of 1994, the fund had already reached $400 million, and the target was raised to $650 million. Then in the fall of 1995, the goal was again raised, this time to $750 million. The money was starting to pile up. The Carlyle Group had everyone from Soros to Colin Powell helping them out, talking to investors, and opening wallets.

In Carlyle's previous fund, Carlyle Partners I, the defense investments Carlyle had made in the late 1980s were finally starting to cash out in the mid-1990s, and the payment was handsome. The company took a $38 million investment in Vought Aircraft in 1992, turned the company around, then sold it to Northrop Grumman just two years later for $130 million. Word got around quickly that Carlyle had the best game in town. Rumors of 46 percent annual rates of return had investors salivating. Members of the bin Laden family were in for untold millions. The state of Florida was in for $200 million. And the California Public Employees' Retirement System (CalPERS) was in for $80 million.

By the time Carlyle Partners II closed in September 1996, the fund had raised more than $1.3 billion, 13 times the size of the company's first fund, and more than twice the anticipated amount. The billion dollar mark is an important right of passage for any private equity firm, and Carlyle had now reached the levels of the elite. From this massive fund, the company would spread its investments all over the defense world. Carlyle Partners II was, and still is, the company's crown jewel. Many more funds would come down the line, but none with the power, scope, and success of Carlyle Partners II.

The Rich Get Richer

The time had come to start investing the money the company had worked so hard to raise. And true to its word, Carlyle sunk the bulk of the cash into an impressive series of defense, aerospace, and security companies. Names like Aerostructures Corp., United Defense, United States Marine Repair, and U.S. Investigations Services dominated the list of investments. And most of them had one thing in common: They depended on government contracts to make a living. Carlyle Partners II would ultimately go on to become the source of massive controversy, but before that it would make a killing, returning better than 30 percent annually to its investors, and finally making Carlyle's co-founders very, very rich.

Carlyle was really starting to hit its stride in the mid-1990s, both in raising capital and cutting deals. No deal illustrates that better than Howmet, a maker of blades that go into jet engines and gas turbines. In the fall of 1995, a major French multinational corporation called Pechiney was looking to unload Howmet quickly and quietly. Part of Carlyle's strategy in identifying investments—the company was looking at more than 1,200 potential deals a year at this point, but rarely invested in more than four or five—was to avoid getting into an auction with all of the other big names in private equity, like Kohlberg Kravis & Roberts or Forstmann Little & Co. As it turned out, the big guys weren't interested anyway, because the aerospace industry was in a major slump. So Carlyle joined forces with a maker of rocket fuel named Thiokol, and each picked up half of Howmet for $100 million. The two companies leveraged the rest of the purchase, which ended up costing $750 million in total. They all agreed they had overpaid.

Carlyle then applied a formula that would result in many successes for them in the future. They structured a sweeping system of financial incentives, from the executives to the shop floor workers. Stock options for upper management, and straight

bonuses for the grunts. They taught every last employee in the company, all 10,000 of them, how to manage cash flow. They dangled a great big green carrot. And it worked. In the first two years Carlyle owned the company, sales increased by 25 percent while expenses fell consistently.

By the fall of 1997, just two years after the buyout, Carlyle had managed to pay down more than half the debt that was incurred during the buyout and was ready to take Howmet public. The initial public offering was valued at $1.5 billion. Carlyle was entitled to half of that, making their $100 million investment worth $750 million. Not bad for a two-year turnaround. The boys at Carlyle had learned much since the early days of Chi-Chi's and Caterair. Things were starting to come more easily for them.

Carlyle was on a serious roll now. They decided to hit the global scene, using the same formula they had applied domestically: hire ex-politicos to open doors and wallets. By this time the company had George Bush Sr. casually working for them on and off as a "senior advisor." (Bush and Rubenstein had become very close friends at this point.) So it wasn't difficult to hook former U.K. Prime Minister John Major, as well. Fresh off his 16 years in government, the last seven of which were as prime minister, Major was another huge score for Carlyle. He had been America's ally during the Gulf War, which put him largely in the good graces of Carlyle's Middle East investors. And Carlyle had plans to create another massive buyout fund, this time targeted at European companies. The fit was perfect, and in late 1997, John Major became a member of the Carlyle European Advisory Board—just months after he left his post as prime minister in May.

The hiring of Major set up another of Carlyle's global ironies. It was, of course, Major that fought so hard to restore the value of the pound during Britain's disastrous recession in the early 1990s. And it was Soros who had opposed him; almost single-handedly defeating Major's efforts by speculating on the pound, and bringing the British economy to its knees. Now they were partners in

their business with Carlyle. Apparently, world leaders can forgive and forget. Nothing personal. With all that behind them, it was time to party.

The company held a lavish celebration marking its tenth anniversary in the fall of 1997. Inside the Library of Congress, the capitol building visible through the windows, the Carlyle Group celebrated its success with a gala affair that included a 20-piece orchestra. The room was wall-to-wall dignitaries, world leaders, ex-presidents, and business leaders. The Carlyle gala was the place to be, the tough ticket in DC. These were good times, and the partners at Carlyle knew it. They had finally made it.

Globalization

The European fund, like Carlyle Partners II, took off. Thanks to the help of Major, European heavy hitters, like Credit Lyonnais, Commerzbank, and Credit Agricole, contributed to the fund. As did American heavies, like AIG Global Investment, AMR Investment Services, BankAmerica, and the World Bank pension fund. (Afsaneh Mashayekhi Beschloss, then treasurer and chief investment officer at the World Bank, was the woman in charge of pension fund investments. After she retired from the World Bank, having committed an undisclosed sum of money to Carlyle, she took a job with Carlyle, a trend that would be repeated through Carlyle's history. That is not to say that Carlyle promised anyone they did business with a job, but the regularity of deals that look like quid pro quo is alarming.) The money rolled in yet again, and by late summer in 1998, the company had doubled its initial goal for its second consecutive fund, closing it at $1.1 billion. It seemed as if Carlyle could do no wrong.

But they didn't stop there. Over the next two years, the company would raise funds for investments in Asia, begin marketing funds to Latin America and Russia, and start up several venture

capital funds aimed at smaller investments of up-and-coming companies. It would set up real estate funds in Europe and the United States. By the end of the decade, Carlyle stood with more than a dozen funds and close to $10 billion under management. It was officially a juggernaut, and the world was taking notice. The company was hiring politicians from all over the world to further their cause: former president of the Philippines Fidel Ramos; Prime Minister of South Korea Park Tae-joon; former SEC Chairman Arthur Levitt. And, of course, George Bush Sr.

In the way that money breeds more money, Carlyle was becoming an unstoppable force during the latter half of the 1990s. Both the money and the talent that was pouring in was building something that transcended a traditional private equity firm. In fact, it transcended traditional business. Carlyle was transforming into an entirely new kind of company, unique in both its makeup and its approach to business. With all of the politicians now on board, Carlyle was far more powerful than other investment banks. It had an enormous amount of money and clout, both of which had a certain snowball effect that led the company into uncharted waters. But there was even more good fortune ahead. Much more.

10

BUYING BUSH

The shady world of bribes, kickbacks, and improper campaign contributions.

—*Harper's Magazine,* "Notes on a Native Son," an article on the Bush campaign, February 2000

Cast of Characters

George W. Bush	President of the United States of America.
Paul Silvester	Former Connecticut State Treasurer.
Wayne Berman	Washington insider, financial backer of George W. Bush, president of Park Strategies.
Denise Nappier	Connecticut State Treasurer.
Thomas Hicks	Founder of Hicks, Muse, Tate & Furst, Texas billionaire, Bush backer.
James Baker III	

George W. Bush is a president who has long been criticized for being beholden to corporate interests. And perhaps no company holds more sway over the president than the Carlyle Group. After all, George W. Bush owes his presidency to two men: his father, who provided him the Bush surname and his legacy of success; and James Baker III, the man who first helped Bush Sr. get elected president, then fought in the trenches of the Florida recount to capture the 2000 election for his son. Both of those men work for the same company: the Carlyle Group.

George W. Bush becoming the president of the United States would turn out to be a major boon to Carlyle's business. This was an eventuality that was not lost on Carlyle's executives during the younger Bush's campaign for the presidency, and as a result, Carlyle and its partners played as large a role as anybody in securing Bush's victory in 2000. But the road to the Bush White House was fraught with land mines for Carlyle. As Bush campaigned, the press examined his and his father's relationship to Carlyle, and the result was a series of stories about dubious investments, seemingly crooked kickbacks, and near-miss scandals, any one of which, had they hit their mark, could have brought Carlyle crashing back down to earth. Instead, as it had done so many times before, Carlyle deftly traversed the tricky terrain and reached the Bush White House relatively unscathed.

A Bush Bonanza

While Carlyle had amassed a formidable employee roster by the late 1990s, it wasn't until George W. Bush's announcement of his intent to run for president in 2000 that the full potential of the Carlyle arsenal began to dawn on the rest of the world. After all, it was Carlyle that had placed young Bush on the board of Caterair when he needed to beef up his business resume (though he would later eliminate any reference to the disastrous Caterair debacle in his official bio). And it was Carlyle who had been paying the senior Bush to give speeches and meet with foreign leaders around the world on their behalf. And then there was the host of former Reagan-Bush stalwarts, like Baker, Darman, and Carlucci, now on board at Carlyle. With billions already under management, funds closing at twice their initial targets, and a growing international profile, the prospect of George W. Bush becoming president on top of all that seemed unjust. After all, how was anyone in the private equity world going to compete with them now?

But that's exactly how things were setting up for the boys at Carlyle. Not ones to leave anything to chance, Carlyle did what they could to ensure their desired outcome to the 2000 elections. The company was among the top political contributors in the defense industry in the 2000 election cycle. According to the Center for Responsive Politics, Carlyle contributed more than $427,000 to political candidates in 2000. A total of 84 percent of those contributions went to Republicans, making Carlyle the most partisan of the top 10 defense contributors. George W. Bush received more than $190,000 in campaign contributions from defense contractors in 2000, more than four times the amount Democratic presidential nominee Al Gore received.

While the tantalizing prospects of one of their own setting up shop in the White House filled their dreams, the campaign of George W. Bush cast an unwanted light on the connections that Carlyle had cultivated over the previous decade. And the resulting investigations by the press would add to the public's suspicions of the Carlyle Group.

Close Call in Connecticut

It all started off innocently enough. The news that Connecticut's former state treasurer was under investigation for investing the state's pension fund without proper due diligence barely caused a stir in New England, let alone Washington. Things like this happened all the time. And the situation in Connecticut looked relatively harmless as compared to other pension fund scandals. He probably just made a few bad investments. Didn't do his homework. Nothing to get too upset about.

But gradually the story started to take on a life of its own, and it became clear that this was not your run-of-the-mill negligence. This was something far more sinister. Over time, the

complicated web of bribes and kickbacks was uncovered, and the result was the Carlyle name getting dragged through the mud again.

After he lost his bid for reelection to the Connecticut State Treasurer's office in November 1998, but before he left office in January 1999, Paul J. Silvester was a busy man. He invested $800 million in state pension funds in a series of eleventh-hour placements during those two frenetic months. This inordinate amount of action for a lame-duck treasurer raised eyebrows at the FBI, and the Bureau began an investigation. The Bureau wanted to know where the money had been placed, and why Silvester was in such a hurry to invest it. Silvester told the press that there was nothing irregular about the investments, and the whole thing was nothing but "a politically motivated witch hunt," contrived by one of his former political rivals. Nevertheless, Silvester resigned his newly acquired position at an investment firm called Park Strategies to concentrate entirely on the investigation. His new boss at Park Strategies, Wayne Berman, told the press early on that Silvester "resigned for personal reasons." It was one of the last times Berman would talk to the press on the matter.

But the investigation turned when agents realized that at least two of the investments that Silvester had made during the period in question were placed through Park Strategies, the same firm that had hired Silvester upon his leaving the state treasury. It worked like this: Silvester landed a high-level position at Park Strategies almost immediately after placing the investments and leaving office. On the face of it, it appeared as if Silvester was securing his future by investing the money through Park Strategies, which in turn had agreed to hire him.

Incidentally, Park Strategies placed $50 million of the money that Silvester invested into an Asian buyout fund run by Washington, DC's most connected company: The Carlyle Group. By the

summer of 1999, the focus of the investigation shifted onto whether Silvester had shuttled the money through Park Strategies in return for getting a job. The fact that the money had ended up with Carlyle seemed irrelevant. But every week, media scrutiny on Wayne Berman increased. Park Strategies LLC was a consulting firm that Berman set up with former U.S. Senator Alfonse D'Amato, a Republican from New York. Berman worked in the first Bush administration's Commerce Department and was also one of the largest fund raisers to the George W. Bush campaign, having raised more than $100,000 for the cause. He was thoroughly connected in DC.

Soon, the focus of the investigation again shifted. The FBI now wanted to know if Silvester had received illegal kickbacks, either from Berman or his clients like the Carlyle Group, in exchange for his placement of the $800 million, of which $50 million went to Carlyle. Federal officials subpoenaed information from Park Strategies and Carlyle, as well as dozens of other investment firms. Homes were searched, files were confiscated, and dozens of interviews were conducted as part of the investigation. And finally, Silvester cracked. On September 23, 1999, Paul Silvester pleaded guilty to charges of corruption. Over the ensuing months, a complicated ring of kickbacks would result in fines and indictments for several of Silvester's family members, including his brother and brother-in-law. Together, the Silvester family had been accepting bribes for years, buying themselves boats and shiny new coats of paint on their houses.

Many of the documents from the case remained sealed, but the *Hartford Courant* quoted court documents that explicitly said Silvester "understood that his employment opportunity and/or substantial salary was contingent on his investing Connecticut state pension money with" a particular fund, referred to ambiguously as "Fund No. 4." The newspaper also reported that Berman had received fees, as much as $1,000,000, by virtue of Silvester's

investments with Carlyle. Berman says the number was closer to $900,000. Finder's fees are not illegal, and though unusual, they are not unheard of. The concern is they can sometimes be used illegally as quid pro quo in kickback deals.

To this day it is not clear which fund the court documents are referring to. According to Bernard Kavaler, director of communications at the Connecticut Treasury Department, the U.S. attorney's office has not named the firms involved because the case is still pending. Paul Silvester has yet to be sentenced, though he is spending his days in jail. "They used letters and numbers in the court documents," Bernard Kavaler told me in September of 2002. "They still haven't named the who's who yet." In the meantime, the public is left to speculate.

As a result of the added scrutiny, Berman suspended his fundraising activity for George W. Bush. Berman maintains his innocence on any and all accusations to this day and calls the whole mess "ancient history." He went on to tell me that "the only thing I suffered from in this was some bad publicity from a 50,000 circulation newspaper. It all just evaporated. Everything I did was aboveboard." Berman told me that after the U.S. attorney's office requested some paperwork from him, which he provided, they never again contacted him on the matter. "I was never interviewed, they never called, never sent me a letter, never sent me a birthday card. I was never questioned. It is fair to say, therefore, they didn't think I did anything wrong."

On September 30, 1999, the new treasurer in Connecticut, Denise Nappier, called for new disclosure standards for Connecticut and asked that all recipients of state investments reveal to whom they had paid finders' fees. She also announced that she would make the findings public. The idea was to make investment banks more accountable for their behavior, be it legal or illegal. Following are excerpts from the first letter from Nappier to Rubenstein:

Dear Mr. Rubenstein:

As part of an ongoing federal investigation, the United States Attorney for the District of Connecticut recently disclosed a series of improper and illegal activities engaged in by my predecessor, Paul J. Silvester.

The information detailed by the United States Attorney focused, in part, on improper use of finder's fees. While it is my understanding that use of such fees can, in certain circumstances, be a legitimate business practice, the federal investigation has raised a myriad of legal and ethical issues, including possible and probable conflicts of interest and appearances of impropriety. In our effort to comply with the spirit and letter of all Connecticut and federal laws, and consistent with my longstanding interest in public disclosure, it is necessary that we formally ask all firms and individuals doing business with the Office of the State Treasurer to disclose finder's fees or other compensation paid to anyone as a part of any transaction related to the introduction, award, or continuation of business with my Office.

Accordingly, I request that you provide, on the forms enclosed herewith, a detailed disclosure of any and all finder's fees, placement fees, consulting contracts, or other compensation currently made in connection with any transaction or ongoing arrangements related to procuring or doing business with the Office of the State Treasurer, as well as any such arrangements during the past five (5) years. As part of this disclosure, I ask that you identify the individuals or entities receiving any such compensation and the amount of each payment. In the event that your company did not pay finder's fees, placement agent fees, or furnish other compensation at any time during this period, kindly so indicate in your response.

Please forward your response on *or before October 15, 1999,* to the attention of Catherine E. LaMarr, Esq., General Counsel, Office of the State Treasurer, 55 Elm Street, Hartford, Connecticut 06106-1773.

> My office values our relationships with each of our vendors, and we appreciate your prompt and careful attention to this matter.
>
> Sincerely,
>
> Denise L. Nappier
> State Treasurer

Hundreds of funds, fearful of losing Connecticut's business, complied with Nappier's requests immediately. But Carlyle's disclosure for its Asia fund was unacceptable by Nappier's standards, and the company outright declined to submit a report on its European fund, which Silvester had also invested in during his tenure as treasurer.

Nappier, her patience wearing thin, then sent another letter to Carlyle, more than a month after the first, threatening to cease all business dealings with the firm if they refused to disclose their finder's fees.

> Dear Mr. Rubenstein:
>
> By letter dated September 30, 1999, I requested that your company voluntarily disclose all compensation paid or promised in connection with any transaction or ongoing arrangements related to procuring or doing business with the Office of the State Treasurer since January 1, 1995. To date, we have not received a response to this request.
>
> Disclosure of this information is the policy of this administration. Failure to comply will certainly jeopardize your company's current business relationship with the Office of the State Treasurer, as well as any prospects for future business.
>
> In the event that we do not receive a full and complete response by the close of business on November 15, we will work with Connecticut's attorney general to pursue every legal

> recourse available to suspend or end our business relationship with your firm.
>
> Sincerely,
>
> Denise L. Nappier
> State Treasurer

More than a month had passed since Nappier's original request and still nothing from Carlyle about their European fund. The *Wall Street Journal* reported on September 29 that Nappier was already starting the process of unwinding or canceling $561 million in investments made under her corrupt predecessor, including money invested with Carlyle. The clock was ticking, and there was $150 million at stake for Carlyle. It appeared as if Carlyle did not want the public to know something. Why else risk losing the money?

Finally, Carlyle came clean, delivering a full report to Nappier and the state of Connecticut. The company said that it had paid Wayne Berman a $1 million finder's fee for a $100 million placement from the Connecticut State Pension Fund into the Carlyle European Partners fund. In addition, the Associated Press reported in January 2000 that the Connecticut State Treasurer's office had paid a whopping $2,971,945 fee to Carlyle Europe Partners, the nature of which remains unclear to this day.

More Money, More Problems

The Silvester case was a close call for Carlyle, and the company's profile was becoming a little too pronounced for Rubenstein and company. It wasn't just the Silvester scandal that was turning up the heat however. George W. Bush's campaign for president had the press in overdrive, digging voraciously into the younger Bush's past, looking for examples of corporate cronyism, nepotism, shady

dealings—anything that would sell newspapers. Democrats were eager to portray Bush as the "corporate candidate," or "Daddy's little boy." With Carlyle, both the media and Bush's opposition thought they had found something. They were asking copious numbers of questions. Who was this secretive company that Bush Sr. was working for? Aren't there some conflicts of interest inherent in this arrangement? Just how much business has George W. Bush done with the Carlyle group?

As it turned out, the Silvester affair led reporters to another questionable association between George W. Bush and big business, and once again Carlyle found itself running for cover. Enterprising young reporters were more interested in establishing the elusive connection between Berman's dealings with Silvester, and his generous campaign contributions to Bush. It was a connection they failed to establish. But the hunt for questionable campaign contributions led them to another financial supporter of Bush: Tom Hicks.

In February 2000, *Harper's Magazine* wrote an epic piece laying out the George W. Bush's business history in excruciating detail. It scrutinized the relationship between Bush and Thomas O. Hicks, a self-made Texas millionaire whose company, Hicks, Muse, Tate & Furst, was among Carlyle's biggest competitors in the private equity business. Hicks, a dedicated Texas Longhorns fan, had been up for a seat on the University of Texas' board of regents when George W. became governor in 1994. With the transition in power in Austin threatening his promised seat, Hicks provided Bush with a $25,000 campaign contribution, after he'd already won the election. Some say contributing to a campaign after the campaign is already over is another way of giving free money to a politician in return for a favor. And Bush did push through Hicks' coveted appointment to the board. Favor granted?

Through his new position, Hicks encouraged the University to more aggressively invest its $13 billion in financial assets, which includes endowments, donations, alumni contributions, and so

on. Frustrated with the conservative strategy of years past, Hicks felt the University was leaving money on the table and had big ideas on how to change that. The answer was the P-word: *privatization*. Hicks fought hard to create a private company through which the assets of the University of Texas would be managed. It was a bold strategy, but one that fit with the larger trend toward privatization sweeping the nation.

By 1996, University of Texas Investment Management Company (UTIMCO) was born. Tom Hicks was quite pleased with the creation of UTIMCO, but the public and press were a bit miffed. As it turned out, the nonprofit company no longer had to divulge details on the investments of the University's money to the public; due diligence reports were not made available to the press. No one knew what the University's money was being spent on anymore. It was an untenable situation for the University's investors. But it went on for years.

Over time, the press and political action committees forced UTIMCO to open up its books, for fear that investments were being made based on political leanings and personal relationships. They found what they had suspected. Among the reams of Republican-friendly recipients of investments was, perhaps not surprisingly, the Carlyle Group. Weeks after Bush became governor in 1994, the University's board of regents placed $10 million into Carlyle Partners II, the fund that holds the bulk of the company's defense investments, as well as the lion's share of its controversy. It was a stunning example of how big business and politics are never far apart. Tom Hicks, an appointee of George W. Bush, had helped place $10 million of the University's money with a firm that not only had employed George W. a year earlier (via Caterair), but at the time was also considering employing George H. W. Bush. It was classic Carlyle, commingling business and politics to the point that the lines are blurred.

Hicks told *Harper's* that he didn't know of the relationships within the Carlyle Group when he made the investment. In fact,

he went on to say that he suspected internal problems within the firm (most likely the ongoing feud between Norris and Conway) and had reservations about the investment from the onset. Which begs the question: Why invest in them at all? Especially in light of the fact that Carlyle is the supposed competition to Hicks, Muse, Tate & Furst. Tom Hicks, like so many others that do business with Carlyle, declined to be interviewed for this book.

It appears that UTIMCO's investments were at least partially politically motivated, rather than purely financially motivated. And that is the power of Carlyle. When an investor commits capital to a Carlyle fund, are they making a sound financial investment or a strategic political contribution? The inherent confusion works to Carlyle advantage.

Baker's Battle

Many political experts thought that the revelations about Berman and Hicks would do serious damage to George W. Bush's presidential campaign. It's impossible to know just how much of an effect the news had on voters. But however great the damage was, it paled in comparison to the value of the money that Berman and Hicks would contribute to Bush's campaign over time. Miraculously, Carlyle managed to tiptoe through the landmines relatively unscathed, aside from some unwanted attention. However, speculation over Carlyle's political leanings and what the company had or had not done to further George W. Bush's political aspirations became a moot point when James Baker got a call from Bush's campaign manager the day after the 2000 presidential elections: He was needed in Florida.

From the moment he was called into duty on November 8, 2000, until the day that Gore conceded the election on December 13, Baker dedicated himself tirelessly to winning the Florida vote for Bush. Having sat out the previous two campaigns, including

George W. Bush's, Baker jumped into the fray with both feet. It was obvious he hadn't lost a step.

After taking a plea for help from Bush's campaign manager, Baker flew to Florida immediately to assess the situation. So many things were riding on this vote. Baker, already as partisan a politician as there is, had many reasons to want the younger Bush in office. For one, there was the eight long years he had spent in exile since the Clinton administration took office. The hatred that Republican stalwarts harbored for Clinton and Gore cannot be overstated. Then, there was Baker's fierce loyalty to his close friends in the Bush family. And finally, the new life that Baker had carved out for himself since leaving the public's eye—that of a lawyer at Baker Botts and a globe-trotting deal maker for Carlyle Group—would benefit substantially if a close family friend were in office. The motivation was stacked.

Baker brought the same tenacity into Florida that he brought to his previous five Republican presidential campaigns. He relentlessly went to work attacking the Gore camp's motto, repeated ad nausea during the fight for Florida, of "Count all the votes." Baker was quoted in Jeffrey Toobin's definitive book on the subject, *Too Close to Call: The Thirty-Six Day Battle to Decide the 2000 Election,* as saying, "We need a PR strategy, we're getting killed on 'Count all the votes.' Who the hell could be against that?" Republicans, that's who. Baker wanted to limit the amount of votes that were recounted, knowing that with Bush already in the lead, the fewer votes that are recounted, the better Bush's chances of winning. Recounting them all could only lead to bad things.

But the Gore camp decided not to get too greedy by asking for a full recount throughout the state. Instead, they asked for a selective recount, only in the most controversial counties. Gore's people thought the tactic would be seen by the public as generous and fair, but they forgot that the campaigning was over, and the public's impression no longer mattered.

Baker turned the tables on Gore, filing a federal lawsuit claiming that the Gore camp's selective recount request only included counties in which Gore was likely to pick up votes. Many of the lawyers at work with Baker felt filing a lawsuit would look bad, and ultimately be a losing strategy. But Baker knew better. It was a litigious long shot, and ironically opposed their real goals. The fact of the matter was that the Baker/Bush camp had no intention of recounting all of the votes. They didn't want any of the votes recounted. As far as they were concerned, they had already won the election.

Baker carried out the operation in Florida with military precision. He spoke to George W. Bush often, sometimes four times a day. Though Baker kept Bush informed, he was in no way taking orders from the much younger presidential candidate. Baker was in complete command, calling all the shots. He managed to somehow sway the opinion of the court and Florida lawmakers against a recount, painting Gore as a sore loser, desperate to gain an edge. He held press conferences, claiming to be acting to "preserve the integrity and the consistency and the equality and the finality of the most important civic action that Americans take: their votes in an election for the president of the United States."

Over time, Baker developed an overused mantra of his own: The vote in Florida was counted and recounted, referring to the automatic recount of machine ballots. This was a claim, which Toobin points out, was entirely untrue. The automatic recounts that took place in Florida simply rechecked the totals that machines had spit out. It did not put the ballots through the machines again, the true meaning of a recount. Eighteen counties failed to properly recount their votes, accounting for more than a quarter of the total votes cast. Yet Baker managed to make Gore look like a fool for asking for "third" and "fourth" recounts. It was a brilliant strategy. And it worked.

The public relations battle in hand, Baker turned his attention to the legal arguments. The Gore camp never had a chance. Baker assembled an army of high-powered lawyers and political operatives, spread them around the state and country, and summarily eviscerated the Gore camp, which was led by Warren Christopher, no slouch in his own right. It was Baker at his very best: relentless, merciless, and victorious. On December 13, Gore conceded and George W. Bush became the forty-third president of the United States.

So much of what the Carlyle Group had done to this point in their history was setting them up for this moment: the defense investments, the extensive interests in the Middle East, the Republican administration in exile. Though the company would lose some of their most useful advisors and friends to the Bush White House staff, like Colin Powell, who became secretary of state, and Donald Rumsfeld, who became secretary of defense, they knew their buddies would not be far away. In fact, they would be right down the street. And even more useful than ever.

11

FAMILY BUSINESS

To this day we don't understand why [George H. W. Bush] hasn't resigned. It's causing a scandal.

—Tom Fitton, Judicial Watch,
in a phone interview, November 2001

Cast of Characters

William Kennard	Former chairman of the Federal Communications Commission (FCC), Carlyle director.
Frank Yeary	Former investment banker at Salomon Smith Barney, Carlyle director.
Arthur Levitt	Former chairman of the Securities and Exchange Commission (SEC), Carlyle advisor.
George Herbert Walker Bush	Former president of the United States of America, Carlyle advisor.
Park Tae-joon	Former prime minister of South Korea, Carlyle advisor.
Michael Kim	Son-in-law of Park Tae-joon, Carlyle managing director.
Crown Prince Abdullah	Heir to the Saudi Arabian throne.
Tom Fitton	President, Judicial Watch.

Merriam Webster's Dictionary defines *nepotism* as a noun, meaning favoritism based on kinship. It is a simple definition, inherently neutral, and easy to understand. After all, isn't it natural to favor your own family members over strangers? It seems harmless enough. But when applied to international politics, it could not

be more inappropriate. Our world leaders have a responsibility to act on behalf of the people they represent. Many of them take an oath to that effect. So when a politician, particularly the president of the United States, demonstrates nepotism in his actions, it is cause for serious and immediate alarm. George Herbert Walker Bush and his son George W. Bush have repeatedly and flagrantly crossed this border of impropriety since the younger Bush became president in 2001. And the company creating this ongoing breach of the public's trust is the Carlyle Group.

Money: A Bi-Partisan Goal

The ascension of George W. Bush to the presidency wasn't all good for the Carlyle Group. It was true that the new president had close ties to the company and would be in a position to send all kinds of business their way. It could even be said that the new president might be inclined, or at least not disinclined, to push policies and projects that might fatten his father's, and in a less direct way his own, bank accounts. But along with those newfound advantages for Carlyle came the continued, and at times increased, scrutiny of its behavior; fevered charges of cronyism; and the occasional accusation that the company was not a private equity firm at all, but rather a shadow government pulling the strings in Washington. Some of these concerns are more legitimate than others, but there was another more immediate issue: Who were they going to hire now that all the Republicans were going back to work?

Carlyle had been cultivating an unseemly reputation as a Republican boys club, whose membership privileges included the thrill of deal making on a global scale and a hefty paycheck at the end of the month. Indeed, it was difficult to spot any Democrats on the employee roster aside from Rubenstein himself, and he was 20 years removed from service by this time. But as always,

Carlyle already had a plan. It was time once again to pick over the bones of an outgoing administration. And this time, they were looking to harvest a host of Democrats.

In the spring of 2001, just a few months after Clinton had cleared out his desk, Carlyle snatched up both outgoing Federal Communications Commission (FCC) chairman William Kennard and outgoing Securities and Exchange Commission (SEC) chairman Arthur Levitt. The announcements of their hirings were less than a week apart. Both men are loyal to traditional democratic doctrine. Levitt has long been known for his concern for the individual investor, fighting to defend the little guys from the scourge of corporate greed. In one master stroke, indeed in one week, the Carlyle Group went from being a dark and mysterious GOP lair to a bright and open bipartisan buyout firm with a heart. It was Rubenstein at his best, fully aware of public opinion, and ready to make whatever changes were needed. Incidentally, the company had also picked up two of the best minds in the telecommunications and securities businesses.

But like most of Carlyle's high-profile hires, it seems that Kennard and Levitt did not come without baggage. Kennard in particular had the apparent stink of a quid pro quo deal.

Over the course of 2000, SBC Communications, the parent company of the Baby Bell Southwestern Bell, was pursuing two major agendas simultaneously. On one hand, SBC was eager to buy into the Saudi Telecommunications Company (STC), as the Saudi Arabian Kingdom took the state-owned and run telephone monopoly private. In so doing, the company had contracted Carlyle to help them, because, as one European investor noted, "Carlyle had Saudi Arabia completely sown up. They controlled the deal flow in and out."

Two years earlier, Carlyle had hired Frank Yeary, former head of the media and telecommunications investment group at Salomon Smith Barney. With Salomon, Yeary had helped SBC grow from a thriving regional telephone company into the second

largest telecommunications firm in the country by acquiring Ameritech and Pacific Telesis. Then in 1998, he had helped Carlyle and a partner buy some cable properties in Virginia and Maryland from SBC for $250 million, then turn around and sell them six months later to Comcast for $735 million. He was a legend in telecom. And he was very close to the folks at SBC. Carlyle was in the perfect position to facilitate the deal in Saudi Arabia, which they did, extremely quietly, in August 2000. The deal was so secretive, it was near miraculous that anybody got wind of it at all. But an Arabic daily called *Asharq al-Awsat* reported that the Saudi government had chosen SBC Communications to buy between 20 percent and 40 percent in the Saudi Telecommunications Company, which had an estimated value of $12 billion at the time. The deal was termed a "strategic partnership." Any number of telecom companies would have wanted in on it, but with Carlyle on its side, SBC never had any real competition.

At the same time, SBC was chaffing under newly established restrictions on telecommunications companies at home in the United States. Under the Telecommunications Act of 1996, regional bell operation companies, or Baby Bells, had to make their local lines available to the national long distance companies before they would be able to enter the long distance market themselves. Baby Bells, by nature of the telecommunications structure in the United States, had been government sanctioned regional monopolies since Ma Bell was broken up. Each Baby Bell owned and operated all of the local telephone lines for a given geographic area. Like Bell Atlantic in the Northeast, Pacific Bell in California, or Southwestern Bell in Texas. But the Telecommunications Act of 1996 was supposed to change all of that, opening up each region to competition. The tricky part was ensuring the Baby Bells would allow new competitors in to use their lines, thereby taking customers away. A bureaucratic nightmare of line request forms, fees, and fines for noncompliance emerged. Not surprisingly, new competitors had an impossible time securing lines from

the Baby Bells, who protected their turf with arrogance and defiance of the new law. It was a mess.

Baby Bells, like SBC, abused the spirit of the Telecommunications Act of 1996 repeatedly. When competitive local carriers requested lines for a new customer, the Baby Bells would drag their feet, with little or no incentive to help a new competitor steal their customers. The fines for this anticompetitive behavior, levied by the FCC, were nominal and harmlessly factored in as a cost of doing business by the Baby Bells. Many of the would-be competitors in local markets dried up and died waiting for lines they knew they would never get from the likes of SBC. SBC was among the biggest offenders, drawing millions in fines and testing the patience of regulators and potential competitors alike.

That's why jaws dropped when SBC filed an application to begin delivering long-distance service in Texas at the end of 1999. Competitors that had been trying to get a fair shake in Texas, waiting in vain to gain access to SBCs local lines, couldn't believe it. The law clearly stated that a Baby Bell must open its local lines up to competition before it would be allowed to enter the long distance markets. SBC had not done that yet. So the U.S. Department of Justice recommended in February of 2000 that the application be rejected on the basis that SBC had not sufficiently opened up its network to competitors. But the Department of Justice (DOJ) doesn't get the final say in the matter. The FCC, chaired by William Kennard, does.

SBC voluntarily withdrew the application, and reapplied a few months later. After being embarrassed by the original rejection, the company pointed to the recommendation of the Texas Public Utilities Commission (TPUC) to approve the application, which the DOJ had summarily dismissed. The TPUC, happens to be chock full of Bush appointees, and SBC was one of the largest single corporate contributors to Bush's presidential campaign. "What this sounds like is, [the DOJ] is telling the Texas state commission it doesn't know what it's doing," said

Michael Balhoff, managing director at Legg Mason, in an interview with the *Houston Chronicle*.

To the shock and dismay of many, SBC's application was ultimately approved by William Kennard and the FCC in the summer of 2000, and SBC was free to deal long distance in Texas. And in January 2001, the FCC approved SBC's application to offer long distance in Oklahoma and Kansas as well, making it the first Baby Bell company to offer interstate service since the breakup of Ma Bell. The approval was handed down on Kennard's last day as FCC chairman. Less then two months later, Kennard was working alongside Frank Yeary and the boys at Carlyle. It was all sounding awfully familiar.

The hiring of William Kennard brought with it the same appearance of impropriety that the hiring of Frank Carlucci brought. It looked quite a bit like the hiring of Paul Silvester at Park Strategies after he left the office of the treasury of Connecticut, and that of Afsaneh Mashayekhi Beschloss after she left her post at the World Bank. Here were men and women that made industry-altering decisions while in powerful positions and public office, then put themselves in a position to profit from those decisions months after they left their posts. Did Kennard act with foreknowledge of his employment with Carlyle? And what happened to his "cooling off" period? Kennard was on fire when he accepted a job at Carlyle. Only William Kennard, and maybe a few folks at Carlyle, know the answers to these questions. Perhaps that's why they all declined to be interviewed for this book. Regardless, while the Kennard situation smells bad, there was, and still is, another problem that Carlyle has on its hands that has a much mightier stink.

That ex-presidents cash in on their celebrity after their careers as public servants is understood. Most erstwhile chiefs end up on the public speaking circuit, pulling down $100,000 a speech. Many set up charity organizations, dabble in the stock market, or play a lot of golf. But never has an ex-president

had the opportunities that George H. W. Bush has, doing business with heavily regulated industries, subject to the whims of the country's commander-in-chief, who also happens to be his son. And we may never see such an extraordinary arrangement again.

Papa's Got a Brand New Gig

After George W. Bush's swearing in, the national media immediately picked up Carlyle's scent again. Though the press missed the ironies and improprieties of Levitt and Kennard, they seized on the mother of all impropriety: The Bush family stood to gain financially from policy decisions George W. made while in office. The *New York Times* finally got in on the game, writing a revealing article in March 2001, detailing the relationships between the current administration and the Carlyle Group. It was the first most people had ever heard of this company, and it scared the pants off of them.

In the article, Charles Lewis, the executive director of the Center for Public Integrity is quoted as saying:

> Carlyle is as deeply wired into the current administration as they can possibly be. George H. W. Bush is getting money from private interests that have business before the government, while his son is president. And, in a really peculiar way, George W. Bush could, some day, benefit financially from his own administration's decisions, through his father's investments. The average American doesn't know that and, to me, that's a jaw-dropper.

As a member of their Asian advisory board, Bush Sr. was visiting the Middle East, and in particular, Saudi Arabia, on behalf of the Carlyle Group. Photos taken of a meeting between Bush Sr.

and King Fahd started popping up all over the Internet. A natural confusion arose over the nature of Bush's visits to foreign dignitaries. Were the trips a form of commercial diplomacy? Were they social visits? Was the former president representing U.S. interests? Or was he just there on behalf of a moneymaking behemoth by the name of the Carlyle Group? The same questions arose in the United Kingdom over the actions of John Major, who accompanied Bush on the trips to Saudi Arabia.

Of greater concern was that Major and Bush Sr. were meeting with less savory characters than the royal family. They had been to see the bin Laden family, the wealthy relatives of a known terrorist (by this time Osama bin Laden was unambiguously viewed as a terrorist threat to the United States, and estranged from his family). It wasn't clear what either of the former world leaders were up to. And it was this confusion, on the part of both the public and foreign world leaders, that played to Carlyle's advantage. Carlyle repeatedly reaped the benefit of blurred boundaries, with foreign business owners and world leaders not knowing whether Bush Sr. represents American political interests or Carlyle's financial interests. That was, and still is, a very powerful tool for Carlyle. But while everyone was waiting for a conflict of interest to arise in the elder Bush's business with Saudi Arabia—as indeed it would later—the real controversy was happening half a world away, in the tiny peninsula off the Eastern coast of Asia: Korea.

Sowing Carlyle's Seeds in Korea

On May 27, 1999, former president George H. W. Bush touched down in Seoul, South Korea, for a whirlwind business trip. His visit was celebrated in Seoul, with newspapers hailing his arrival, excited about the possibility of American investment in Korea in the wake of the Asian economic crisis of 1998. He met with South

Korea's Prime Minister Kim Jong-pil, and president of the United Liberal Democrats party Park Tae-joon, a major political figure in South Korea who had been advising Carlyle since 1998. He also met with the chairman of South Korea's Financial Supervisory Commission, Lee Hun-jai, chairman of SK Telecom Choi Tae-won, and the president of a financially ailing Asian conglomerate called Halla. Again, it was classic Carlyle: a measured blend of business and politics that sufficiently blurred the boundaries between the two.

Carlyle's spokespeople, when questioned by the press about the impropriety of the senior Bush working for a defense contractor while his son is president, often retort by explaining that all the senior Bush does for them is make speeches about world events. They say his job is to pack the house, get the crowd excited, then step aside while Rubenstein pries open their wallets. But this trip to South Korea was much more than that. Bush Sr. wasn't just giving speeches to rooms full of investors; he was doing business, one on one, with CEOs and politicians. These were not motivational talks about global politics. This was business. And he was good at it.

Carlyle was really starting to get busy in South Korea now. That same spring, the company hired Michael Kim, a Harvard-educated native Korean, to open its brand new Seoul offices. Kim is the son-in-law of aforementioned Park Tae-joon. Carlyle and nepotism seemed to go hand in hand.

Immediately following Bush's visit, Korean newspapers lauded an announced $1 billion investment in the country by Carlyle, including a buyout of a division of Mando Machinery, a South Korean industrial firm, owned by Halla, the same company Bush Sr. had visited weeks earlier. Bush had been busy, and apparently, successful on his quick two-day trip to South Korea. Carlyle was in business on the peninsula.

Bush went on to tour Thailand, with former prime minister and Carlyle advisor Anan Panyarachun, spreading more of the

good news that money from America was coming. But back in Korea, Michael Kim was working to put together another massive deal. This time Carlyle was looking to buy one of the few healthy banks left in Korea, KorAm Bank. Korea, like the rest of Asia, had suffered terribly from the economic crisis that swept through the continent in the late 1990s. Many of the country's banks had faltered and collapsed. But KorAm was an exception. It had taken some hits, like all businesses in Korea, but had remained solvent. The Korean government had a vested interest in keeping the firm in Korean investors' hands. But Carlyle had other ideas.

Carlyle gained approval for the buyout by the KorAm board, thanks to its high-powered connections with Park Tae-joon, who became prime minister of South Korea in January 2000 and lobbied on Carlyle's behalf. But when Park resigned just four months after taking office, amid allegations of corruption, Carlyle had lost its regulatory advantage. It was going to be difficult to get the government to approve the deal without Park Tae-joon's involvement. So the firm then struggled to get the deal, which was to be for a 40 percent stake in the bank, approved by Seoul's Financial Supervisory Commission, the chairman of which Bush had met with a year prior. Carlyle was slipping, losing their political edge because of the unexpected and unseemly departure of Park Tae-joon from politics. They were losing the deal.

But after some months in self-imposed exile, Park Tae-joon, still a popular figure in Korea despite the allegations of corruption against him, came through in the end, rising from the ashes and lobbying the key government officials to allow the deal to happen, according to press accounts of the deal. By the fall of 2000, Carlyle had won, snagging 40.7 percent of the bank for $450 million. Between Bush Sr. and Park Tae-joon, Carlyle had made all the right moves to get their business in Korea humming. After another purchase of a small telecommunications carrier called Mercury Telecommunications, Carlyle had invested close to a billion

dollars into Korea's recovering economy. It was the best financial news Korea had seen in years, and it was largely Carlyle's doing. But the mirth would soon come to an abrupt halt.

A Foreign Policy Flop

When George W. Bush was sworn in to office in January 2001, everything changed suddenly and dramatically. One of the first things that young Bush did as president was call off the missile control talks that the Clinton administration had been conducting with North Korea for years. Bush revealed open hostility toward North Korea, calling it a rogue state that cannot be trusted. It was a stunning reversal of American policy, which heretofore had been to use diplomacy in mitigating North Korea's military aggression toward South Korea. And it was coming from a man that had virtually no experience in foreign affairs. The nation watched in disbelief.

Not surprisingly, the backlash from Bush's brash actions was felt far and wide. North Korea accused the United States of planting a "time bomb" in the midst of their fragile negotiations with South Korea. The South Korean government received Bush's actions as a rebuff to their safety, knowing that North Korea would be more inclined to attack without Washington's involvement. Kim Dae-jung, South Korea's president, was forced to turn to the European Union for help in filling the sudden gap the United States had created in the peace process between North and South Korea. He was also getting lambasted at home for not being on top of the situation in Washington.

Bush had made the South Koreans look bad, and undermined their safety, all with one fell swoop. Analysts speculated that Bush was motivated by his desire to create a national missile defense system, part of his campaign platform. If North Korea had no missiles to defend against, the thinking went, Bush's need for

a missile defense system would evaporate. As absurd as it sounds, peace between North and South Korea, and between North Korea and the United States, did not further his broader agenda in the White House. Regardless of his rationale, he had created an international crisis on just his second month on the job.

This also threatened Carlyle's extensive investments in South Korea, which would plummet in value as instability in the region increased. The threat of war always sends local economies into a tailspin, much like America's economy since September 11. And Carlyle could kiss regulatory approval for future deals goodbye, with South Korean officials feeling slighted by the United States, and particularly George W. Bush. At first it seemed as if this was a rare case in which being associated with the Bushes was not going to work to the benefit of Carlyle. But that would not prove to be the case.

Adding to the disarray George W.'s stance toward North Korea was causing, the unionists at KorAm bank were starting to rebel against their new American owners, accusing Carlyle of being nothing more than a speculative investor that had already broken its promise not to intervene with management. Employee representatives at the company believed that Carlyle intended to restructure the company, probably threatening jobs. And the union was rallying against Carlyle. The situation was dire. Carlyle had just ploughed nearly $1 billion into South Korea, and the man they all thought would be so good for business, George W. Bush, was on the verge of screwing it all up. Something had to be done.

On June 6, Bush reversed course. In a statement, the president announced plans to resume negotiations with North Korea, essentially picking up where the Clinton administration had left off. Among the issues that the new administration would work on with North Korea was improving relations between North and South Korea. The sigh of relief could be heard around the world, and especially from Carlyle's offices on Pennsylvania Avenue

and in downtown Seoul. Just like that, the situation was all better. But what could have created the sudden change of heart?

On June 10, 2001, just a few days after the welcome announcement by President Bush, the *New York Times* reported that the senior Bush had forcefully argued for his son to reopen negotiations with North Korea shortly before President Bush did just that. The article opened:

> In an effort to influence one of his son's most crucial foreign policy decisions, former President George Bush sent to the president through his aides a memo forcefully arguing the need to reopen negotiations with North Korea, according to people who have seen the document.

It was the first time that anyone had tangibly seen the influence of the father on the son. According to the article, Bush Sr. felt that his son was being unduly influenced by the Pentagon, and that he should adopt a more moderate stance toward the Korean peninsula. He also spelled out that the hard-line policy toward North Korea was undermining the government in South Korea, thereby hurting U.S. interests in North Asia.

White House spokesman Ari Fleischer confirmed the report in the *Times,* and told the press that the argument for reopening negotiations came originally from Donald Gregg, former ambassador to South Korea under the first Bush administration. Fleischer said that Gregg had sent a memo to the senior Bush, who then sent the memo to national security advisor Condoleeza Rice, who then passed along "the thoughts in the note" to the president. It was a way of watering down the connection between George W. Bush and his father, even though it has been widely reported that the two speak regularly. Nobody in the White House wanted the press to get the impression that senior Bush was directly influencing the president. That's probably why Fleischer's accounting of the events made so little sense. Why Bush Sr. would have to go through Rice

to relay crucial information on foreign policy to his son, when he talks to him twice a week on the telephone, is anyone's guess.

Bush Sr. went on to do even more damage control, recording reassuring remarks on U.S. policy to be distributed among participants in a crucial meeting between South Korean President Kim Dae-jung and North Korea's leader, Kim Jong-il, on Cheju Island. It seemed the former president was everywhere at once, acting as counsel to his son, ambassador to Korea, and businessman for Carlyle. For a man that had supposedly retired from politics, Bush Sr. was awfully busy.

Bush of Arabia

The folks at Carlyle refuse to talk about how ex-president Bush is compensated for his work on their behalf. Former employees, however, say that he is invested in the funds that he helps raise and place. If that is the case, the senior Bush's involvement in foreign policy regarding South Korea is a clear conflict of interest. He stands to gain financially from decisions that he is urging his son to make. It doesn't get any more egregious than that. But the press missed the connection at the time. Indeed it was a difficult connection to make, given that Bush Sr.'s trips to Korea and his work on behalf of Carlyle was kept very quiet. Then another story hit the front pages. Bush Sr. was at it again.

This time the *New York Times* reported that in July 2001, just months after he had advised his son on North Korea, the elder Bush had placed a call to Crown Prince Abdullah of Saudi Arabia on behalf of his son, to reassure Saudi Arabia's leadership that his son's "heart is in the right place," when it comes to Middle East policy. The call was necessitated by the younger Bush, who had upset the Arabs with his one-sided approach to the Israeli-Palestinian conflict. And Daddy was again there to bail him out.

The report said "former President Bush said that his son's 'heart is in the right place' and that his son was 'going to do the right thing,' a Middle East diplomat said. A senior administration official said that the phone call, warm and familiar in tone, was designed to encourage Abdullah to think of the new president as having a grasp of the Middle East similar to that of his father. According to one of the accounts, President Bush was in the room when his father made the call."

The news was stunning, and it undermined the credibility of George W. Bush on foreign policy. Who was making the decisions in the White House? Why didn't Bush Senior run for president instead? But more than that, the news of Bush Sr.'s continued involvement in foreign policy was undermining the credibility of both Bushes ability to keep politics and family business apart. Like the situation on Korea, Carlyle's extensive business interests in Saudi Arabia and throughout the Middle East, were in grave danger if the younger Bush kept pissing off the royal family. So the Senior Bush needed to step in and preserve the relationship once again. It was testament to the sway ex-president Bush still held over foreign affairs. And it didn't look good.

The reports of Bush Sr.'s actions sent the Washington, DC–based public advocacy groups into a tizzy. Tom Fitton, general counsel of Judicial Watch, a conservative watchdog group in the Beltway, is beside himself to this day. "It screamed conflict of interest," he says. "We asked publicly that the senior Bush should step down. To this day we don't understand why he hasn't resigned. It's causing a scandal."

That Judicial Watch has called on Bush Sr. to resign from Carlyle is more telling than you might think. This is not your average, ultraliberal watchdog organization. Judicial Watch is a public interest group that was conceived during the Clinton administration as a way to monitor activities that diminish the public's trust in government. It is an extremely conservative group, designed originally to bring down a Democratic president that the group

felt was corrupt. "The Clinton administration was the most corrupt in history," says Fitton. "He was a rapist who took money from the Chinese. But he's lowered the bar so far that there is an acceptance of this everyday type of corruption." Other watchdog groups had been howling at Carlyle's antics for years, but when Judicial Watch, which had a reputation as a Republican-friendly group, could no longer look the other way, Carlyle had to take notice. "We're a conservative group, but we're not Republican. The Carlyle Group has been very upset with us, but this is an extraordinary company, very unique," says Fitton. "They hire these people, and I don't think they hire them for their good looks. I'm sure it smarts for them to know that we have raised ethical concerns on the part of the president's father."

Fitton points out that not only has the former president been making investments for Carlyle and weighing in on foreign policy that directly affects those investments, but he is also privy to CIA briefings whenever he sees fit, referred to internally at the CIA as "President's daddy's daily briefing," a right that all ex-presidents maintain. And according to press reports, Bush Sr. still requests and receives CIA briefings often. Despite being 10 years removed from his presidency, Bush Sr. remains an extremely powerful and influential man. Imagine what a global enterprise, that does large amounts of business with arms contractors and foreign governments, could do with weekly CIA briefings. Or a company with the ability to influence foreign governments and global events. A company like that would have access information that would set it apart from any company to come before it. A company like that could be very successful. A company like that might look a lot like Carlyle.

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BIG GUNS

Killing this killing machine won't be easy.
—*Wall Street Journal,* "Heavy Metal," May 5, 2001

Cast of Characters

General Shinseki	U.S. Army chief of staff.
George W. Bush	President of the United States of America.
Donald Rumsfeld	Secretary of defense.
Andrew Krepinevich	Executive director of the Center for Strategic and Budgetary Assessments, opponent of Crusader.
Milo Djukanovic	President of Montenegro.
Colin Powell	Secretary of state.
Frank Finelli	Retired Army colonel.
Frank Carlucci	

The part of Carlyle's business that has naturally attracted controversy over the years is its defense business. It makes sense. War, after all, is inherently controversial. It usually involves heated passions, covert strategy, and death on a large scale. So it's not entirely surprising that ordinary American citizens felt outrage at Carlyle's commingling of ex-politicos, guns, and money. The idealist in all of us wants to believe that war is an awful, but necessary, part of the human condition. We want to think that our nations enter reluctantly into battle, always as a last resort, after all other means of resolving conflict are exhausted. And we never want to believe that war, and the destruction and horror that accompany

it, could ever be seen as a business. But it is true. At least the people profiting from these wars aren't the same elected officials that have led us into battle in the past and still hold sway over current decision makers in the White House and the Pentagon, right? Wrong.

Crusader's Crusade

By 2001, the world outside of Washington, DC, was becoming dimly aware of the Carlyle Group. People would chat about them casually at cocktail parties, noting the intimidating employee roster and joking about shadow governments and X-files episodes. But it was all speculation at that point. No one in the media had put together the apparent conflicts of interests the Bushes had cultivated in Korea and Saudi Arabia. Yet people had a vague and nagging notion that there was something wrong with the way Carlyle was conducting its business. They were just having trouble putting a name to it. Everyone was looking for the proverbial smoking gun. Little did they know that it was literally a smoking gun they would find.

The saga began in the summer of 1997, when Carlyle was raising money like mad, hiring world leaders, and, in general, becoming the dominating global private equity firm it is today. Among the investments Carlyle had targeted for its Carlyle Partners II fund—the one chock full of defense, aerospace, and security companies—was a maker of armored vehicles named United Defense. The owners of United Defense were FMC Corporation and Harsco Corporation—the same company that Carlyle had unsuccessfully and hostilely tried to acquire six years earlier. All Carlyle got for its $63 million back then was one lousy board seat with Harsco. But what a valuable board seat that had suddenly become.

The news around the defense industry August 1997 was that General Dynamics had bid $1 billion for United Defense, far more

than any other bidder. General Dynamics already made armored vehicles, so United Defense's expertise—they made the Bradley fighting vehicles used in the Gulf War—fit perfectly with that of General Dynamics. The deal seemed like a no-brainer: highest bidder, synchronized interests, little overlap. There really was no competition. But at the last minute, Harsco and FMC decided instead to sell to the Carlyle Group, which had submitted a low-ball bid of $850 million, 15 percent less than General Dynamics had been offering. It turns out that rumors had begun to circulate around Washington, DC, that General Dynamics was going to run into antitrust issues. Eventually, the rumors grew so loud that General Dynamics was forced to back out of the bidding, and Carlyle was there to pick up the scraps. It was another stunning victory for Carlyle.

Despite paying a fire-sale price for United Defense, Carlyle was not without its challenges regarding the new acquisition. Since 1994, United Defense had been working on a massive gun: a mobile howitzer that can fire 10 rounds of 100 pound shells per minute, 25 miles in distance, cruise at 29 mph, and reload on the battlefield. The "Crusader" was the most advanced artillery system the U.S. Army had ever conceived. It is the kind of weapon that makes the United Stated unbeatable in large scale, open warfare, lobbing multiple shells at varying trajectories so that they rain down at their desired target at the same time. It is a fearsome weapon. A killing machine. It was also United Defense's future cash cow.

But times had changed considerably since Crusader was first conceived in the early 1990s. In fact, the very nature of war had changed and had left Crusader behind. The gun had two very serious problems: It was too big, and it was designed to fight a type of battle that no longer presented itself to the U.S. armed forces. The gun is so out of date, in fact, that according to a congressionally appointed independent National Defense Panel in 1997, which reviewed all of the military's ongoing weapons projects, the Crusader was a Cold War inspired weapon, rapidly approaching

obsolescence due to a military trend toward swift deployment and agile forces. It was a gun designed to fight large scale, open field battles, the kind the United States had not fought since World War II. Unfortunately, for Carlyle, the damning report came out just a few months after the company had acquired United Defense.

The problem was that at 60 tons each—plus a supply vehicle that weighed an additional 50 tons—the Crusader was impossible to deploy quickly enough to hot spots around the world. It could not be airlifted by any of the massive cargo planes employed by the Army. And shipping Crusader would take too long to reach the ephemeral battles to which the Army had recently grown accustomed. The United States had learned that lesson the hard way, when it took more than a month to ship its Apache helicopters to the action in Kosovo in 1999, a conflict that lasted only 78 days total. The United States wasn't fighting long, drawn out land wars in Europe anymore, and Crusader's effectiveness for the new breed of fighting was being called into question.

"For the foreseeable future, no one is going to stand out in the open and fight the American forces," says Andrew Krepinevich, a member of the 1997 National Defense Panel that panned the Crusader and executive director of the Center for Strategic and Budgetary Assessments. "The U.S. will be fighting in more complex terrain, like mountains and cities, and in those areas there is not a lot of use for heavy artillery of this nature. The big challenges are how do you get there fast and how do you fight people that won't fight you out in the open." The panel recommended the Crusader program be dramatically scaled back, and some, including Krepinevich, wanted it canceled outright.

A cancellation of the Crusader program would have been catastrophic for United Defense. The company had just lost out on a crucial contract with General Dynamics to build tracked fighting vehicles for the army. It was a devastating loss, leaving Crusader as the saving grace for the company. Losing the Crusader

contract, originally valued at $20 billion, would jeopardize the future of the company and would be a mighty hit to Carlyle's premier fund, Carlyle Partners II.

The momentum against the Crusader was building rapidly by the turn of the century, as more defense analysts recognized the importance of mobile armed forces that could be deployed instantly. When General Shinseki took over as U.S. army chief of staff in June 1999, he preached the gospel of a faster, lighter army in which the Crusader played no role. Even George W. Bush, when running for office, questioned the utility of the Crusader. In a campaign speech in 1999, Bush recognized the end of the Cold War as an opportunity to "skip a generation of technology." It was all part of an effort to build an army "not by mass or size, but by mobility and swiftness," according to Bush. The future of the Army was at hand, and almost everyone was on board but United Defense. The Crusader had become the poster child of the old, lumbering Cold War army. *Time* magazine said of the Crusader, "the kind of war it was meant to fight is already obsolete." The *Wall Street Journal* called it a "dinosaur."

By all accounts, the Crusader was headed for the scrap heap. But Carlyle was just getting started. The effort the company put forth to save their precious gun would illustrate exactly how the Iron Triangle of defense, government, and business work together to the benefit of all three. Carlyle had been built to prevail in situations like these, when the large amounts of money were riding on the decisions of a few men in public office. It was time to call in a few favors.

Slimming Down

In the fall of 1999, General Shinseki told United Defense that if they did not reduce Crusader's weight to under 42 tons, light enough to be transported on a C-17 cargo plane, he was going to

kill the program. He gave the company three months. "We were given a bogey," says Doug Coffey, vice president of corporate communications for United Defense. "We were told that we had to be able to put any two of the Crusaders on a C-17, so you could take a complete system anywhere in the world."

United Defense worked furiously through the winter to meet the goal. They redesigned the engine, stripped armor, and reduced ammunition. They worked through the Thanksgiving and Christmas holidays. By 2000, they had made their designated weight: 42 tons on the button.

In the meantime, Carlyle and United Defense were waging a political battle for the Crusader. Shortly before Carlyle bought the company, United Defense organized a political action committee (PAC) through which the company would funnel contributions to key lawmakers. In the cycle leading up to the 1998 elections, United Defense made campaign contributions of only $49,500. But by 2000, under Carlyle's leadership, the company's PAC had spread around more than $180,000 to more than 70 senate and house members. The bulk of the company's largesse went to politicians on the house and senate arms committees. And often, a good deal of money found its way to the house and senate members whose districts were expected to participate in manufacturing the Crusader. It was also uncanny how United Defense planned to build manufacturing facilities for the Crusader in the backyards of key members of the arms committees, creating jobs and wealth that hadn't existed before. These are the kinds of things that get politicians reelected, and get businesses what they want.

Rick Santorum, a Republican senator from Pennsylvania, netted $10,000 from the United Defense PAC in 2000. York, Pennsylvania, is home to a United Defense manufacturing facility. Another manufacturing facility for Crusader was located in Minnesota, home of republican senator Rod Grams, who took another $10,000 from the United Defense PAC. Republican representative J. C. Watts of Oklahoma received $6,000 from the United Defense

PAC. Watts's corner of Oklahoma, which included Fort Sill, was targeted as a factory site for assembly of Crusader. Watts was also a member of the House Armed Services Committee. Carlyle was being thorough and strategic, and they were starting to make up ground. Reports of Crusader's death had in fact been greatly exaggerated.

When reporters question Carlyle representatives about the potential for people like Frank Carlucci to lobby his good friends in the Pentagon and the White House, they receive admonishments and are made to feel unpatriotic for even suggesting the thought. One *Los Angeles Times* reporter was excoriated by a Carlyle spokesperson, "I assure you [Carlucci] doesn't lobby. That's the last thing he'd do. You'd have to know Carlucci to know he'd never do that, and you'd have to know Rumsfeld to know it wouldn't matter." The company often aggressively defends itself from accusations that it lobbies or has any undue influence over key decision makers. But concentrating on whether Carlyle "lobbies" or not is a red herring argument, designed to lead reporters on a wild goose chase for the elusive definition of lobbying. Besides, according to official records, Carlyle does in fact lobby.

According to the Center for Responsive Politics, the Carlyle Group spent more than $1,200,000 in 2000 hiring lobbying firms to wage battle on Capitol Hill on behalf of United Defense. What Carlyle representatives are really saying when they assure the public they do not lobby is that their high-profile hires like Carlucci, Bush, and Baker don't personally register as lobbyists and work to drum up support for various programs. That, of course, is true. But to say that the Carlyle Group doesn't lobby is simply not true. Rubenstein, a former lawyer, has been playing a cat-and-mouse game of semantics with the press for years. Does the Carlyle Group register as lobbyists? No. Do they hire lobbying firms to do it for them? Yes. Do they influence key lawmakers and help shape policy? Of course they do. People like Carlucci

don't need to lobby, in the traditional sense of the word. They already know the lawmakers involved in key decisions, and the lawmakers know them. There are memorandums and meetings. There are unspoken understandings that are reached over a drink and a wink. "It's impossible to say when people working for Carlyle are wearing more than one hat," Peter Eisner, managing director at the Center for Public Integrity, told me. It would be ludicrous to imagine George Bush Sr. fighting it out in the trenches with all the other registered lobbyists. But does George Bush Sr. have a say in policy decisions made by this White House? That much has already been proven.

Regardless of your definition of lobbying, in the case of the Crusader, Carlucci and his team did lobby, and they lobbied hard. According to the *Wall Street Journal,* Carlucci called Defense Undersecretary Jacques Gansler multiple times to have the program spared. The *Wall Street Journal* also reported that Carlucci called defense think tanks and pleaded with them not to write anything negative about Crusader. Carlyle hired recently retired senator Dan Coats and his former staffer, a retired army colonel named Frank Finelli, to start stumping for Crusader. In an interview, Greg McCarthy, a spokesperson for now retired representative Watts, said this of Carlyle and Finelli: "Carlyle's strength was within the DOD. As a rule someone like Frank Carlucci is going to be able to have access, and members of congress are going to have an open door to Frank. Without question, they have influence. But the fact that this is all known mitigates that influence to some extent. They are not able to hide. But they have other, less visible people. They have these staff types that are behind the scenes; they work in the dark. Guys like Frank Finelli who know everything about the army and about Capitol Hill."

One of the lobbyists who Carlyle hired to work congressmen on Crusader had this to say of Carlyle: "I felt that in this effort, they were like any other lobbying group, aside from the fact that they are not one. They have been able to reach into Congress,

and there was a lot of contact with the Pentagon. They definitely influenced the decision-making process."

Lobbying laws in the United States are vague and ill defined. Lobbyists are required to register with the federal government and disclose their clients and the payment amounts publicly. But what exactly constitutes lobbying is much less clear. The formal definitions of lobby are: (1) to conduct activities aimed at influencing public officials and especially members of a legislative body on legislation; and (2) to attempt to influence or sway (as a public official) toward a desired action. By those definitions, contributing funds to various lawmakers, calling the defense undersecretary to plead for the Crusader, and hiring $1,200,000 of lobbying groups on United Defense's behalf would indeed be considered lobbying. It's hard to see what Carlyle did in this case as anything but lobbying.

What they did was save their precious gun. Between the slimming down of the gun, the massive lobbying effort, and the scaling back of the original order from 1,200 to 480, the Crusader survived. When Bush's proposed defense budget for 2002 was finally handed down in June 2001, it included funding for Crusader. It was nothing short of a Hail Mary pass with no time left on the clock for Carlyle. And within two months of the decision by Bush, the Carlyle took its first dividends from United Defense, a windfall of $289 million. The Crusader was saved for the time being, but opponents continued to fight to have the program cancelled. The raging debate would not be ultimately settled until long after September 11, 2001.

Documenting Carlyle's Access

The actions of the Carlyle Group in the fight to save the Crusader drew an enormous amount of unwanted attention to the firm. Though the company defended itself from claims of undue

influence, public advocacy groups were sure Carlyle had unmitigated and unethical access to the highest ranks of government. The problem was, proving those kinds of things was nearly impossible. Interested parties would have to tail Frank Carlucci for months, and even then, all you would learn was whom he met with and when, not what was said. It just wasn't the kind of thing a reporter could spend time on. But then there was a break.

Judicial Watch, the public interest law firm that investigates government corruption and repeatedly called for the resignation of Bush Sr. from the Carlyle Group, has been using legitimate and legal means to prove to the American public that the Carlyle Group has the ability to access and influence key decision makers in the current administration. By utilizing the Freedom of Information Act, a law that gives the right for all citizens to request and receive information from the federal government, Judicial Watch has been able to obtain a smattering of documents from the Department of State and the Department of Defense that illustrate the sway Carlyle holds. Many of Judicial Watch's requests were ignored or delayed indefinitely, heightening their suspicions of foul play and forcing them to file a lawsuit against the state and legal departments to obtain the requested documents. Finally, they saw a few documents coming their way. But only a few.

Judicial Watch grew increasingly frustrated as they were consistently stonewalled in their requests. But even the limited documents that the state and defense departments did release show the power, reach, and influence of Carlyle. The first documents Judicial Watch received are correspondences between Carlucci and William Perry, another former secretary of defense, and Carlucci's good friend Donald Rumsfeld, the current secretary of defense. In the letter to Rumsfeld from Carlucci and Perry, which is on Carlyle letterhead, the two former secretaries of defense urge Rumsfeld to heed the findings in a report the BENS Tail-to-Tooth Commission wrote on reducing infrastructure

spending in the Pentagon. Both Carlucci and Perry served on the BENS Commission: The BENS Commission stands for the Business Executives for National Security, and the suggestion, as the letter shows, is to "cut the cost of defense infrastructure and re-invest in modernization and other priority programs."

> Dear Don,
>
> Thanks for lunch last Friday. It was great seeing you in such good spirits even if you are "all alone."
>
> We thought it useful to follow up on our discussions on the need for reductions in the infrastructure of the Department—and how that might best be done. Over the past three years, the two of us have served as senior advisors to the BENS Tail-to-Tooth Commission. We believe the Commission has addressed the most critical areas that must be tackled if we are to cut the cost of defense infrastructure and re-invest the savings in modernization and other priority programs.
>
> Because the "what to do" is so well known, the beauty of the Commission's report is not in the issues it identifies—rather, it is the focus on implementation, the "how to do it," that sets it apart.
>
> We have taken the liberty of enclosing copies of this package and would be happy to discuss it with you or your staff. Or, perhaps more helpful, we would be pleased to introduce to you, or to whomever you might designate, the Commissioners who put this effort together.
>
> Best Regards,
>
> Sincerely,
> Frank C. Carlucci
> William J. Perry

In Rumsfeld's response, the secretary is clearly amenable to Carlucci's suggestions. He even invites the two of them to come in and address the staff within the Pentagon.

> Dear Frank and Bill,
>
> My apologies for the delay in getting back to you on your letter of February 15.
>
> There is no question but that we are going to have to tackle the infrastructure issue. I've been impressed with the BENS Tail-to-Tooth report, and congratulate you folks for good work. What I may do is ask the two of you to come in and meet with some of the key staff folks who are working on those types of things here in the department.
>
> I will be back in touch with you. With my appreciation and best wishes.
>
> Sincerely,
>
> Donald Rumsfeld

The BENS Commission report showed that too much money was being spent on support, overhead, staff, and the like, while not enough was being spent on supporting combat forces. In other words, Carlucci was encouraging Rumsfeld to spend less on infrastructure, more on weapons and the like—the precise business in which Carlyle is so heavily invested. The mere fact that Carlucci could have such unimpeded access to such an important decision is disturbing enough, but the nature of their correspondence is wholly inappropriate, given the obvious financial benefit of Carlucci should Rumsfeld follow his advice. And sure enough, by July 2001, Rumsfeld's defense budget was incorporating the BENS Commission's suggestions. "BENS has long advocated cutting overhead," beamed BENS CEO General Richard D. Hearney in the *Aerospace Daily*. "We are pleased to see that Secretary Rumsfeld is taking this approach in transforming the Pentagon."

The second document that Judicial Watch obtained was a long, in-depth letter from Carlucci to brand new Secretary of State Colin Powell, sent on February 23, 2001. In it, the chairman of

the Carlyle Group, again on Carlyle letterhead, lays out an extensive argument for the United States to support Montenegro's desire for independence from Yugoslavia. Montenegro is among the more outspoken republics in the formerly war-torn region of Yugoslavia.

After allying with the United States in isolating, and eventually removing Slobodan Milosevic, Montenegrin President Milo Djukanovic was now pressing his case for Montenegrin independence in the Balkans. The move was widely opposed by the international community, including the United States, because of fears that the move toward independence would again destabilize the region, which had been at war for years and had finally reached some semblance of peace. Djukanovic came to the United States to press his case in early February 2001 and was rebuffed by Secretary Powell in his request for a meeting. The Bush administration had taken a stand against Montenegrin independence, fearing it would in fact plunge the entire region back into war. Djukanovic did manage to meet, however, with Frank Carlucci of the Carlyle Group. And the following is Carlucci's plea to Colin Powell on Montenegrin independence:

> Dear Colin,
>
> We congratulate you on your great start as Secretary of State. We recognize that there is no shortage of serious issues seeking your attention, but one of the earliest will certainly be Montenegro's relationship to Serbia.
>
> As you know, Montenegro is the last of the five original non-Serbian republics to press its claim for independence. President Djukanovic was in Washington recently, and I hosted a long and spirited talk for several of us with Djukanovic to discuss his thinking. . . .
>
> Djukanovic struck us as determined to proceed to independence. . . . Djukanovic stressed that he planned to achieve independence democratically and nonviolently without destabilizing

> the region. . . . He said he understood that the real issue behind the coolness of Washington and the Europeans toward Montenegrin independence was not Montenegro itself but the impact of independence on Kosovo. . . .
>
> At the conclusion of the meeting, he asked that the U.S. return to the position that, while you prefer Montenegro to remain part of the FRY, if the process to independence is open and democratic, the United States would accept it. On behalf of Mort Abramowitz, Max Kampelman, Jeane Kirkpatrick, Richard Perle, Steve Solarz, and Hal Sonnenfeldt, we believe this position makes good policy sense and would be prepared to discuss it with you.
>
> Best wishes,
>
> Frank C. Carlucci
> Chairman

Why Frank Carlucci, the chairman of a private equity firm, would be meeting with leaders of war-riddled nations is anyone's guess. It is easy to see how anyone would be confused as to what role he has in Montenegro's independence. Is he acting on behalf of the United States? Or as a Carlyle executive, since the letter is on Carlyle letterhead and signed "Chairman." But it is even more baffling why he felt it necessary to directly lobby the state department for support of Montenegro's independence in the first place. Perhaps his thinking was that the more instability in the Balkans, the more need for war and the more weapons that are sold. All of which benefits defense contractors, like Carlyle. Although unsubstantiated, that could be the intent behind Carlucci's overtures to Powell. Regardless, Powell's administrators had the good sense to recommend against the inappropriate meeting, recognizing that Carlucci would likely have more to talk about with Powell than just Montenegro. In this memo, Powell's assistant offers the secretary two potential replies to Carlucci. Powell's stamp and initials indicate his declining of the meeting.

To: The Secretary

From: EUR—James F. Dobbins

Subject: Response to letter from Frank Carlucci

Issue for Decision

- Whether to sign attached response to Frank Carlucci, who has written you regarding the Administration's policy toward Montenegro.

Mr. Carlucci wrote to you on February 23 regarding the Administration's policy toward the government of Montenegro, asking that you take a more forthcoming position on the issue of independence. . . .

While there is no harm in such a meeting, I am not sure that it would be worth your time. The discussion at such a meeting would likely go beyond Montenegro. . . .

The few documents that Judicial Watch was able to recover show the extraordinary reach of Carlyle Group into the Bush administration. In addition to making these documents public on their Web site, www.judicialwatch.org, the organization has repeatedly called for the resignation of George Bush Sr. from Carlyle, at least while his son is president. Judicial Watch chairman and general counsel had this to say in the group's May 4, 2001, press release:

> This is simply inappropriate. Former President Bush should immediately resign from the Carlyle Group because it is an obvious conflict of interest. Any foreign government or foreign investor trying to curry favor with the current Bush administration is sure to throw business to the Carlyle Group. And with the former President Bush promoting the firm's investments abroad, foreign nationals could understandably confuse the Carlyle Group's interests with the interests of the United States government.

He goes on to say, very presciently, "questions are now bound to be raised if the recent Bush administration change in policy toward Iraq has the fingerprints of the Carlyle Group, which is trying to gain investments from other Arab countries who would presumably benefit from the new policy." This press release was issued in May 2001, before the terror attacks on the World Trade Center and the Pentagon, and before President Bush began incessantly banging the war drum on Iraq.

By the summer of 2001, the public outcry against the Carlyle Group had seemed to reach a fever pitch. The *New York Times,* the *Washington Post,* the *Wall Street Journal,* and the *Los Angeles Times* had all written grim and damning accounts of the company's business dealings within the Iron Triangle, particularly around the Crusader. Photographs and news accounts of Bush Sr. visiting the Saudi royal family had graced the cover of the *New York Times,* outraging those who believed Saudi Arabia to be more of an enemy than an ally. These were all stunning realizations for the American public. But nothing would compare to what was to come, on the day the world was changed forever: September 11, 2001.

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9/11/01

No one wants to be a beneficiary of September 11.

—Carlyle partner Bill Conway, *The Nation,*
"Crony Capitalism Goes Global," April 1, 2002

Cast of Characters

Shafiq bin Laden	Estranged half-brother of Osama bin Laden, family representative to Carlyle investments.
Basil Al Rahim	Former Carlyle employee, Middle East fund-raiser.
Cynthia McKinney	Former Democratic representative from Georgia.
Chris Ullman	Carlyle spokesperson.
Richard Conte	Vice president and treasurer of IT Group, a Carlyle company.
Paul Wolfowitz	Deputy secretary of defense.
Donald Rumsfeld	

September 11 changed everyone's life. It's that simple. The impact is still being felt around the world as economies buckle, war looms, and uncertainty accompanies every step we take. Few can look back at the events of that day and conclude that anything good came of the attacks. But the grim reality is that for some, the September 11 attacks were not all bad. In fact, some businesses stood to make a lot of money from what went on that fateful day. Vendors on New York City streets could not stock the shelves with Fire Department hats and t-shirts fast enough.

Tourism in lower Manhattan boomed during the cleanup as hordes of onlookers crowded the streets, hoping to get a peek at the gaping hole the attacks had left.

For most New Yorkers, the willingness to profit from the tragedy was shameful and embarrassing. But it was mere pennies compared to the millions that Carlyle would go on to make after the attacks.

An Extraordinary Day

The skies over Manhattan that morning were astonishingly blue. It was one of those rare days of late summer, not a single cloud in the sky, temperatures so mild and inviting, you almost didn't mind getting up and going to work. It was an election day in New York, but there was no discernible difference in the way the city went about its business, aside from the buzz on the local news stations. Trucks honked industrial-strength horns, echoing down canyons of steel and glass. Cabbies swerved and jerked their bright yellow Fords from stoplight to stoplight on rush hour streets. Businessmen sidestepped delivery men on frenetic sidewalks, everyone hustling, with somewhere important to be. And the sky, unambiguously blue, looked down silently at the city below.

At 8:43 A.M., American Airlines Flight 11 from Boston tore through the daily cacophony of New York, ripping a path down midtown Manhattan, roaring toward the north tower of the World Trade Center. Many in midtown would shrug off the incident, wondering why a jumbo jet was flying so low, and maybe speculating with a friend, but never suspecting the ultimate destination. It wasn't until the thick, dark stripe of smoke from the explosion billowed and writhed against the clear blue sky on the southern horizon, that most New Yorkers knew something was terribly wrong. In Manhattan, the avenues cut from north to south, in dead straight lines. People began gathering on street corners

to peer down the long avenues and get a look at the smoke. Coworkers crowded around company television sets, watching with confusion and fear, as the single tower smoked and burned.

Less than 20 minutes later, as the city, thirsty for information, devoured live television news reports, United Airlines Flight 175, banking hard from the west, disappeared into the south tower of the World Trade Center amidst a ring of fire and smoke. Newscasters were initially baffled, as if their networks had suddenly come across footage of the first plane hitting the tower. Suddenly the dreadful logic of what was unfolding quickly took hold, and the grim reality dawned on the city's collective conscience at once, with inescapable reality: It was a second plane, and we were under attack.

The fear that descended on the city was immediately palpable. Without speaking, everyone not directly involved in the horrifying events taking place at the Trade Center asked themselves the same questions: How long will this go on for? Is my building safe? Who do I know in the Twin Towers? Will God ever forgive us for this?

The city was instantaneously shut down. Bridges and tunnels were sealed off. Subways stopped running. Airplanes were redirected and landed at alternate airports. Then, at 9:43 A.M., American Airlines Flight 77 crashed into the Pentagon, leaving little doubt that the attacks were ongoing.

A Chance Meeting

That same morning, in the plush setting of the Ritz-Carlton hotel in Washington, DC, the Carlyle Group was holding its annual international investor conference. Frank Carlucci, James Baker III, David Rubenstein, William Conway, and Dan D'Aniello were together, along with a host of former world leaders, former defense experts, wealthy Arabs from the Middle East, and major international investors as the terror played out on television. There with

them, looking after the investments of his family was Shafiq bin Laden, Osama bin Laden's estranged half-brother. George Bush Sr. was also at the conference, but Carlyle's spokesperson says the former president left before the terror attacks, and was on an airplane over the Midwest when flights across the country were grounded on the morning of September 11. In any circumstance, a confluence of such politically complex and globally connected people would have been curious, even newsworthy. But in the context of the terrorist attacks being waged against the United States by a group of Saudi nationals led by Osama bin Laden, the group assembled at the Ritz-Carlton that day was a disconcerting and freakish coincidence.

At 10:05 A.M., the world stifled a collective cry as the south tower of the World Trade Center, once the mightiest building on earth, seemingly evaporated behind a shroud of dust and smoke. For all the confusion and cloudiness, it was impossible to tell what had happened from television. But for those on the ground, the unthinkable was the only explanation: the tower had collapsed. Twenty minutes later, the north tower met the same fate as its twin, pounding mercilessly into the streets of downtown Manhattan, leaving thousands dead and hundreds more fleeing for their lives.

By noon, New Yorkers were paralyzed in fear, uncertain whether the attacks had ended and unclear as to the safest place to be. By mid-afternoon, all traffic on the island of Manhattan had ceased. Citizens wandered the streets, dialing and redialing their cell phones to contact loved ones, vaguely moving in the direction of their homes. Survivors walked aimlessly northward from what would come to be known as Ground Zero, caked in soot and dust, battered and bleeding, clutching strangers and sobbing. Throngs of shell-shocked Brooklynites marched silently across the Brooklyn Bridge, eager to get home and assure their families of their safety.

In Washington, a state of emergency was declared by 1:30 P.M. The Pentagon ordered five warships and two aircraft carriers to

various locations throughout the East Coast. The ships were saddled with guided missiles capable of shooting down any aircraft perceived to be a further threat. President Bush had been whisked from Florida to Louisiana to Nebraska. Colin Powell was on his way back from Latin America. Donald Rumsfeld was in the Pentagon. By 4:30 P.M., the president was on his way back to Washington, and the first reports of Osama bin Laden's involvement in the attacks has already been aired. Newspapers would later report that the bin Laden family members that were in the United States at the time, of which there were many, were quickly moved to safe locations awaiting their expedited travel arrangements back home to Saudi Arabia.

During sunset, buildings burned and lurched, cleaved and collapsed, and filled the sky with smoke and dust. Brooklyn, a mile southeast of Manhattan, lay covered in noxious dust, singed documents, Daytimer pages. The stench of burning plastic permeated every crevice of New York, a stinging reminder of the already unforgettable events of the day.

At 8:30 P.M., the president, now back at the White House, addressed the nation on television. He spoke of the "thousands of lives suddenly ended by evil." He boldly claimed that "these acts shattered steel, but they cannot dent the steel of American resolve." And he cast the net of America's vengeance far and wide in making no distinction between the terrorists who committed the acts, and those who harbor them.

It is impossible to say whether during the darkest day in America's history, it dawned on the partners at the Carlyle Group that what was to come, as a direct result of this attack, would serve their financial interests. Perhaps it was that very day, in the midst of the chaos and grief that had gripped the nation. It might have been after they had ascertained the whereabouts of their many friends at the Pentagon, and the future started to become clear. Or maybe it was the next day, when President Bush characterized the attacks in no uncertain terms

as "acts of war." Regardless, there was little doubt by the third day after the attacks that Carlyle was in for some heady times. Congress overwhelmingly approved $40 billion in emergency funds, about half of which was earmarked for the armed services. Also in the works was a massive increase in the Pentagon budget, $33 billion, in time for the Department of Defense's 2002 fiscal year, beginning October 1, 2001.

Cashing in on Tragedy

The partners of Carlyle—Rubenstein, Carlucci, Conway, and D'Aniello—stood to gain the most of anyone in the company, possibly in the country. Those four would have to shake off the devastation of September 11, and look forward to their big payday. It is not an exaggeration to say that September 11 was going to make all of them very, very rich men. This is the reality of the business they chose. And in the defense industry, war time is boom time.

"Capitol Hill is prepared to do whatever the Pentagon wants," said Gordon Adams, a budget official in the Clinton administration, in a *New York Times* piece a week after the attacks. Indeed Capitol Hill provided enough money to the Pentagon to make the budget woes and tough decisions of the past year suddenly irrelevant. Among the weapons programs that had been given new life was, of course, the unkillable gun: the Crusader.

The money was pouring in now and there was no longer any reason to deny the army its precious gun. After the attacks, opponents to the gun were silenced, not wanting to assume the political liabilities of killing a weapons program in the midst of war. On September 26, just two weeks after that attacks, the army signed a $665 million contract with United Defense for the next phase of the Crudader's development. The money would carry the gun maker through 2003. But the first prototype for Crusader

was not due to be delivered until 2004, and production of the units would not come for years after. It was highly unlikely the war in Afghanistan would still be ongoing by that time. And nothing had changed the original argument against the gun: it was still too heavy, even at 42 tons, and the need for this type of open battlefield weapon was waning, as the fighting in the caves and tunnels of Afghanistan was demonstrating. But none of that was important anymore. There was enough money to go around for everyone. "A rising tide does lift all boats," said John Williams of the National Defense Industrial Association, in a *New York Times* article.

The defense landscape had changed so dramatically, and so thoroughly, after September 11 that Carlyle quickly and wisely decided it was time to take United Defense public weeks after the attacks on the America. On October 22, 2001, the company filed an S-1 registration with the Securities and Exchange Commission, planning an initial public offering before the end of the year. In the filing, United Defense listed the following as its reasons for selling shares to the public:

1. The U.S. defense budget submission for fiscal 2002 reflects an 11 percent increase over fiscal 2001.
2. Defense procurement and development accounts are growing proportionately with overall national security spending and are expected to continue growing in the near future.
3. The Bush administration's recently published Quadrennial Defense Review calls for retaining the current force structure and increasing investment in next-generation technologies and capabilities to enable U.S. military forces to more effectively counter emerging threats.
4. The terrorist attacks of September 11, 2001, have generated strong congressional support for increased defense spending.

William Conway would later go on the record as saying "No one wants to be a beneficiary of September 11," in a report in *The Nation* entitled "Crony Capitalism Goes Global." Nevertheless, Carlyle took United Defense public on December 14, the day after Congress passed the defense authorization bill allowing for full funding of Crusader program going forward. On that single day, Carlyle took profits of $237 million. On paper, the company had made three times that amount. All the time spent lobbying government officials, calling on old friends, and greasing the palms of congressmen had finally paid off. Crusader was alive and well.

Bin Laden's Business

In the mean time, Carlyle was dealing with yet another public relations crisis, and this one dwarfed all that came before it. Carlyle had been doing business with dozens of families and businesses throughout the Middle East since the early 1990s. And they had been extremely successful in the region. So successful that they had garnered a reputation for having a tremendous amount of influence over the deal flow in the area. After all, the company had been running the Saudi Economic Offset Program for years, a government funded program designed to encourage foreign investment into Saudi Arabia, under the condition that a portion of the profits be reinvested in Saudi Arabia. In a sense, Carlyle had become the gatekeeper to foreign investing in Saudi Arabia.

Not many people knew any of this at the time of the September 11 attacks. But by the end of September, the general public would know far more about Carlyle's business than anyone at Carlyle was comfortable with. In the weeks following the attacks, the name Osama bin Laden leaped onto the forefront of America's consciousness as public enemy number one. Storefronts

hung pictures of his likeness, cut out of newspapers, with headlines of "Wanted: Dead or Alive." Not since the Red Scare of the 1950s had the United States had a more tangible opposition. It seemed that the entire nation was united in its hatred of one man. Then, on September 27, the *Wall Street Journal* ran a story entitled "Bin Laden Family Is Tied to U.S. Group." That group, of course, was Carlyle.

Carlyle had a relationship with the bin Ladens that began in the early 1990s, when they tried to put together a deal for the Italian Petroleum (IP) company. At the time, Basil Al Rahim, a young Carlyle associate, was traveling from Saudi Arabia to Amman to Bahrain, to United Arab Emirates, drumming up support for Carlyle's forthcoming international funds. "I met with 101 different potential clients in 16 days," recalls Al Rahim. "No one had really ever heard of us." Since that time, Carlyle's business in the Middle East blossomed. One of the clients that Al Rahim helped secure was the bin Laden family, which owned a $5 billion construction business by the name of Saudi Binladin Group.

The bin Laden family consists of more than 50 brothers and sisters, all the progeny of Mohammed bin Laden. Osama had his Saudi citizenship revoked in 1991, and was reportedly cut off from his family. Since his father's passing, Bakr bin Laden became the head of the business and the family, and as such he committed money to Carlyle on several occasions. It was a fruitful relationship for both parties involved. But now, all of that had changed.

The article in the *Wall Street Journal* pointed out the most stunning and atrocious irony of Carlyle's history: through Carlyle, the bin Laden family was in a position to make millions from the war being waged against their own brother. The news that George Bush Sr., James Baker III, and Frank Carlucci had visited the bin Ladens in recent years also stunned the American public. It was, in fact, the Carlyle Partners II fund in which the bin Laden family

was invested. The same fund that held United Defense, as well as a host of other defense holdings.

Carlyle told the press that the bin Ladens were only in for $2 million, a relatively small amount of money considering the whole fund was worth $1.3 billion. But one bin Laden family financial representative says the number was much larger. And Al Rahim says that earlier in his time with Carlyle, which ended in 1997, the bin Laden family had several times that amount invested in the company. Regardless of the actual amount, the irony ultimately proved too much for Carlyle, and by the end of October, they severed ties to the family, liquidating their holdings.

A month had elapsed between when the news of Carlyle's bin Laden connection emerged and the company divested their millions. During that time, every major news outlet had picked up the story. Carlyle was sustaining significant collateral damage and was ill-equipped to handle it. Up to this point, Rubenstein had always acted as the company's spokesperson to the press. But this was too much. Calls were pouring in from around the world. Everyone wanted to know about the company that connected the Bush's and the bin Ladens. It was a disaster.

A Congresswoman's Accusations

The company hired a public relations specialist for the first time in its history, but he was overmatched. The press was digging faster and deeper than ever before, dredging up all of the old controversies and conflicts of interest. From sources of varying credibility came claims the now all too familiar charges of cronyism, influence peddling, and dirty dealing in the Middle East. It was all the same accusations the press had levied before, just in greater volume than ever. But it wasn't until an actual elected official called out Carlyle by name that the company started fighting back.

In a March 2002 interview with a Berkeley, California, radio station, Representative Cynthia McKinney, a Democrat from Georgia, spoke publicly what was already making so many Americans uneasy: "Persons close to this administration are poised to make huge profits off America's new war." She went on to say, "An administration of questionable legitimacy has been given unprecedented power . . . We know there were numerous warnings of the events to come on September 11 . . . What did this administration know and when did it know it . . . Who else knew, and why did they not warn the innocent people of New York who were needlessly murdered . . . What do they have to hide?"

In the address, McKinney named the Carlyle Group as an example of the cronyism she was talking about. McKinney was implying that the Bush administration knew the attacks were coming, allowed them to happen, and was now reaping the profits, both financial and political, through its connections to the Carlyle Group. The comments resonated with a growing group of cynics on the Internet and spread like wildfire across the Web. For weeks there had been reports of an intelligence breakdown and foreknowledge of the attacks in the major news outlets. McKinney was simply giving a voice to what many already suspected. And she was absolutely lambasted for it.

Carlyle spokesman Chris Ullman, in easily his most entertaining, not to mention effective, public statement in his six months on the job asked the press if McKinney had "said these things while standing on a grassy knoll in Roswell, New Mexico?" And the public lashing was on. Representative Johnny Isakson, a Republican from Georgia, said McKinney has "demonstrated in Washington a total lack of responsibility in her statements." Senator Zell Miller from Georgia called her "very dangerous and irresponsible." Kathleen Parker, a nationally syndicated columnist, called McKinney's statements "idiotic" and bordering on treason. Parker suggested the advent of a new award, the McKinney Award, "for people too stupid to serve in public office."

Parker also pointed out that it was McKinney that publicly admonished New York Mayor Rudolph Giuliani for declining Prince Alwaleed's offer of $10 million in aid after the September 11 attacks. McKinney offered to find appropriate charities for the Prince's money if he still wanted to donate it. He didn't.

McKinney would eventually back off a little from her comments, issuing a statement saying "I am not aware of any evidence showing that President Bush or members of his administration have personally profited from the attacks of 9/11. A complete investigation might reveal that to be the case." In the end, McKinney received vindication when it became clear that a complete investigation would indeed be necessary, as enough information had emerged that indicated Bush's prior knowledge of the attacks. But McKinney's over-the-top comments probably did more damage than good in the drive to address the truly important issues surrounding the Carlyle Group. Charles Lewis, executive director of the Center for Public Integrity, said the comments undermined the important work the center has been trying to complete in regards to Carlyle by making a "caricature of the issues that may make it easily dismissible."

McKinney was certainly an easy target to discredit. And by August her previously loyal constituents voted her out of office. But at least part of what she said in that interview was dead on: Persons close to the Bush administration were in fact in a position to gain financially from the September 11 attacks, as the United Defense IPO had already demonstrated. But there were other ways the company was getting rich off the events of that day as well. Lots of ways. And September 11 was turning into an outright bonanza for the boys at Carlyle.

Beyond Big Guns

Most of the American public first heard of anthrax a week after the attacks on the World Trade Center, when a granular substance

was found in letters sent to NBC news in New York and the *New York Post* offices. But the deadly virus soon found a permanent place in the American terrorist lexicon when every day brought new cases of infection. First it was an editorial assistant at the *Post* who noticed a blister on her finger: cutaneous anthrax. Then an assistant to NBC anchor Tom Brokaw found a lesion. Then a photo editor at *The Sun* in Boca Raton. Mail sorting facilities were shut down. News media outlets were on edge, and stopped opening their mail. In many ways, the anthrax scare had Americans more on edge than the September 11 attacks. It seemed more insidious, like we were seeing the beginnings of what could ultimately be a far more deadly act of terror.

And the terror spread rapidly, from mail processing facilities in Trenton, New Jersey, to the Hart Senate Office building in Washington, DC. The country was ill-equipped to handle this kind of an attack, psychologically or logistically. Building after building was shut down, crippling postal service and severely inhibiting the Beltway's political machine. The government gave mixed messages on a daily basis, encouraging citizens not to panic, while at the same time warning of the lethality of anthrax. It was a confusing, fearful time for the whole country. But once again, Carlyle had the uncanny ability to be at the right place at the right time, and profit from the situation.

Carlyle owned 25 percent of a Pittsburgh, Pennsylvania–based company called IT Group, an environmental and hazardous waste cleanup specialist. At the time of the anthrax attacks, IT Group was in bad shape, suffering under the weight of nearly $700 million worth of debt, and on the verge of declaring bankruptcy.

In the wake of the anthrax attacks, IT Group scored a number of cleanup contracts with anthrax-infected buildings. Among the new work coming their way was the contract for the Hart Senate Office Building and the Trenton postal facility. The company had 400 workers on site at various locations working 24 hours a day, 7 days a week to clean up anthrax spores. It was snapping up contracts with government agencies left and right, like the General

Services Administration, the Army Corp of Engineers, the Center for Disease Control and Prevention, and the U.S. Navy. Richard Conte, vice president and treasurer of IT Group would tell reporters that the anthrax work "is very good for our bottom line." For a moment, it looked as if IT Group was going to miraculously save itself from bankruptcy and emerge one of the few winners in the war on terrorism.

But the anthrax scare turned out to be much more limited an attack than was originally feared. In the end, IT Group still declared bankruptcy and was bought out by the Shaw Group for $105 million plus close to $95 million in assumed debt, a price that presumably would have been much lower had anthrax never burst on the scene and given IT Group some last minute business. Carlyle had saved at least some of its bacon.

Then rumors spread around the Internet that Carlyle was also invested in a company called Bioport, which held the only government contract on an experimental and highly controversial anthrax vaccine. The company has retired Admiral William Crowe, a man who was chairman of the Joint Chiefs of Staff while Carlucci was secretary of defense. The two know each other well, but Carlyle's involvement with the company is unknown. Both companies are private, and as such have no obligation to disclose investments to the public. Carlyle Group spokesperson Chris Ullman asserts that Carlyle has nothing to do with Bioport.

There were other ways that Carlyle was capitalizing on both the airplane attacks and the anthrax letters: security. Deep in the belly of a mountain in Boyers, Pennsylvania, exists an underground facility carved into rock that holds one of Carlyle's most important investments, U.S. Investigations Services. USIS, as it is known, is a classic example of privatization, and a classic Carlyle investment. Once known as the U.S. Civil Service Commission, then the U.S. Office of Personnel Management (OPM), and finally the Office of Federal Investigations (OFI), the organization was a staple of the U.S. government's ability to gather

information on any individual applying for a job with the government. Its charter, as it had been from the beginning, was to investigate the backgrounds of government employees, and provide them with varying levels of national security clearance. USIS's cave-like work environment is something that only James Bond could love. Rock walls, tight security, no open-toed shoes, and no open flames—employees have steamed lunches brought into the facility every day. The former mine is also home to the personnel files of thousands of government officials. It is top secret stuff.

The company's history, like most of the companies in Carlyle Partners II, is highly controversial. Since going private in 1996, USIS has been incredibly successful. But getting private wasn't so easy. Employees of the government-run Office of Federal Investigations fought the privatization the whole way, fearing layoffs and salary cuts. They hired lawyers, testified at congressional hearings, and protested the decision to take it private, which was made by the Clinton administration. To quiet them down, the government offered the investigators an employee stock ownership plan (ESOP) and promised them the same or better salaries in the newly formed private enterprise. After years of acrimonious battles, the Office of Federal Investigations became USIS in July 1996. Employees retired from OFI and started work the next day at USIS.

As life under the ESOP went on, some employees felt they had been duped. One former USIS employee says that USIS executives harassed older investigators, encouraging them to leave the company so they could hire younger employees, who wouldn't vest in the stock plan for five years. That left more of the equity pie to the high-level executives, should the company ever go public or sell itself. Before USIS had gone private though, the only investigators allowed to work on national security investigations had to have five years experience. That meant that the company would have to rely on less experienced

investigators for some of the most important jobs in the country. Many of the older investigators then left in disgust. The result was a watering down of the talent at USIS, and many blamed Carlyle for the changes.

The company was growing profits and acquiring smaller firms by the turn of the century. But nothing would compare to the explosion of business after September 11. "Since 9/11, USIS's acquisition of contracts has exploded," said one employee that declined to be identified. "All the new FAA, Department of Transportation, Transportation Security Administration, INS, Customs, . . . all of those employees being hired are being investigated by USIS. They also have contracts with all the major airlines, and the contract companies who provide airport security. I do not exaggerate when I say that Carlyle is taking over the world in government contract work, particularly defense work. Carlyle is a one-world shadow government."

USIS is just one more example of how Carlyle was in a frighteningly good position to reap the benefits of September 11. There are more examples, like EG&G, a company Carlyle bought in the summer of 1999, which makes, among other things, the X-ray scanners that are used in airports. Whether the company is a "shadow government," is for conspiracy theorists to debate. But the company's uncanny ability to be in the right place at the right time sure doesn't help to dissuade the cynics.

Crusader Denouement

By 2002, Carlyle's decade of cultivating ties with prominent politicians and acquiring countless defense contractors was really paying off. President Bush was creating an Office of Homeland Security, and Secretary of Defense Rumsfeld was talking of the war on terrorism being a long, drawn out affair, perhaps something that never ends. Defense budgets were soaring and

Carlyle was already looking to take other defense-related businesses public in the coming year.

After the unrelenting bad press about the Crusader approval reached a fever pitch in Washington, Rumsfeld, at the behest of Deputy Secretary of Defense Paul Wolfowitz, finally gave the order to kill the gun once and for all, but only after United Defense had already made gobs of money from its public offering. It also came after Rumsfeld was publicly embarrassed by an Army-sponsored lobbying campaign of Congress that went on behind Rumsfeld's back, after the Defense Secretary had already made it clear the program was to be cancelled. The actions on the part of the Army would result in Rumsfeld launching an investigation (still ongoing) and excoriating those responsible for the clandestine lobbying effort. "I have a minimum of high regard for that kind of behavior," Rumsfeld would tell the press in an article by the Associated Press.

But Carlyle had already taken its profits. And besides, the very same day the U.S. Army officially notified United Defense of the termination of the Crusader contract, that same Army awarded United Defense a brand new contract for a new artillery system, much like the Crusader only much, much lighter.

"United Defense and its industry partners welcome the new contract and the challenge of bringing the technological advances matured in the Crusader program to the Objective Force and the Future Combat System," said Keith Howe, vice president and general manager of United Defense's Armament Systems Division, in the same press release that announced the end of the Crusader contract. "The contract recognizes the tremendous capability and the performance of the over 2,200 employees nationwide that brought Crusader to the Army's Proving Ground and who will now focus their energies and talents on the need to field a less than 20-ton system to the Army by 2008."

Everyone was happy with the result. Rumsfeld and Carlyle avoided a damaging public relations fiasco over the Crusader by

killing the program in a decidedly public manner. The Army was assured of getting an even better gun in the same time frame as the Crusader had been promised. And United Defense got to prop up its stock price by announcing the new contract the day they announced the death of the old contract, without ever skipping a beat. It was classic Carlyle. United Defense also picked up in September 2002, a contract to provide Taiwan with $250 million worth of amphibious assault vehicles. The deal happened after Carlucci, who is the chairman of the U.S.–Taiwan Business Council, met with Tang Yao-Ming, the defense minister in Taiwan. Just another day in Carlyle's global playground.

The saga of Crusader is one of the clearest examples of how Carlyle does business. To the outside observer, the company lives on the edge, deftly maneuvering its way through the revolving door of politics and business. Keenly aware of public opinion, and how to manage the press, Carlyle has always been able to avoid the kind of scandal that brings a company down. "No one has any proof because there is no proof," explains Chris Ullman, the company's spokesperson.

Though more financial companies are learning from Carlyle's example—hiring politicians like Al Gore or Rudolph Giuliani, during their political downtime—we may never see another company like Carlyle. The sheer volume of political capital the company has amassed in its 15 years of existence is unprecedented, and would be nearly impossible to duplicate.

With $13 billion under management, close to 500 employees throughout the world, and hundreds of defense, aerospace, telecom and health care companies in their portfolio, it is safe to say that Carlyle has already gone well beyond Eisenhower's vision of a military industrial complex. There is every indication that with the current administration, and war remaining on the foreseeable horizon, Carlyle's power and reach may exceed anything Eisenhower might have imagined when he first warned against the formation of an Iron Triangle.

The important thing to remember is that the story of Carlyle, while it makes good reading, is still young. The amount of influence the company wields is already disconcerting, but at only 15 years old, the company is in a relative infancy. The potential of the company should not be underestimated, and a healthy dose of paranoia is probably in order when viewing any of the Carlyle Group's actions. As America's most revered companies are brought down through scandals and abuses of the public's trust, it has never been more important for the average citizen to remain vigilant and skeptical, of our country's business and political leaders, even during war time, when we are expected to be exceedingly patriotic. While the Carlyle Group is certainly not about patriotism, it is a uniquely American story. It is about money, power, war, and politics. All of the things that build America's might, and compromise its integrity.

EPILOGUE

It may well be that writing a book about the Carlyle Group in 2003 is a premature exercise. The company is, after all, only 15 years old, and is just now hitting its stride. In fact, the future holds even more intrigue for this private equity behemoth than the past.

In the summer of 2002, Carlyle helped form the China Venture Capital Association, a nebulous organization charged with warding off corruption in China and strengthening ties with the Chinese government. Chang Sun, the chairman of the group, said "within the industry we need to have a minimal level of code of conduct so that we don't have people who ruin the reputation of the industry. We will talk about how to regulate ourselves rather than be regulated by the government." A truly scary prospect, but nothing we haven't seen before.

China, like Saudi Arabia decades ago, is fertile ground for American investment. Edging its way toward a more capitalistic society, China is still a massive untapped market controlled largely by the government: a combination tailor made for Carlyle's special brand of access capitalism. In other words, watch this space.

Another area to keep an eye on would be Europe. In the fall of 2002, Carlyle completed an acquisition of Qinetiq, the research and development arm of the United Kingdom's Ministry of

Defense. When news of the acquisition broke in England, the MOD came under fire for potentially compromising the national security of the United Kingdom by selling such a crucial unit to an American company run by so many ex-politicians. Fiona Draper, a representative of the trade union Prospect, which includes the scientists at Qinetiq, told reporters, "the fact that they are a foreign company will obviously exacerbate my members concerns, given Carlyle's fairly opaque structure, there must be concerns over whether undue influence may be brought to bear which may not be in Britain's interest."

The "opaque structure" to which Draper refers is not uncommon for private companies, especially private equity companies. The nature of the business is such that a private company buys other private companies, none of which are obligated to reveal their financial records. All of which makes gathering information on Carlyle very challenging. Though it excels in buying and selling businesses that are under heavy government regulation, Carlyle itself is under almost no scrutiny from federal overseers. The only thing keeping Carlyle the least bit honest at this point is public interest groups and the media. And at a time when American patriotism is at an all-time high following the attacks on the World Trade Center and the Pentagon, criticizing the current president and his father for questionable business practices is a tricky business. There is frighteningly little tolerance for muckraking at the moment.

When Carlyle was notified of this book, the company immediately circled its wagons, declining to allow any interviews of its employees and waging what one insider termed as a "scorched earth campaign," instructing anyone that could be used as a source to clam up. Several people who have spoken to the partners about this book said the company is "scared to death" of the publicity that is sure to follow.

It is common for former employees of the company to fear that Carlyle will somehow discern their identities if they speak

to reporters, either on or off the record, and ruin them. The company has required many of its ex-employees to sign nondisclosure agreements, or gag orders, instructing them not to talk about their work to the press, a highly unusual move. The result of the company essentially pleading the fifth is that they maintain plausible deniability of anything written about them. But the unintended effect is that it makes them appear as if they have something damaging to hide. All the while, Carlyle executives take umbrage at the mere suggestion that the company is secretive. Yet the names of some of their most prominent employees, like George H. W. Bush, is not listed anywhere on the company's Web site. There are many things this company doesn't want anyone to know.

Conspiracy theorists that obsess on secret societies and outlandish plots overlook the more insidious and destructive effects of a company like Carlyle. By insinuating itself into the very fabric of the world's economic structure, Carlyle has accomplished far more than any Trilateral Commission or Masonic society could dream. They have made themselves an indispensable part of the international community's cash flow. Millions of people are invested in Carlyle and don't even know it, like the 1.3 million people relying on CalPERS to manage their pension fund. Do they even know that CalPERS is a part owner of Carlyle?

Ultimately, the success of the Carlyle Group depends on its continuing ability to gain access to high-level government officials, thereby getting a jump on policy changes, both domestic and international. And that access hinges on Carlyle's remarkable track record of hiring the most powerful men in the world. To keep their stockpile of political powerhouses fresh, don't be surprised to see the company reach deep into the current Bush administration after the president leaves office and snare anyone from Colin Powell to Dick Cheney to Donald Rumsfeld to George W. Bush himself. The revolving door to Carlyle is always turning.

Though company officials are outwardly amused by the rumors and accusations that swirl around Carlyle, there is a reason why

people fear them. It's difficult to explain away certain aspects of the company. Like why George Bush Sr., in the face of mounting criticism and the undermining of his son's credibility in office, doesn't simply resign from the company? He is already wealthy, with his family's legacy secure. And there must be a thousand different job opportunities available for the ex-president that don't involve obvious conflicts of interest or incidents of international political intrigue. Or why James Baker III, with his own law firm and a foundation that bears his name, feels the need to continue toiling for a firm that clearly threatens his heretofore untarnished reputation? It begs the question: What are these men up to?

From Watergate to Iran-Contra to Lewinsky-gate, the public and the press have performed admirably in keeping our politicians honest, or at least accountable, while they are in office. But the civil checks and balances mechanism breaks down after politicians leave office. The power and influence of politicians diminishes upon their retirement from public service, but it is still formidable. And the work that Carlyle's ex-politicos perform, both in nature and in scale, is unlike anything that's come before them. That's why Carlyle will continue to be both a compelling story to follow, as well as a cautionary tale.

AFTERWORD

In a move that *BusinessWeek* immediately characterized as an attempt to "scramble the conspiracy theories," Carlyle named Lou Gerstner, the long time IBM Chairman and CEO, as Frank Carlucci's successor to the chairman position at Carlyle. Carlucci retained the role of "Chairman Emeritus." Charles Lewis of the Center for Public Integrity was quoted in the *New York Times* as saying, "I'm not sure what the motive is, but this does seem to be a move away from Carlyle's image of cashing in on the old Washington rolodex."

Gerstner will certainly bring a new sense of financial credibility to Carlyle, on which he plans to spend about 20 percent of his time, according to the Carlyle press release. It will certainly be a significant bolstering of the business side of the Iron Triangle. At IBM, Gerstner led a stunning reversal of the computer maker's fortunes through the 1990s and, unlike many tech CEOs of late, leaves with his company and his legacy well intact. His knowledge of global markets will be invaluable to Carlyle.

But the company will still be run by Rubenstein, Conway, and D'Aniello, just like it always has been. And newcomers to Carlyle should not be fooled by the impeccable pedigree of Gerstner: This is still a company that made its fortunes on the strength of political power. And it is likely that it always will be.

Appendix A

COMPANY CAPSULES

Carlyle is among the largest private equity firms in the world. It employs 491 people in 21 worldwide offices. It has more than 535 investors from more than 55 different countries. And as of June 2002, the company had over $13.5 billion under management in 21 different funds. Following is a small sampling of the hundreds of companies that have been a part of the Carlyle family since the firm's founding in 1987. From the list, which is merely the tip of the iceberg, it is clear how thoroughly Carlyle has insinuated itself into the political, military, and financial fabric of the United States. From security to weapons to information technology, Carlyle has all of the bases covered.

United Defense was born from a partnership between Harsco and FMC, or Food Machinery Corp., when the two combined their defense units in 1994. The company made a name for itself by producing the Bradley Fighting Vehicles, which was used to great effect during Desert Storm. The company was bought by Carlyle in 1997, in the midst of a major political battle over the future of its next-generation fighting vehicle, a massive mobile howitzer called Crusader. After a contentious battle to save the gun program, despite widespread opposition, the Crusader program was cancelled in the summer of 2002, after United Defense had gone public in December 2001. United Defense was subsequently awarded another contract for the development of a new

next-generation gun for the Army. Carlyle remains the majority shareholder.

USIS was originally a government-run agency called the Office of Federal Investigations. U.S. Investigations Services is a private company, headquartered in an underground bunker facility in western Pennsylvania, that performs background checks on virtually all government employees, airline employees, and preemployment checks for corporate hires. The company has more than 3,600 employees, most of which are investigators, and operates in 178 locations throughout the United States. It performs more than one million cases a year for the federal government. Carlyle invested in USIS as a strategic partner in October 1999.

Vinnell is one of the oldest companies to make an appearance in Carlyle's portfolio. Vinnell has a long, but mysterious past. Originally a heavy construction company that built airstrips in Vietnam, Vinnell burst onto the forefront of the public's consciousness when in 1975 the company signed a multimillion dollar contract with the Saudi Arabian royal family, agreeing to train the Saudi National Guard, a private army charged with protecting the Saudi monarchy. The company pioneered a wave of military privatization, leading the way for dozens of similar mercenary outfits. The company claims to have operated on behalf of the U.S. government in more than 50 countries on five continents. But recent revelations have indicated that the company, at least at one time, served as a cover for CIA activity in the Middle East. Vinnell was bought by BDM, a Carlyle company, in 1992. It was then purchased by TRW in 1997.

BDM is historically one of the most successful defense consultants in history. Thanks to its erstwhile CEO Earle Williams, the company became a player in the defense contracting business in Washington during the 1980s, and was bought by the Carlyle Group in 1990 from Loral, which had acquired the company

from Ford Aerospace. After a rocky past, BDM settled in under Carlyle, doing more business in the burgeoning Saudi Arabian market. BDM was among the few companies that stayed on in Saudi Arabia during the Gulf War, a fact that was not lost on the royal family, or Saudi citizens, who bombed the office buildings of BDM in 1994.

Composite Structures is a maker of composite and metal-bond structures. Its products can be found on everything from fighter jets to Apache helicopters to missiles. The company does about $60 million in annual sales and employs 350 people. Among the military aircraft products that Composite manufactures are: AH-64 Apache Helicopter; C-17 Military Transport Jet; and the Bell UH-1 Military Helicopter Series. The Carlyle Group is a part owner of Composite Structures, which it purchased from Alcoa in the late 1990s.

EG&G is named after its 1931 co-founding triumvirate, Harold Edgerton, Kenneth Germeshausen, and Herbert Grier. EG&G has been involved in everything from the Manhattan Project to modern day weapons design and analysis. Among the company's clients are the Departments of Energy, Defense, Treasury, and Transportation. It's annual sales are estimated at $500 million, and it employs more than 4,500 people. Carlyle bought the company outright in August 1999.

Federal Data Corporation is the premier provider of information technology services to the U.S. government. Federal Data Corporation boasts contracts with everyone from the Air Force to the Internal Revenue Service, and lots in between. Its annual revenues exceed $500 million, and it has more that 1,400 employees. Carlyle bought the company in 1995 for under $100 million, and grew its revenues in 5 years from $140 million to $538 million, then sold the company to Northrop Grumman in 2000 for $302 million.

Lier Siegler Services Inc. (LSI) is a major military contractor, providing logistics support, or supply and maintenance, of a variety of military aircraft programs. LSI has managed the Royal Saudi Air Force Peace Hawk program for more than 14 years. It provides maintenance and refurbishment for Army vehicles throughout Europe. It contracts with the Air Force for the F-15, F-5, and AH-1 aircrafts. And it has provided Army vehicle maintenance and modification since 1980, including work on the Bradley Fighting Vehicles, a United Defense product. The company was bought by Carlyle in September 1997.

Vought Aircraft is perhaps the company with the longest and richest history in the Carlyle portfolio. Vought has been making military aircraft and missiles since before the first World War. The company has worked on dozens of famous fighters and bombers, including the F-8, B1-B, C-17, and B-2 bombers. Carlyle originally bought a stake in the company in the early 1990s, only to sell it to Northrop Grumman and buy the company back outright in July 2000.

Appendix B

CARLYLE CORRESPONDENCES

UNCLASSIFIED

200103677

THE CARLYLE GROUP
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2505
(202) 347-2626
(202) 347-1818 (Fax)

54

February 23, 2001

RELEASED IN FULL

The Honorable Colin Powell
U.S. Department of State
2201 C Street, N.W.
Harry S. Truman Building
Washington, DC 20520

Dear Secretary Powell: Colin

We congratulate you on your great start as Secretary of State. We recognize that there is no shortage of serious issues seeking your attention, but one of the earliest will certainly be Montenegro's relationship to Serbia.

As you know, Montenegro is the last of the five original non-Serbian republics to press its claim for independence. President Djukanovic was in Washington recently, and I hosted a long and spirited talk for several of us with Djukanovic to discuss his thinking. Djukanovic is, of course, a proven friend and ally of the United States, whose supportive role during the NATO bombing campaign helped diminish the threat to American and allied airmen. He also took great risks to oppose Milosevic and aid the Serbian democrats during their darkest hours. He protected Mr. Djindjic and many other Serbian democrats during the Kosovo war, and since 1998 has sheltered high rates of Kosovo refugees of all ethnic groups. He has been the engine of pro-Western change in this heretofore-solidly pro-Milosevic society, though he understands that Montenegro has further to go to achieve full democratization and economic reform. Montenegro will for some time remain a divided society whether or not it obtains independence, since Montenegrins who allied themselves with Milosevic continue to side with Belgrade on retaining the FRY.

Djukanovic struck us as determined to proceed to independence. He plans to hold special parliamentary elections April 22, which – if the pro-independence parties gain a majority – he intends to follow up with a referendum on independence 45-to-60 days later. If he obtains over 50 percent of the vote in the referendum, he plans to declare independence and then begin a serious negotiation with Serbia about the future nature of their relations. He said that he views independence as a means to achieve full democracy, market efficiency, and integration with Europe. By taking over the functions of security, foreign affairs, trade, customs, currency, and economic management during Montenegro's tenure as the key U.S. ally in the region, Djukanovic maintains the country has already acquired *de facto* independence.

Djukanovic stressed that he planned to achieve independence democratically and non-violently without destabilizing the region. He expressed confidence that all Montenegrins, despite their political differences, would respect the majority decision in a referendum. He said he understood that the real issue behind the coolness of Washington and the Europeans toward Montenegrin independence was not Montenegro itself but the impact of independence on Kosovo.

Djukanovic said the Kosovo problem had originated long ago and escalated after Milosevic had revoked Kosovo's constitutional autonomy. Then came the massive Serbian military intervention and NATO's war. Meanwhile, Montenegro had maintained good relations with the Albanians, and Djukanovic had established a multiethnic state and cooperated with ethnic Albanian political parties in Montenegro.

UNITED STATES DEPARTMENT OF STATE
REVIEW AUTHORITY: DONALD A. JOHNSTON
DATE/CASE ID: 29 APR 2002 200104059

UNCLASSIFIED

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The Honorable Colin Powell
February 23, 2001
Page Two

He said it was inaccurate to claim that Yugoslavia was the only framework for solving the Kosovo problem, as it was not solved when Yugoslavia existed. A solution could only come through the efforts of Belgrade and Pristina with the help of the international community. He underlined that Montenegro was irrelevant to this process and that the success of Montenegro's multiethnic governance and reforms would have a stabilizing impact on both Serbia and Albanian communities in the region.

In his view, Belgrade was just trying to frighten the international community by raising the problems of Kosovo, Macedonia, Greece, and the independence of Bosnia's Republika Srpska. The Bosnia problem, he said, was "nonsense," stressing that Republika Srpska was a problem because of Serb nationalism in Belgrade. "Belgrade tries to scare the international community that Montenegro's independence will cause Republika Srpska's secession, while all the time Belgrade is supporting Republika Srpska," he noted.

He drew our attention to Belgrade media reporting that the U.S. by refusing to receive him at your level had rejected Montenegro's independence effort. Despite this, the Serbs were still generally anti-American, while the Montenegrins were pro-American. Serbia had refused to cooperate with the Hague tribunal, while Djukanovic indicated that he would arrest indictees residing in Montenegro if the chief prosecutor handed him any sealed indictments.

Asked whether he thought that maintaining the FRY would promote stability or instability, he said there was no question that it would be destabilizing: "So long as Yugoslavia exists, Serbian nationalism lives on. The concept of Greater Serbia is not gone."

He said much of Europe was unhelpfully inclined toward the status quo. Despite the fact that Montenegro had met the terms of the European Union's own Badinter Commission on independence for the Yugoslav republics, most Europeans had gone back on these principles, especially the two nations most friendly to Belgrade, France and Italy. These legal and performance principles were the same ones by which the EU and U.S. had recognized Slovenia's independence, which is now favored by many for NATO membership.

At the conclusion of the meeting, he asked that the U.S. return to the position that, while you prefer Montenegro to remain part of the FRY, if the process to independence is open and democratic, the U.S. would accept it. On behalf of Mort Abramowitz, Max Kampelman, Jeane Kirkpatrick, Richard Perle, Steve Solarz, and Hal Sonnenfeldt, we believe this position makes good policy sense and would be prepared to discuss it with you.

Best wishes,

Frank C. Carlucci
Chairman

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3/14

S/S #200103677

United States Department of State

Washington, D.C. 20520

ACTION MEMORANDUM S/S

CLP

UNCLASSIFIED

RELEASED IN FULL

TO: The Secretary

FROM: EUR - James F. Dobbins

SUBJECT: Response to Letter from Frank Carlucci

Issue for Decision

- Whether to sign attached response to Frank Carlucci, who has written you regarding the Administration's policy towards Montenegro.

Mr. Carlucci wrote to you on February 23 regarding the Administration's policy towards the Government of Montenegro, asking that you take a more forthcoming position on the issue of independence. He writes also on behalf of Mort Abramowitz, Max Kampelman, Jeanne Kirkpatrick, Richard Perle, Steve Solarz and Hal Sonnenfeldt. At the end of the letter, he offers a meeting to discuss this issue further.

While there is no harm in such a meeting, I am not sure that it would be worth your time. The discussion at such a meeting would likely go beyond Montenegro. Attached are two alternate replies. The first does not pick up the offer of a meeting, the second does.

Recommendation(s)

That you sign the attached letter to Mr. Carlucci, which does not offer a meeting.

Approve CLP Disapprove

Alternatively, that you sign the attached letter to Mr. Carlucci, agreeing to a meeting to discuss Montenegro.

Approve Disapprove

Attachments:

Tab 1 - Proposed reply which does not offer a meeting.
Tab 2 Proposed reply offering a meeting.
Tab 3 - Letter from Mr. Carlucci.

UNCLASSIFIED

UNITED STATES DEPARTMENT OF STATE
REVIEW AUTHORITY: DONALD A. JOHNSTON
DATE/CASE ID: 29 APR 2002 200104059

UNCLASSIFIED

THE CARLYLE GROUP
1001 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2505
(202) 347-2626
(202) 347-1818 (Fax)

February 15, 2001

Granted

Secretary Donald H. Rumsfeld
Department of Defense
Rm. 3E880
1000 Defense Pentagon
Washington, D.C. 20301-1000

Dear Don,

Thanks for the lunch last Friday. It was great seeing you in such good spirits even if you are "all alone."

We thought it useful to follow up on our discussions on the need for reductions in the infrastructure of the Department – and how that might best be done. Over the past three years, the two of us have served as senior advisors to the BENS Tail-to-Tooth Commission. We believe the Commission has addressed the most critical areas that must be tackled if we are to cut the cost of defense infrastructure and re-invest the savings in modernization and other priority programs.

Because the "what to do" is so well known, the beauty of the Commission's report is not in the issues it identifies – rather, it is the focus on implementation, the "how to do it," that sets it apart.

We have taken the liberty of enclosing copies of this package and would be happy to discuss it with you or your staff. Or, perhaps more helpful, we would be pleased to introduce to you, or to whomever you might designate, the Commissioners who put this effort together.

Best regards,

Sincerely,

Frank C. Carlucci

Sincerely,

William J. Perry

THE SECRETARY OF DEFENSE
WASHINGTON

APR 3 2001

Honorable Frank C. Carlucci
Honorable William J. Perry
The Carlyle Group
1001 Pennsylvania Avenue, NW
Washington, DC 20004

Granted

Dear Frank and Bill:

My apologies for the delay in getting back to you on your letter of February 15th

There is no question but that we are going to have to tackle the infrastructure issue. I've been impressed with the BENS Tail-to-Tooth Commission report, and congratulate you folks for good work. What I may do is ask the two of you come in and meet with some of the key staff folks who are working on those types of things here in the department.

I will be back in touch with you. With my appreciation and best wishes,

Sincerely,

U06812 /01

State of Connecticut
Office of the Treasurer

DENISE L. NAPPIER
TREASURER

HOWARD G. RIFKIN
DEPUTY TREASURER

September 30, 1999

David M. Rubenstein
Carlyle Asia Partners, L.P.
1001 Pennsylvania Avenue, N.W.
Suite 220 South
Washington, D.C. 20004-2505

Dear Mr. Rubenstein:

As part of an ongoing federal investigation, the United States Attorney for the District of Connecticut recently disclosed a series of improper and illegal activities engaged in by my predecessor, Paul J. Silvester.

The information detailed by the United States Attorney focused, in part, on improper use of finder's fees. While it is my understanding that use of such fees can, in certain circumstances, be a legitimate business practice, the federal investigation has raised a myriad of legal and ethical issues, including possible and probable conflicts of interest and appearances of impropriety. In our effort to comply with the spirit and letter of all Connecticut and federal laws, and consistent with my long-standing interest in public disclosure, it is necessary that we formally ask all firms and individuals doing business with the Office of the State Treasurer to disclose finder's fees or other compensation paid to anyone as a part of any transaction related to the introduction, award, or continuation of business with my Office.

Accordingly, I request that you provide, on the forms enclosed herewith, a detailed disclosure of any and all finder's fees, placement fees, consulting contracts or other compensation currently made in connection with any transaction or ongoing arrangements related to procuring or doing business with the Office of the State Treasurer, as well as any such arrangements during the past five (5) years. As part of this disclosure, I ask that you identify the individuals or entities receiving any such compensation and the amount of each such payment. In the event your company did not pay finder's fees, placement agent fees or furnish other compensation at any time during this period, kindly so indicate in your response. In addition, be advised that such disclosure will continue to be the policy of this administration. For your convenience, these forms may be downloaded from my website, www.state.ct.us/ott/.

Please forward your response on or before October 15, 1999 to the attention of Catherine E. LaMarr, Esq., General Counsel, Office of the State Treasurer, 55 Elm Street, Hartford, Connecticut 06106-1773. Should you have any questions regarding this request, you may contact Christine Shaw, Esq., Chief Executive Assistant, at (860) 702-3211.

My Office values our relationships with each of our vendors and we appreciate your prompt and careful attention to this matter.

Sincerely,

Denise L. Nappier

Denise L. Nappier
State Treasurer

State of Connecticut

Office of the Treasurer

DENISE L. NAPPIER
TREASURER

November 5, 1999

David M. Rubenstein
Carlyle European Partners
1001 Pennsylvania Avenue, N.W.
Suite 220 South
Washington, D.C. 20004-2505

Dear Mr. Rubenstein:

By letter dated September 30, 1999, I requested that your company voluntarily disclose all compensation paid or promised in connection with any transaction or ongoing arrangements related to procuring or doing business with the Office of the State Treasurer since January 1, 1995. To date, we have not received a response to this request. In the event you already have submitted your full and complete disclosure, you may disregard this letter.

Disclosure of this information is the policy of this administration. Failure to comply will certainly jeopardize your company's current business relationship with the Office of the State Treasurer, as well as any prospects for future business. Please forward your response on or before November 15, 1999 to the attention of Catherine E. LaMarr, Esq., General Counsel, Office of the State Treasurer, 55 Elm Street, Hartford, Connecticut 06106-1773. Should you have any questions regarding this request, you may contact Christine Shaw, Esq., Chief Executive Assistant, at (860) 702-3211.

In the event we do not receive a full and complete response by the close of business on November 15th, we will work with Connecticut's Attorney General to pursue every legal recourse available to suspend or end our business relationship with your firm.

Sincerely,

Denise L. Nappier

Denise L. Nappier
State Treasurer

55 ELM STREET, HARTFORD, CONNECTICUT 06106-1773, TELEPHONE: (860) 702-3000
AN EQUAL OPPORTUNITY EMPLOYER

ACKNOWLEDGMENTS

Researching and reporting this book presented me with a number of unique challenges. First, the Carlyle Group has a very obvious fear of publicity and, as a result, declined to be interviewed for the project. The company went a step further and notified many of their friends, former colleagues, and business partners, if contacted, not to cooperate with the author. Some of them respected the wishes of the folks at Carlyle, some of them did not, and some just fell between the cracks. But with the exception of a brave few, most notably Stephen Norris, almost all of the sources that still had direct contact with Carlyle either declined to be interviewed or would do so only if their identities remained anonymous. There is a very real fear of retribution out there.

All quotations are either from those that said them or from those that overheard the words being spoken, unless otherwise attributed to a newspaper or magazine article. I would like to thank Tim Shorrock for his work with *The Nation,* Michael Lewis for his work in *New Republic,* and Leslie Wayne for her work in the *New York Times.* And I would have been lost without the work of dozens of journalists from the *Washington Post,* which witnessed and chronicled the birth and rise of the Carlyle Group, understanding

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Central Banks and Coded Language

Central Banks and Coded Language

Risks and Benefits

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Dramatis Personae

To me, that is the hallmark of credibility: matching deeds to words.[1]

Alan Blinder, *Central Banking in Theory and Practice*

We do what we say and we say what we do.[2]

Otmar Issing, 'The Eurosystem'

Words are also deeds.[3]

Ludwig Wittgenstein, *Philosophical Investigation*

In the beginning was the deed.

Goethe, *Faust* (I).

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Introduction

> The central bank owes the public transparency and accountability. Communication is at the heart of both.
>
> Blinder and Goodhart et al. 2001, 2

This book is concerned with the new paradigm of central banking. In a democratic society, transparency and accountability are not optional, but are required of independent central banks. The independence of modern central banks does not infer that central banks exist independently of structures in society or of the interactions between various agents in the financial markets (Cukierman 2008; de Haan, Masciandaro, and Quintyn 2008). A feature of the new paradigm is the interactive dimension of central banking and the financial markets. 'Monetary policy works *through* the market, so perceptions of likely market reactions must be relevant to policy formation and *actual* market reactions must be relevant to the time and magnitude of monetary policy effects. There is no escaping this' (Blinder 1998, 60).

The current consensus relates central banking practice to communication. The reason regularly given for why a central bank should speak publicly, or for why communication matters, includes the description of important aspects of the transmission process, the improved predictability of interest rate projections, and the shaping of market expectations (Bernanke 2004a; Chirinko and Christopher 2006, among others). A central bank's actions need also to be understood by market participants. Empirical findings underline the importance of the point of reference: the communication of a central bank with financial markets has crucial influences on interest rate projections made by market participants, and generates an anchor for the expectation-building process (Ehrmann and Fratzscher 2008; Issing 2005a; Kohn

and Sack 2003; Rudebusch and Williams 2006). This implies that the effectiveness of a central bank cannot be separated from language interactions and, hence, from 'language games'. Moreover, communication cannot be reduced to the disclosure of information by a central bank.[1] To put it more precisely, monetary policy and a central bank's communications cannot be described by linear input-output transmission, nor by purely deductive arguments resulting from a model view. The reason is – as explained by Alan Greenspan (2004, 36), among others – because 'uncertainty is not an important feature of the monetary policy landscape; it is the defining characteristic of that landscape'. There is no option as to whether or not to acknowledge this uncertainty. With uncertainty in the landscape, central banking needed anchoring.

I should immediately add that through communicative interactions and the use of language, monetary policy must be seen as a distinguishing feature of the decision-making process, since the decisions and actions of a central bank indicate its goals. Consequently, the attempt at achieving its goal also depends on the public's understanding. The functions of language in daily communicative interactions cannot be explained by the analogy of a mechanical impulse-resonance, as assumed in the traditional model of central banking. Meaning and understanding are generated through a process of communicative interaction. Furthermore, meaning and understanding arise out of a person's perception, recognition, and interactive procedures. Any reflection on information, interaction, and situation necessarily refer to language activity, or ways of acting. I would like to propose that modern central banking, too, should link its consideration of communicative interactions with cognitive science and language sciences.

According to the modern view of central banking – see, for instance, Blinder and Goodhart et al. (2001, 1) – 'attitudes and policies toward central bank communications have undergone a radical transformation in recent years. Not long ago, secrecy was the byword in central banking circles. Now the unmistakable trend is toward greater openness and transparency. Increasingly, central banks of the world are trying to make themselves understood, rather than leaving their thinking shrouded in mystery'. The view that 'the times, they are a-changin' has significant implications and consequences for economics and, hence, for central banking. Changing times inevitably include changing questions, taking the initiative of rethinking the primary methods and instruments in economic science, and the acceptance of an interdisciplinary approach to macroeconomic theory. Alan Blinder (2004) characterized the changes in modern central banking as a 'quiet revolution'.

In his presidential address, 'the missing motivation in macroeconomics' at the American Economic Association meeting in 2007, George Akerlof argued for an interdisciplinary approach in the field of macroeconomic theory, one of preferences with a concept modified and supported by research in sociology and psychology, to replace the prevailing abstract and deductive approach to economic problems. He refers to the dominating 'five neutralities' in macroeconomics. Preferences in macroeconomics are, respectively, devoted to abstraction or to model abstractions. These neutralities are linked to premises of the model and predefined preferences and, hence, to the avoidance of linking them to actions, observations, and behaviour. Norms, the interactions in changing contexts and circumstances which socially determine values and preferences, are the missing factors.

I set out in this book to assess certain implications and consequences of this new paradigm which until now have barely been discussed in the literature: the predominant formal language approach in central banking literature has to be supplemented by an everyday language approach. In doing so, I propose to focus on expectations and economic interactions as communicative actions, hence as articulations or 'language games'. The constitutive role of the use of everyday language should be integrated as an important component in the modern view of central banking and not be neglected in the academic debates. Language is not a label (Issing 2008).

Even the attempt to communicate through a coded language or a special, formally designed language has to be retranslated into everyday language in order to be an appropriate form of central bank communication. A coded language or formally designed language approach to economics and central banking is free of ambiguity and vagueness, which seems to be beneficial because of their particular methods, which focus on quantifying, measuring, and forecasting. The risk of a coded language, or even a formally designed language, is that necessary changes in monetary policy action will not be part of the communication because the coded language is defined as being independent of changing environments and contexts. A coded language approach to central banking, regardless of its context, culture, and constitution, lacks credibility and reputation. A coded language *cannot* fulfil the central banks' genuine task of guiding market expectations. My point is this: the uncertainty would be elevated by the use of a coded language or a purely formally designed language.

In contrast to a coded language, the use of everyday language – the language in practice – configures a certain context which is understood by

the participants of the financial markets and the central bank. Therefore the language in use functions as an anchor for the expectation-building process and decision making in an uncertain environment. Certainty does not arise out of formal symbolic or deductive reasoning because it is encapsulated in a predefined world or system. It therefore provides certainty within a well-defined logical system. According to acting in markets, certainty has to be grounded in language interactions. There is no certainty to be found in reliance on numbers or codes. Certainty is not an option or possibility. According to the uncertain landscape of central banking, *any kind of a vision of certainty* can only be perceived as the result of a common understanding among heterogeneous agents in the markets (Simmons 2006).

Regarding the landscape of uncertainty, individuals are creating a realm of certainty by linking through action and articulation their perceptions of the situation (in which they are acting) to the perceived actions of other agents (Gerd Gigerenzer and Richard Selten 2001a, 2001b). John Maynard Keynes (1936, 161) described this interaction and reliance on one's own view in relation to the perceived views of other agents as follows: 'Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits – of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.' The metaphor 'animal spirits' implies a particular state of confidence and trust in a particular situation (Boyd 1979; Muchlinski 1996a; Akerlof and Shiller 2009). A necessary condition in creating a state of confidence is that this confidence is perceived and shared by other agents in the market. To argue that an agent creates his or her private state of confidence makes no sense. A state of confidence cannot be private. Also, an agent in the financial markets cannot create a private meaning of the situation, although she or he is able to perceive the situation differently. This is also true for the use of language, as Bertrand Russell and Ludwig Wittgenstein emphasized. Wittgenstein (1959, § 241) pointed to agreement in uncertain situational contexts: 'That is not agreement in opinion but in form of life.' Agents in the markets take direct possession of the commodity or product, or the option to buy or to sell, without having doubts. They use everyday language. In acting without doubts, heterogeneous agents create a kind of certainty or state of confidence homogenously. This is comparable to a building having supporting foundations. The 'logic' of everyday language is rooted in language interacting in practice. Everyday language does not refer to a system of abstract logic.

I wish to introduce four main considerations: first, according to the success of the scientific process in the sciences, it should be noted that the scientific process is not – at least ideally – based on the avoidance of alternative questions and methods of exposition. This is also true for central banking and macroeconomics. The crucial objective for a central bank is to guide market expectations. A central bank's way of acting creates the normative meaning of sentences. Concepts are embedded in economic interactions. The meaning does not arise out of a prefixed or predetermined world.

A second consideration concerns the central premise throughout this book: anchoring is only possible by acknowledging that language interactions and different modes of communication are essential to economics. Economics is not driven by universal laws or natural laws (Issing 2010a, 2010b; Muchlinski 2011). This is of crucial importance to a central bank's task of guiding market expectations. A central bank's way of acting creates the normative meaning of sentences. Concepts are embedded in the language-game. Not only are times changing, but language-games also are changing and bringing, therefore, a change in concepts and the meaning of words. It is not possible to anchor central banking in a system of formal symbolic or coded language successfully. To explain a word requires going back to the language-game itself, which is also mutable, as the current financial crisis has underlined. The current crisis has also been driven by new financial methods of reallocation and by financial products labelled by codes: AAA, AA, A, BBB, BB, B, and so forth. This 'Esperanto of the capital markets' (Franke and Krahnen 2009) has been substituting for everyday language since the late 1990s. These codes have been created by rating agencies and accepted throughout the economic business as a guarantee of quality and as a promise of gains and wealth. As a code system, this method has contributed to keeping up an appearance of certainty in order to reallocate risks internationally.

My third consideration deals with the implications and consequences of the new paradigm of central banking. The implications arise from the proposition that the meaning of a sentence is embedded in the use of its context. For this reason, I provide a reinterpretation of 'monetary mystique', linking this term both to its historical context and to current debates in central banking literature.

A fourth consideration examines the risks and benefits of coded language by emphasizing communicative interaction as language-based interaction – that is, interaction based on everyday language. However, this text subscribes to communicative interaction as being aimed at a

common understanding and, therefore, as being opposed to mechanical analogies. A central bank's decisions and communicative interactions can be devoted neither to abstract premises nor to a coded language.

The innovation which emerges from this book is the supplementing of standard economic methods, known as deductive and formal reasoning, with an interdisciplinary approach linked to inductive and hermeneutic principles. The argumentative strategy favoured by deductive reasoning emphasizes truth and certainty according to predefined premises, axioms, and variables. Embedded in a logical system of argument, deductive reasoning leads to exactness, non-ambiguity, and the measurability of economic factors, which themselves have been prepared in order to be quantified and measured. Here we can understand why deductive reasoning in economics is indisputably acknowledged. Deductive reasoning presumes certainty of knowledge in the present and future, since the context is presumed to be stable or invariant. However, this certainty arising out of deductive reasoning is a result of the prearranged, systematic application of predetermined, fixed rules to a subject.

Turning to inductive reasoning we find an array which seems to frighten scientists because it moves from the sphere of influence. Inductive reasoning implies vagueness, ambiguity, uncertainty and is mainly based on probabilistic argument. However, neither inductive reasoning nor the hermeneutic and the heuristic approach to social phenomena presume truth or scientific objectivity. As outlined in the previous paragraph, the presumption of truth and objectivity is regularly attributed to deductive reasoning with regard to the scientific design of the deductive argument as logical consistency, coherence, exactness, and precision.

As is appropriate for all sciences, economics uses particular concepts, categories, symbols, and codes in describing and explaining its scientific results. Scientific terms are used in order to be as precise as possible and to avoid disputes about their meaning. Similar to different branches in macroeconomics, central bank literature uses systems of codes. Their meaning is easily understood by deductive reasoning. They are understandable by tautologies. For instance, the decision to raise the Federal Reserve Funds rate leads to a particular perception that the Federal Reserve Bank (Fed) now has a different assessment of the business cycle and movement of prices than before, regarding, for example, that expectations of inflation are in the air. The Federal Reserve Funds rate is embedded in a logically defined system regarding the macroeconomic effects of its movement. Every decision to change the Federal

Reserve Funds rate will therefore unavoidably move other variables of this predefined system. Moreover, this predefined system contains a huge variety of different specified variables, such as expectation, risk, uncertainty, and communication, among others. At this point the crucial question reaches the agenda of how the public perceives and understands the decision of the central bank regarding the public's own methods and instruments for assessing the economic context and creating economic forecasts regarding inflation expectations, short-term and long-term interest rate projections in various money markets, and the expected yields.

Communication in science is often based on axiomatic and deductive reasoning. However, to focus on language in different contexts and communication interaction of central banks requires stepping beyond the axiomatic logical system in order to acknowledge the role of language as an instrument of cognition and acquisition of knowledge. Language is not neutral towards thoughts and cognition. In order to be successful 'through' market interaction, a central bank needs to acknowledge the constitutive role of language for creating economic contexts.

We need to perceive that neither central banking *nor* the communication of central banks will lead to truth or objectivity. The success of communication is based on language interactions among heterogeneous participants in distinct markets surrounded by variable contexts. Therefore, truth and objectivity are embedded in the language interaction. Moreover, communication also implies miscommunication which will initiate further dispute. We have to recognize that communication is not a linear transformation of information and an already given meaning. Understanding is not the exchange of an already given meaning of a sentence or of words. Understanding is not based on a measurement of wording, because the meanings of sentences do not come from the measurement.

This book also endeavours to add consideration of communicative interaction and the creation of meaning and understanding from modern cognitive and language sciences. I propose a *conceptual framework based on three dimensions* to expound upon why a coded language is not capable of contributing to the effectiveness of monetary policy. I want to bring central bank literature into dialogue with important research in the language sciences as well as with heuristic and communications approaches in the social sciences. I investigate why economic interactions and procedures can be treated neither as 'universal laws' or 'invisible hand mechanisms', nor be discussed in terms of 'universal concepts'. Economics as a social science must also focus on

particular cases of the discontinuity of events, and on the sensitivity of contexts. Economics and economic activities are without question not self-regulating or self-ordering mechanisms or functions. The most recent financial crisis has, almost as a cliché, shown how relevant are changes in macroeconomic concepts, methods, and instruments. One has to acknowledge that a barter economy differs fundamentally from a monetary economy. A monetary economy is based on a multiplicity of relationships between creditors and debtors as types of contracts, and on heterogeneous agents in the domestic economy as well as in different countries, regions, and currency areas. Macroeconomic policy can only be treated in light of coordinative interactions between these different agents. In this light the importance of institutions becomes a significant consideration, because they are 'repositories of knowledge and experience' (King 2004). It should also be stated here that this book does not deal with the role of language as modelled in game theory, nor with institutional economics and evolutionary economics. A great deal of work has already been done in this field of research. Although investigation of central banks as learning organizations with particular interorganizational relations and networks still remains to be done, it is not the subject of the present book. This book explicates the interdependence of structures and actions, customs, norms and their social impregnation, and how understanding by disagreement, agreement, and interpretation shape contexts because meaning and understanding are not predefined, already given qualities which can be exchanged in market transactions.

This book is structured as follows: In Chapter 1, certain aspects regarding the Federal Reserve Bank's road from 'monetary mystique' towards 'matching deeds to words' are expounded with reference to lines of argument in the Federal Open Market Committee (FOMC) transcripts of the Paul Volcker era. The Volcker era could be reread as an example of an inadequate formal approach, because the 'k-percent rule' or 'money growth-targeting' ignored the circumstances of institutional interactions between the central bank and commercial banks regarding the concepts of money, and of money demand and supply in the economy.

Chapter 2 introduces a conceptual framework for communicative interaction, which combines the three dimensions of information, interaction, and context. To understand how monetary policy works *through* the market, one needs to acknowledge the processes of perception and the understanding of the central bank's talk and communication within markets involving many different market agents.

Chapter 3 turns to consider the argument that because central banks are part of society central banking needs to refer to circumstances. Central banks shape circumstances by their communicative interactions. This chapter discusses the *forecast-based approach* to central banking as an example that links a central bank's judgment to changing circumstances, because it gravitated towards new concepts and different methods of communication in order to configure the debate on the methods of decision making and monetary policy. The chapter introduces the 'risk-management-approach' as a superior approach to central banking, emphasizing that a central bank should avoid being trapped into selective perception and a cognitive straitjacket, thereby being imprisoned by cognitive dissonance and captured by false precisions, exactness, and a supposed linearity of information through following inadequate, rigidly fixed rules and optimization instead of problem solving.

Chapter 4 examines the further aspects of the interdisciplinary approach to central bank communication. If we remember that a central bank can control only the Federal funds rate, which should influence long-term real interest rates (and, hence, the inflation expectations of different interactions in various financial markets), a central bank needs to reflect on its own contributions to the creation of the context which surrounds the decision-making process of both financial markets and the central bank.

Chapter 5 moves on to address the question which runs as a thread through the book, considering a variety of aspects that can be grouped under the heading 'risks and benefits of a coded language or purely formal language approach to central banking' with reference to some debates on the formal language approach to sciences from the 1920s, which are of great relevance to current debates.

The conclusions of the research are presented in Chapter 6.

1
The Way Out of 'Monetary Mystique'

> The mystique thrives on a pervasive impression that central banking is an esoteric art. ... The esoteric nature of the art is moreover revealed by an inherent impossibility to articulate its insights in explicit and intelligible words and sentences. Communication with the uninitiated breaks down.
>
> Karl Brunner 1981

Discourse on central bank transparency and communication has been moving beyond the silence of a black-box mechanism. It has initiated a theoretical upheaval on modern central bank theory. This is also true for the areas of research related to a central bank's interactive procedures touching its market interdependencies and relations. The focus on the central bank's way of acting, on the use of language and modes of communicative interactions, has also been drawing much attention.

Two decades ago, central banks were envisioned as being 'temples of secrets' (Greider 1989) surrounded by so-called mysterious silence and opacity. Today, modern central banks no longer perceive themselves as temples of secrecy rooted in the realm of metaphysics and unable to communicate and explain their procedures. This is true for a central bank as an institution interacting with the financial market which, itself, is not invariant. As an institution, a central bank acts within historical and contextual forms of life and norms. The success of a central bank's communicative interactions with the agents of financial markets is not rooted in presumed invariant structures of the markets itself. Any communicative interaction involving the central bank affects and shapes its circumstances and, therefore, the context of its action. The goal of a central bank, its mandate of price stability, its policy and instruments, are not phenomena of nature and, hence, not an issue for

natural science. The concepts of economics as social science are not embedded in natural science or natural laws.

Paper money is created by the central bank based on certain principles and, foremost, on the acceptability of its role in society. A central bank's macroeconomic responsibility is to provide price stability and, hence, stable money throughout the whole of the economy. Credit is created by teamwork or interaction between central banks and commercial banks. Commercial banks borrow money from central banks in order to lend it to the public; they also use the deposits or savings held by the public. Commercial banks have to pay back the borrowed money to the central banks. Under normal circumstances, the process works because commercial banks function as intermediaries. They borrow money from central banks and lend money to the public at a higher interest rate than they have to pay to for borrowing or for the deposits.

The acceptance of a central bank's money depends on how money possesses credibility as a store of value, a standard of deferred payment, and medium of account (Tobin 1983). Money is not a veil for a barter economy. Money is not neutral regarding its function in a monetary economy. Taking this into account, any action of a central bank is, itself, a part of conceptual actions within a complex situation. It is for this reason that central bank talk (see Blinder et al. 2001, How do central banks talk?) matters and why it gives the use of language an important role in shaping the position of central banks. As was said in the introduction, words or sentences have no meaning beyond their use in a context. 'Every sign *by itself* seems dead. What gives it life? – In use it is *alive*' (Wittgenstein 1978, § 432). The history of central banks provides many examples of how the meaning of words has changed according to the changing environment. As treasuries of knowledge and experience, central banks have to recognize the epistemic preconditions of a successful communicative interaction with the market. Otherwise it will treat economic agents as machines.

Knowledge of context and environment is also created. This embodies a central bank's history, which can be described by using concepts expressed in language. These concepts are impregnated by their usage in historical context and have to be reread in the light of current debates. The literature on central banks and their decision-making procedures under conditions of uncertainty has begun to reconsider and revise important concepts (Blinder et al. 2008, 2001; Issing 1999). Also, economics, like science, changes all the time and, hence, the economic background also shifts constantly. We base all the judgments with which we formulate decisions and actions – and regard

concepts, meanings, and methods –upon variable social contexts. Therefore concepts, conceptual investigations, and methods must be flexible.

It is a crucial characteristic of scientific procedure to change, rebuild, and reassess concepts, methods, and models when they do not fit the contemporary world. Judgments about the market have constantly been rethought and scrutinized. Only through living in a 'panelled boardroom', or seeing oneself as a representative of the principles of the classical or neoclassical world, are we embedded in a certain world without any perceived need to change our views and considerations. In contrast to this artificiality of a constructed world, judgment made under uncertainty necessitates the orientation of a common background. Keynes criticized the artificial world in his article on the theory of interest rates:

> [A]ll these pretty, polite techniques, made for a well-panelled Board Room and a nicely regulated market, are liable to collapse. ... I accuse the classical economic theory of being itself one of these pretty, polite techniques which tries to deal with the present by abstracting from the fact that we know very little about the future'. (Keynes 1937, C.W., XIII, 215)

The contextually received history of central banks can be judged and described by their applied concepts and their implemented actions, both then and now. The new paradigm which can be pictured by two main concepts of 'matching deeds to words' (Blinder) and 'we do what we say and we say what we do' (Issing), implies the acknowledgement of language as a social fact. The consequence is that the predominant formal language approach in central banking literature has to be supplemented by an everyday language approach. Even the attempt to communicate through codes or a special 'central bank' language has to be rethought if this could be an appropriate means of central bank communication.

Language is not the gateway to transmitting an already given meaning, like throwing a billiard ball. The function of language activity in a dialogue – even the communicative interaction of the central bank with non-homogeneous agents of the financial market is a dialogue – derives from the wish to be understood. People communicate to reach a common goal or understanding. 'Nothing could be more obvious: we want to be understood, and others have an interest in understanding us; the case of communication is vastly promoted by such sharing' (Davidson 1994, 9). This

is also true for institutions which communicate through people, agents or, for instance, the chairman of a central bank.

As it is known from the history of science, any event is embedded in its historical context. It is not possible to separate the event from the context without, as a result, producing a meaningless object. Also, this meaning and its understanding are embedded in action. Emphasis upon coded words implies the danger of misunderstanding and of veiling the context in which a central bank acts. The attempt to rely upon a coded language neglects the conditions under which the central bank acts to carry out its mandate. In Chapter 5, I emphasize that a strategy of a coded language (or purely formal language) approach to communicative interaction is an impediment to the central bank's road to satisfying its mandate. The effect of a monetary institution like a central bank is a result of its capacity to act and of the acceptance of these actions by society.

The Federal Reserve's road to transparency, flexibility, and monetary policy is evident: since its turning point in the year 1994, the Federal Reserve has been redefining some of its concepts and monetary policy rules (see Kohn and Sack 2003). The Federal Reserve Bank (Fed) has attempted to move out of 'monetary mystique' towards a practice of 'matching deeds to words'. At this point, we need to ask what the terms 'monetary mystique' and 'mystique' mean as regards the history of the Fed, and in comparison to the modern view of the central bank following the maxims: 'matching deeds to words' and 'we do what we say and we say what we do'. I will try to provide an answer to this. Here, I want to outline the changing visions of a central bank's policy.

The term 'monetary mystique' was created to describe the monetarist experiment of the Federal Reserve Bank. I will go on to link the term 'mystique' to the current debate on central banking. The present state of academic discourse emphasizes transparency and communication of central banks as being desirable for both the enhancement of the effectiveness and accountability of central banking (Blinder et al. 2008). In current times there is no longer a possibility for a central bank to conceal itself behind a wall of so-called non-interactive behaviour, as was the case until the Federal Reserve began to change its communications strategy.

Historical trends in macroeconomics can be summed up by focusing on the consequences for both central banks and monetary policy between 1973 and 1998. The breakdown of the Bretton Woods agreements and the international exchange rate system in 1973 (which breakdown actually began in August 1971 with the Smithsonian Agreement),

provided a challenge for central banks in the industrialized countries. The spirit of the Bretton Woods agreement led to a fixed-rate dollar standard from 1950 to 1970, which also implemented the U.S. dollar as a *numéraire*. The Bretton Woods agreement kept exchange rates within 1 percent of this par value. The United States remained passive in the foreign exchange markets, while European countries fixed a foreign par value for domestic currency by using gold, or a currency tied to gold, as the *numéraire*. This asymmetric system of international monetary policy meant that countries other than the United States intervened in the foreign market to stabilize their domestic currencies by using the U.S. dollar as an intervention currency. The U.S. anchored the dollar price level for tradable goods by an independently chosen monetary policy in the United States, while industrial countries other than the United States subordinated the domestic money supply to the fixed exchange rate. The role of central banking in this system of exchange rate targets remained hidden.

After the late 1960s, the willingness of other countries to peg their currency values to the overvalued U.S. dollar evaporated. The U.S. dollar came under pressure to depreciate. A rearrangement to a new par-value system was made in December 1971, but lasted only until February 1973. Up to that point, the central banks of the Western world had conducted monetary policy under the exchange rate target anchored by the U.S. dollar.

How did economic theory respond to this changing economic environment? Both economic theory and empirical evidence noted these changes to central banking and monetary policy formulation. It has been observed that the policy changes after 1973 were not driven by a simple causal mechanism of empirical evidence or theoretical reasoning. 'Economic science evolves by way of a complicated back-and-forth interaction of theoretical and empirical considerations' (McCallum 1999, 172). After 1973, central banks developed new strategies to stabilize the paper money standard around different monetary regimes such as inflation targeting, monetary targeting, exchange rate targeting, and different strategies between rigidly fixed exchange rates and flexible exchange rates. The era of the floating rate, 1973–84, also implied that the United States remained passive in the foreign exchange markets and decided on monetary policy and central banking autonomously and independently with respect to the foreign exchange value of the U.S. dollar (Eichengreen 2007).

Since then, the Federal Reserve Bank has been acting in a significantly different role in the international monetary system compared to

other central banks. The U.S. dollar serves as the nominal anchor. The international floating rate system, combined with gradual elimination of capital controls (and, hence, free currency convertibility of the main currencies of this so-called non-system of the post-Bretton Woods era) did not imply that central banking in the industrialized countries could avoid stabilization policy, that is, aiming at a nominal anchor (Mundell 1995). An example is the regional monetary system implemented by the European Monetary System as a Deutsche Mark Era from 1979 to 1992 (McKinnon 1993).

Changes in both the macroeconomic and central banking theories of this epoch coincided with the rational expectations hypothesis as a fundamental new approach to economic theory. McCallum exposed several misconceptions about the meaning of the rational expectations hypothesis. The reason why the expectations of agents will agree with the analyst's model of the economy can be detected in the analyst's goal to depict the model *as if it* were true. The premise of rational expectations states: 'agents form expectations so as to avoid systematic expectations errors in actuality, which implies that they behave as if they knew the structure of the actual economy' (McCallum 1999, 172). The changes of trends in macroeconomics from 1973 to 1998 also initiated upheavals in the theory of monetary policy and central banking. Moreover, they set in motion a compelling shift for central banking and monetary policy towards paying attention to guiding expectations in order to stabilize a paper money standard.

Central banking and monetary policy rules have become a distinct consideration of economists and theorists (Goodfriend 2003). This has provoked new questions, distinct methods, differing viewpoints, and the opening up of further investigation within the scholarly community. The abandonment of the gold–dollar standard was also an abandonment of the theoretical illusion of stabilizing the functions of a currency by referring to constraints as given by a metallic standard. The radical changes for central banking and monetary policy have evolved out of new perceptions and responsibility for price stability.

As history reveals, central banking and monetary policy have had to pass through a long and painful process of learning and reorientation. The experience of high inflation and the responses of central banks in industrialized countries to tighten monetary policy also produced painful and restrictive effects on domestic economies as well as international economies, business cycles, and macroeconomic performance (Muchlinski 2001b). Nations were confronted with a painful mixture of tightened money policy, a high level of interest rates, and tightened

fiscal policy. A new phenomenon in macroeconomic theory and central banking came to the policy-making agenda, emerging in the literature of the 1970s and early 1980s, namely 'stagflation'. The term stagflation was supposed to encapsulate the new relationship of inflation, recession, and unemployment. It also opened up new and distinct directions in macroeconomic theory and in the fields of research on the role of central banking, its targets and instruments.

The evolution of different perspectives on the relation of short-term and long-term expectations was driven by a critique of the adaptive expectations hypothesis, itself identified with Keynesian macroeconomics (Leeson 1998). The radical shift towards a tight money policy in the middle of the 1970s by the Bundesbank of Germany and the Bank of Japan opened up the still-ongoing debate over the role and responsibility of central banks in democratic societies regarding inflation, employment, growth, stagflation, and exchange rate volatility (Muchlinski 1999b). The research into the effect of central banks and their monetary policies on international monetary relations has become more important and better acknowledged. The function of central banks in the economy and their monetary policy strategy, their instruments and methods, appeared to be something in the background, within the domain of a 'temple of secrets' (Friedman 1996). One striking feature of the late 1970s was that central banks had to learn to deal with different kinds of flexible exchange rate regimes and monetary policies. This observation and experience opened up fundamental debates about proper monetary policy strategy in open economies. The central bank's success was established through the interdependence of short-term and long-term interest rates, interest structure, and inflation expectations (Bernanke and Blinder 1992).

As I have outlined, the situation after 1973 was indeed an experimental epoch. It can be described as

> a situation in which the world's leading central banks were responsible for conducting monetary policy without an externally imposed monetary standard (often termed a nominal anchor). Previously, central banks had normally operated under the constraint of some metallic standard (e.g. a gold or silver standard), with wartime departures being understood to be temporary, i.e. of limited duration. (McCallum 1999, 175)

In the 1970s the Federal Reserve Bank pursued a strategy of circumventing demands by the U.S. Congress that were empowered by the Freedom

of Information Act of 1966 (FOIA). The Federal Reserve was accused of hiding behind a curtain of 'mystique' and 'secrecy' by using 'base-drifts'. In the following chapter I will explain how the 'base-drifts' of the Federal Reserve function as a particular strategy of communication.

1.1 'Monetarist experiment' or 'smoke screen'

In the literature we find at least three different approaches to this epoch. An initial interpretation portrays the years from 1979 to 1982 as a monetarist experiment by Paul Volcker, at that time the chairman of the Federal Reserve. Volcker was held responsible for a half-hearted approach to implementing the monetary policy and its subsequent lack of success (Friedman 1982). Moreover, there were negative consequences to this half-hearted monetarist experiment, namely that the Federal Reserve's tightened monetary policy constrained not only the domestic economy of the United States, but also caused a sharp rise in interest rates throughout the global financial market and economy. It led to a painful period of high interest rates, lasting until the early 1980s, and to the debt crises of developing countries.

A second interpretation of this period regards the change to monetary aggregates and money market as a success of the monetarist experiment because important macroeconomic indices, that is, the consumer price index (CPI), GDP deflator, and also the Core price index fell after 1980, while the Federal Reserve funds rate had also been increasing dramatically. However, the question arises as to whether inflation went down because of declared money growth-targeting or from setting of the nominal interest.

A third interpretation asserts that no monetarist experiment had actually been implemented. Because of the influence of inflation psychology, with expectations of high inflation in the air, the traditional strategy of setting nominal interest rates was becoming less acceptable to politicians and the public. Steering market expectations through setting the Federal Reserve funds rate was associated with a Keynesian strategy, whereas focusing on monetary supply or monetary growth rates, respectively, was seen as a monetarist strategy. However, the Federal Reserve had never intended to act upon, and never could have acted upon, the basis of a monetarist 'k-percent-rule'. Volcker viewed this period as 'monetarist experiment in practice'. David Lindsey stated that the Volcker regime change was not identical with a monetarist experiment (Lindsey et al. 2005, 224). Feldstein (1994) analyzed the demanded monetarist strategy in light of the weakened position of the

U.S. dollar since 1973. Volcker's policy intended to reinstall its function as a key currency and to stabilize the hegemony of the United States. The FOMC sought to avoid 'great trouble internationally'. Henry Wallich, for instance, stated, 'as the Chairman has pointed out – he gets this question again and again and we get the same thing in the press and in criticism at home and abroad'.[1]

I would like to add some further information regarding the third interpretation given above. Volcker took office as the chairman of the Federal Reserve on August 6, 1979, at a moment in the history of the Federal Reserve which is identified in the literature on central banking and monetary policy as a significant epoch (Volcker/Gyothen 1992).[2] The Federal Reserve's shift towards a targeting of the monetary growth rate by steering the non-borrowed reserves in accordance with desired three-month growth rates of M1 and, later, M2, required a quantifying of the total reserves in relation to the non-borrowed reserves. Open market operations, as carried out by the Trading Desk of the Federal Reserve Bank of New York under direction from the FOMC, imply that the Federal Reserve was also dealing with the level of the Federal Reserve funds rate. The crucial point is that the paradigm shift towards the non-borrowed reserve policy could not work without using the Federal Reserve funds rate. The assessment of the borrowing reserves and its prospective path was discussed regarding the implications for the Federal Reserve funds rate (see for instance FOMC transcript, conference call, June 23, 1983). 'The Federal Reserve funds rate was not ignored; it was used as an indicator of the accuracy of reserve estimates' (Meulendyke 1998, 50).

The Federal Reserve did not publicly outline the contingent nature of the new monetary strategy. It was publicly introduced as a targeting of the monetary growth rate by steering non-borrowed reserves. Volcker defended the new technique in press conferences, in the Congress, and in the FOMC meeting. He provided additional remarks in press releases on the conditions of targeting money growth ranges in response to ongoing inflationary development in order to win the battle against inflation. His announcement to the press in February 1980 emphasized the key role monetary growth rates played at the turning point in the FOMC's monetary policy. The message was clear: the Federal Reserve was prepared to fight inflation by controlling the money supply. It was obvious that the crucial element of this new structure for steering the quantity of money would be to quantify the money supply while the amount of money demand remained unknown.

In the FOMC meeting of August 1979, Volcker emphasized that the FOMC had no other choice while high inflation was expected:

> We do not have a lot of room for maneuver and I don't think we want to use up all our ammunition right now in a really dramatic action; I don't see that the exchange market or anything else really requires that at the moment. Certainly dramatic action would not be understood without more of a crisis atmosphere than there is at the moment. Ordinarily I tend to think we ought to keep our ammunition reserved as much as possible for more of a crisis situation where we have a rather clear public backing for whatever drastic action we take. (FOMC Transcript, 8/14/1979, 22–23)

Under Chairman Volcker, the Fed also sought to diminish congressional criticism through anti-inflationary strategy. By emphasizing a focus on the money supply based on money growth rates and aggregates, the 'monetarist experience' was in fact 'atmospheric' lip service (Lindsey et al. 2005, 229). The aim of the Federal Reserve was primarily to rebuild price stability. Volcker outlined it:

> We could well end up by exceeding the targets for the year, after making a hullabaloo about this change in technique. And we could run into a reaction that at that point would be adverse. So there are advantages, disadvantages, and risks on all sides of this equation. (FOMC Transcript 10/06/1979, 9)

The Federal Reserve press release of October 6, 1979, emphasized control over the money supply. With the declared strategy of retreating to monetarist principles aimed at targeting the monetary growth rate by steering the money supply, the Federal Reserve tried to regain its credibility. The FOMC's target path for the monetary aggregate was to be designed in terms of the quantity of money, or a monetarist approach to central banking. Volcker emphasized it further in his first Humphrey-Hawkins testimony on February 19, 1980. In 1978, the Full Employment and Balanced Growth Act, that is, the 'Humphrey-Hawkins Act', bound the Federal Reserve to monetary targets one year hence. This commitment has been criticized in the literature because of its rigidity:

> If anything, the policy mistake of the late 1960s and 1970s is that actual monetary policy followed the Taylor rule, too closely! Rather than follow the Taylor rule, policy should have been considerably

> tighter. Given the mistake of following the Taylor rule in the 1970s, the deviation from the Taylor rule in the early 1980s and the policy tightening associated with the Volcker disinflation was an appropriate response to the inflation problem created by following the rule. (Orphanides 1999, 19)

The transcripts of the meetings from 1979 to 1983 throw light on the debates in the FOMC regarding the new monetary procedure:

> Against this background, the staff had been directed to prepare memoranda on a package of possible actions designed to show convincingly the Federal Reserve's resolve to contain monetary and credit expansion in the U.S., to help curb emerging speculative excesses, and thereby to dampen inflationary forces and lend support to the dollar in foreign exchange markets. Such a package might include actions on reserve requirements and the discount rate; in addition, the staff had been asked to analyze the implications of a possible shift in Federal Reserve Open Market Committee procedures, whereby the Desk, in its day-to-day operations, would operate more directly on a bank reserves, rather than a Federal Reserve funds rate, target. (BOG Minutes, 10/4/1979, 1-2, in Lindsey et al. 2005, 201)[3]

The Federal Reserve's declared new monetary targeting was not only a quantum leap back to the past, it was a return to rethinking monetary policy in terms of the gold standard 'rules of the game' in order to solve the nominal anchor problem which confronted the U.S. dollar. The Federal Reserve had lost credibility with the public in the domestic economy amid higher prices and continued price acceleration, while at the same time confidence abroad was lost from perceived failure. This consideration was put forward by Emmett Rice:

> First of all, the psychological impact of a change in operating technique will be strong. I think it will be strong not only in domestic markets but also in foreign markets. In my view the foreign markets will read such an announcement as an expression of our determination to control the money supply, and that will have salutary effects. (FOMC Transcript, 10/06/1979, 22)

The Federal Reserve tried to present itself as a firm supporter of an anti-inflationary policy. It organized new political networks, such as the Shadow Open Market Committee, and made certain arrangements

with some of the supply-side thinkers in Congress to defend its own independence as a central bank. Amid controversy, the FOMC discussed the monetarist approach to the central bank's action and the consequences of setting the nominal interest rate in the short run. The FOMC considered specifying desired short-run growth rates for M1, M2, and other monetary aggregates, which were then to be structured for the associated non-borrowed reserves and monetary base.

Volcker portrayed the switch towards a monetary target as being a 'new technique' in order to let the public and the market know that the Federal Reserve Board stood ready to control inflation. This 'new technique' implied new wording, an 'alternative language is also provided for placing main emphasis either on monetary aggregates or on money market conditions' (Bluebook, March 1979, 17).

Volcker declared optimistically that this new technique would also build in a mechanism to guide interest rates in the direction the FOMC wanted:

> The ... possibility is a change in the emphasis of our operations as outlined in the memorandum that was distributed, which I hope you've all had a chance to read. That involves managing Desk operations from week to week essentially, with a greater effort to bring about a reserve path that will in turn achieve a money supply target – which we have to discuss – recognizing that that would require a wider range for the Federal Reserve funds rate and would involve a more active management of the discount rate. And of course the question of reserve requirements and the discount rate change at this point are relevant in that context too. (FOMC Transcript 10/06/1979, 8)

However, doubts remained on the agenda of the FOMC meeting concerning the new technique and how it would influence the Federal Reserve funds rates, the various interest rates in the money market, and inflation expectations. Wallich, for instance, considered the relation between the procedure of money supply and interest rate movements:

> Upward we can control [through] money supply. We're aiming at the tight money supply and that raises interest-rates – or that is what we [are talking about]. But downward has a totally different implication. It involves a signal that we've switched policy and the markets are going to respond accordingly. ... But we need to watch this strategy in terms of what it produces for interest rates and for the exchange

> market so that we don't get surprised by interest rate movements when they could be harmful. (FOMC Transcript 10/06/1979, 19)

Volcker responded that the movement of interest rates, which depends upon the money supply, can neither be anticipated nor controlled:

> Let me just make a couple of comments. I'm not sure it's self-evident that in interest rate terms the new technique is stronger. It may or may not be, depending upon what happens to the money supply. I think that is inherent to the new technique. We will never know the answer, no matter how long we talk, to what the money supply actually will do in coming months. (FOMC Transcript 10/6/1979, 20)

The debate over the adequacy of the new monetary operation, which dominated the agenda of the FOMC meetings between 1978 and 1982, can be headed under central questions, such as the following:

1) How will the banking system make its decisions on liquidity management and excess reserves, and how will this influence interest rates in money markets?
2) Will the new strategy of money supply by operational monetary targets enhance or minimize the uncertainty in the market?
3) Is the new strategy an adequate approach to rebuilding the credibility of the Federal Reserve System?
4) What consequences for the United States and the U.S. dollar can be anticipated regarding domestic and foreign markets?

Volcker pointed out the advantages of 'triggering a faster response' in adapting money supply in the event the economy changed. The outstanding advantage would be that the new technique would be better understood by the market, public, and banks.

Even prior to taking office as chairman, during his time as vice chairman of the Fed, Volcker regarded the new perspective on monetary aggregates – even without precise numerical targets – as the most convincing strategy in times of high inflation expectations:

> I don't think that [money] target itself, though written in our records, is written in heaven, given all the uncertainties that we had when we set it. ... [T]he exact level of the aggregates isn't quite as important to me as the movement on the funds rate. I'd like to make some gesture there. (FOMC Transcript, 3/20/1979, 28–29)

The assumption that by focusing on monetary aggregates the FOMC would also be successful in guiding the economy towards price stability was then repeated by Chairman Volcker:

> Let me try to describe the so-called new system, as I understand it, in an unprejudiced way. ... The base theory of this procedure is that the committee could decide – in this case only through the end of the year – on some monetary supply targets. ... Now, our concept of the process is that those money supply figures that were chosen would be converted into a reserve base number. (FOMC Transcript, 10/6/1979, 24–25)

Volcker admitted that the exact definitions of total reserves, borrowed, and non-borrowed reserves, might be neither convincing nor necessary. Which target should be used? Total borrow? Do we have one reserve target or 'multiple targets'? These and similar questions were put on the agenda of meetings and seen as steps towards the Fed's goal of winning the battle against inflationary expectations. A few months later, Volcker asserted that while the total reserves are not controllable, the non-borrowed reserves are controllable and, hence, were the focus of the new strategy (FOMC Transcript, 1/8–9/1980, 16). In a broader sense, the new technique was declared a new method in decision-making procedure:

> [S]uppose we happen to put a lot of weight on the current projection of the money supply and pick figures that would closely coincide with that. We would then provide, making some assumption on the level of borrowing that seemed to be consistent with the level of interest rates that presumably laid behind the projection of the money supply in the first place – we can't avoid interest rate assumptions the way these things are done – non-borrowed reserves along that path. (FOMC, Transcript 10/6/1979, 25)

Volcker defended the new technique as a means of rearranging the basis of the entire decision-making process of the FOMC, setting the Federal Reserve funds rate in a gradual manner:

> We used to operate with very tiny changes in Federal Reserve funds rate from time to time, or between meetings certainly, and not very large ones even at a meeting. There is no doubt that we have changed; in my opinion, the emphasis is quite different now. (FOMC Transcript 1/8–9/1980, 64)

Furthermore, another advantage was explained: the decision would be made 'in terms of money supply', not in terms of 'interest rate music' (FOMC Transcript 1/8–9/1980, 64). The Feds declared that a shift from concepts of interest rate policy towards monetarist concepts like monetary aggregates or monetary markets would be understood by the public as signal words towards anti-inflationary policies and should therefore direct expectations of inflation downwards. Lindsey et al. (2005, 191) stated, 'This nuance was a significant issue in the minds of many FOMC participants.'

Volcker mentioned several of the disadvantages as being noteworthy. However, he linked these disadvantages to particular cases which could occur, but not to the new technique in general. He specifically pointed to three particular disadvantages: a) the current fragility of financial markets; b) the unexplained determination of money demand and money supply; and c) uncertainty regarding the new monetary operations.

Because of the fragility of the financial market it was presumed that the new technique would minimize the high volatility of the funds rates. Volcker addressed this with several considerations:

> The other element, of course, is that we are not dealing with a stable psychological or stable expectational situation by any means. And on the inflation front we're probably losing ground. In an expectational sense, I think we certainly are, and that is being reflected in extreme volatile financial markets. (FOMC Transcript 10/6/1979, 6)

Volcker expounded further:

> My feeling was that by putting even more emphasis on meeting the money supply targets and changing operating techniques [in order to do so] and thereby changing psychology a bit, we might actually get more bang for the buck. By that I mean our having a more favorable impact on psychology and perhaps a more favorable impact on banks by introducing a little uncertainty per basis point of rise in money market rates than would be possible through the traditional method. (FOMC Transcript 10/6/1979, 8)

This view was supported by another member of the FOMC, Emmett Rice. The new technique would lead to a 'new uncertainty' which was judged to be welcome. The new uncertainty was interpreted as a way of 'cooling down speculative actions and inflationary expectations'. Rice argued in favour of letting the FOMC work against markets. He also

mentioned some risks of the new uncertainty and of this way of acting against the market. Nevertheless, he judged this to be insignificant compared with the advantages:

> I think that if we moved to a technique where we decide what the money supply should be – and we operate directly on the reserve base to get as close to the level of aggregates that we want – we would stand a better chance of producing the kinds or results we would like to see. The good thing about moving to this operating technique is that, contrary to some of the views that have been expressed, we introduce a new uncertainty into the market. I think that's a good thing. The new uncertainty will have the effect of cooling some of the speculative activity and perhaps have an impact on those demands for credit that are based purely on inflationary expectations and on the assumption that money will always be available at any level of interest rates that the Fed tries to establish. (FOMC Transcript 10/06/1979, 22)

The members of the FOMC discussed the fear that the banking system seemed inclined to avoid debt. It would create high liquidity or excess reserves instead of lending money. This could then undermine the goals of the Federal Reserve. A further crucial measure was the setting of the level of non-borrowed reserves which were to be taken as the average of borrowed reserves in recent weeks and subtracting them from the total reserves: '[A] serious disadvantage that has discouraged policy-makers from entertaining such policies in the U.S., however, is the unpredictability of velocity that at times decouples stable money growth from stable income growth' (Orphanides 1999, 32).

With respect to the unexplained determination of money demand and money supply, Wallich drew parallels between the 1930s and his era, the 1970s. He admitted not knowing what the FOMC in the 1930s really wanted to do. The majority of the actions of the FOMC failed at that time because the commercial banks had avoided bearing the risk of lending, having built up high liquidity reserves. The FOMC was powerless. The consequences were a sharp increase of interest rates in the money markets followed by a recession. According to Wallich, these seemed to be analogous to current circumstances. He raised some doubts and objected to the optimism with which the new technique had been introduced in the 1970s. He referred to current criticisms from home and abroad, and explained that reliance on the new technique had been accompanied by neither a common support nor understanding, but

rather by the fear that the United States was returning to the 'rules of the game', that is, to the gold standard and its failures (FOMC Transcript 1/8–9/1980, 7).

Volcker welcomed hearing these criticisms and differing opinions during the FOMC meeting, stating it was necessary to achieve more clarity on the new technique. However several objections remained on the agenda during the following FOMC meetings. Some objections dealt with the presumed inherent relationship between money supply and the movements of interest rates. Other objections were concerned with the interplay between changes of the non-borrowed reserves and its effect on the interest rates in the money market, which were still unexplained. Other criticisms being raised addressed the imprecise definitions involved, the demand functions of the borrowed, non-borrowed and excess reserves and the attempt to calculate each with numbers in order to use them as targets.

Mark Willes expressed his reservations regarding the reaction of the public and the press:

> I'll start out by saying that I don't pretend to understand the procedures, so my comments are probably way off the mark. But the discussion fascinates me. It strikes me very much like the discussion one reads in the paper each morning where people are explaining what happened in the stock market. They always have some specific reason for why the stock market did what it did. I don't think we really know how all these demand functions – for excess reserves, borrowed reserves, non-borrowed reserves – are changing in the short run. ... I feel very [un]comfortable with the situation where we think we can operate on a reserves basis the same way we were operating on a Federal Reserve funds rate basis. I think the two are very different kinds of procedures; we can't move from a federal funds target to a reserves target and make all these very refined calculations and adjustments. (FOMC Transcript 1/8–9/1980, 8–9)

The demand for exact definitions and greater clarity on the new technique – as outlined in the quote above – also underlined the need to step beyond traditional concepts and definitions. Uncertainty was not only in 'the air' because of the expectation of rising inflation but also because of a new terminology. The FOMC changed its technique by creating new definitions of monetary aggregates (for instance M1, M1-A, M2, M2-B), details of which the money market lacked understanding. Additionally, the FOMC itself did not know if and how the markets

understood the new technique. Therefore, an overall lack of common understanding was 'in the air'. At this point, what function could a money growth target have, given the uncertainty of projections and the absence of a clear path? Regarding the procedure of judgment under uncertainty, Volcker stated:

> We live in an uncertain world. And in view of fluctuating projections regarding the trend in the money supply, our first point of judgment would arise – let's say particularly in the present circumstance – because we might get some ease in the money market immediately if we did nothing but follow the path week by week. If we thought we were going to have trouble later because the projection [has money growth] going above [our targets], we would under-supply reserves in the current week to provide some assurance that we're going to cope with the fluctuation later and not have borrowings running ahead of what we'd assumed. ... As the borrowing fluctuates, they would themselves be reflected in interest rates. (FOMC Transcript, 10/6/1979, 25)[4]

Since the problem of inflation still dominated public attitudes and attention, the approach to the new monetary strategy was criticized by the public and economists. Greenspan asked 'whether, if unemployment begins to climb significantly, monetary authorities will have the fortitude to "stick to the new policy"' (*Wall Street Journal* 1979). The historical background of this epoch was the experience of stagflation in most of the industrialized countries, which led to theoretical upheaval and transformed key premises, for instance to the Rational Expectations Hypothesis (REH) (Mayer 1997; Mishkin 1995).

According to the history of macroeconomic theory, we observe that while the macroeconomic literature was mainly concerned with the REH and the 'Lucas-Critique', the literature on the international monetary system was focused on the nominal anchor by outlining different frameworks of international monetary coordination, that is, coordination of nominal interest rates (Muchlinski 1999b). The so-called triumph of the monetarist view over the Keynesian view at that time was primarily based on attributing blame to the Keynesian view and interest rate policy. The signal given by setting the nominal interest rates was interpreted as being misleading to market participants and should have been replaced by a specific signal, that is, a number of the quantity of money, in order to stabilize inflation expectations. The Federal Reserve was accused of having used the Federal Reserve funds rate as

an inappropriate operational target, which encouraged a repeated overshooting of monetary objectives (Meulendyke 1998, 49).

The orientation towards monetarist theory and the vision of steering monetary policy by monetary aggregates was attributed to the spirit of this monetarist 'counterrevolution'. According to the third interpretation, the Federal Reserve had never pursued the monetarist view, since it had already guided monetary policy by setting nominal short-term interest rates. In the literature, the conclusion is that the Fed could not avoid setting the nominal interest rate in order to implement its monetary policy.

Of course, this interpretation is supported by Keynes. In the 1930s, Keynes described monetary policy as follows: 'The banking system has no direct control over prices. ... Nor has it, in reality, any direct control over the quantity of money; ... the governor of the whole system is the rate of discount' (Keynes, 1930, 189). By that time Keynes had already worked out the interdependence of interest rate policy, monetary policy, and exchange rates – four decades before any monetarist attacked the Keynesian theory:

> The short-term rate of interest is easily controlled by the monetary authority, ... because it is not difficult to produce a conviction that its policy will not greatly change in the very near future, and also because the possible loss is small compared with the running yield (unless it is approaching vanishing point). But the long-term rate may be more recalcitrant when once it has fallen to a level which, on the basis of past experiences and present expectations of *future* monetary policy, is considered 'unsafe'. ... (Keynes 1936, 203).

This view is reiterated precisely in the modern view of central banking regarding central bank practice. In the 1970s, the Keynesian view was accused of being an anomaly of macroeconomic theory. Blinder emphasized the importance of interest rates in that period of history, which is also true for monetary policy today because the pervasive uncertainties that surround monetary policy cannot be discussed in terms of the rational choice paradigm (Blinder 1998, 25).

The Federal Reserve 'monetarist experience' was in fact a new approach to the changes of its communication policy. Beyond the new commitment based on the Humphrey-Hawkins Act it was remarkable that the FOMC repeated its efforts to restore a non-inflationary base for economic growth in its statements and releases to the public. 'Was Volcker "a great communicator"?' inquired Lindsey et al. (2005, 227) in

their study. The answer is that Volcker initiated a new strategy of information policy which undoubtedly generated another mode of communicative interaction between the FOMC and the markets.

Although the Federal Reserve cannot be described as 'a paragon of community' (Lindsey et al. 2005) or a paragon of clarity, the textual evidence I present in this chapter shows that new definitions and terminology as well as the FOMC's own considerations of whether and how the public understands what the FOMC is doing or talking about, were the key focus of that new technology. The citations in this chapter are to be read as examples of a very significant epoch of the FOMC's work. The FOMC was concerned with the creation of new definitions and concepts and a distinct approach to a deeper understanding of a highly complex and discretionary monetary policy. The controversy about following a rule or rules based monetary policy was more the focus of the public's commentary than of the sessions of the FOMC itself, because the need to judge distinct situations was uncontested. Also, the FOMC acknowledged discretionary elements of the new technique inevitably connected to it, while the public seemed to expect the new technology to be based on a rigidly fixed rule. It should be noted that the term 'rule' was first of all associated with the 'rules of the game' of the gold standard, that is, with a particular exchange rate regime and monetary experiment in the 1920s and 1930s.

The meaning of the term 'rule' has changed dramatically since then and, in particular, as a result of different uses of the term (Issing 1996). Lindsey et al. (2005, 222) emphasized that the term 'rule' did not always mean what it means today – the Taylor rule or Friedman rule for instance. Apparently Volcker did not use the term 'rule' in the traditional meaning, which might have contributed to the initial widespread confusion in the market. However, Volcker did not provide another definition. He made it clear that following a rule implies the need to base judgments on different circumstances or situations. It is important to acknowledge that the FOMC created the meaning of its new terminology, not new technology, via several adjustments to its implementation. The FOMC transcripts from 1979 to 1983 deliver interesting examples testifying that Volcker responded as cautiously as possible to certain demands for exact or numerical definitions.

The FOMC under Volcker introduced its new technique by an information policy which was itself under construction or should be seen as experimental. It published testimonies, including the speeches of the board members and the Reserve Bank presidents. It opened up new discussions on central banking and monetary

policy in the Humphrey-Hawkins Act. It provided staff reports, bulletins, and articles to the public, and gave media interviews. It initiated a new mode of communicative interactions: 'Officials of the Federal Reserve Bank of New York held separate meetings yesterday with reporters and securities dealers in an effort to clear up some of the confusion surrounding details of the Federal Reserve's anti-inflation techniques announced Saturday. The Fed doesn't plan to be 'rigid or mechanic' in pursuit of bank-reserve targets (in Lindsey 2005, 205).

> 'This may cause some die-hard monetarists to subdue their elation at our change in approach and recall their congratulatory message,' he said. ... When the reporter asked which rates the public should watch for clues to Fed thinking, Mr. Sternlight replied: 'I'm not sure I have a ready substitute to proffer at this point'. He emphasized that 'we're still very much experimental' at this stage. Mr. Sternlight said one key figure the Fed would pay attention to is 'non-borrowed reserves'. But he emphasized that the Fed won't rely exclusively on this and plans to remain flexible in its approach. (*The Wall Street Journal*, October 10, 1979; in Lindsey 2005, 205)

In subsequent interviews, the FOMC avoided specifying rules or definitions of its new technique. Through such conduct, the FOMC obviously disappointed the expectations of market participants because the market had expected to receive exact rules or numerical targets on which the new technique would be based. The opinion arose that the FOMC was trying to play a game against the market in order to fool it. Market participants accused the FOMC of not being predictable:

> 'Anybody looking for a rule of thumb is going to be frustrated', the official said in an interview that sketched a picture of a more flexible – and probably tougher – Fed. 'There are still going to have to be policy judgments made', the official said, indicating the central bank 'isn't going to trap itself by following any rule'. He said the Fed will try to steer between the 'two extremes' of its old practice of inching the Federal Reserve funds rate up and down and 'letting the funds rate go anyplace forever'. (*The Wall Street Journal,* October 10, 1979; in Lindsey 2005, 206)

Lindsey argued that the Federal Reserve Bank began its transparency policy with that monetarist experiment. The question of how and if the

public understood what the new technique implied was placed on the agenda of the FOMC.

Regarding the bond market, the banking system, and their endowments with new credits, Volcker mentioned some restrictions on the bond market and also restricted the access of some of the market participants. He added that a lot of confusion and uncertainty in the markets is engendered by different definitions and concepts of monetary growth rates, and 'all that measures' of reserves and monetary aggregates (FOMC Transcript 2/4–5/1980, 45). Volcker suggested submitting to a press briefing in order to explain the changes of the various definitions in pattern, but this was 'not to give the targets' itself (ibid). A discussion of numerical seasonal targets should not be published. 'If policy fails, we can always revise the seasonal adjustment factors for a while! [Laughter]' (ibid).

Other members of the FOMC supported Volcker in his view that the monetary targets – that is, the numerical targets for M-1A and M-2B – were much more important to explain to the public than the projections of the borrowed and reserve targets. Volcker considered the latter in a more technical way and proposed defining them only in a technical sense. On this point, Bob Black referred to another crucial aspect concerning the discrepancies of private forecasts and the forecasts of the FOMC regarding the prospective level of the Federal Reserve funds rate (ibid). He spoke of the problem that the economic outlook expected a more recessive economic development. The forecast of the Federal Reserve funds rates of 13 percent by the FOMC and of 10 percent by private institutes underlined the distinct views and expectations on the economy both had.

Additionally, John Balles argued for the need to give more attention to the public's perception and to try to minimize these differing views between the private sector and the FOMC via a change in information policy (ibid). He referred to the rise in long-term bond yields as an important indicator of expectations of rising inflation in the market. He argued for the need to face public reaction to the current FOMC policy in order to gain greater clarity on it. The FOMC should figure out if and how the public shared the view of the FOMC regarding the economic outlook, employment, prospective interest rates, and inflation expectations. Balles argued the public's understanding of what the FOMC was doing, or going to do, was of high relevance to the success of the new technique. He also suggested that a broader range of the monetary growth target would provide the Federal Reserve Bank with greater flexibility in its responses to market reactions. The FOMC

needed to face the public reaction because:

> The public pays more attention to what we do than to what we say we are going to do. (FOMC Transcript 2/4–5/1980, 48)

The debates over how market participants perceived and understood the new technique were key issues in the FOMC transcripts.

Larry Roos, for instance, argued in favour of greater openness and a distinct information policy leading to a more flexible response by the market. Market participants did not understand and were hesitant to act or commit themselves to a decision. Roos recommended producing a publication in order to support the market's understanding of what the Fed was doing or going to do:

> I wonder if some of the lack of dynamism or some of the sluggishness in this whole process might not be a reflection of the fact that large segments of the markets aren't quite sure exactly what we're doing. That leads me to the question ...: What would happen if we specifically and publicly described what our paths are – or at least some of our paths – so that the market could adjust to what they know our game plan really is instead of feeling that there's some vague thing going on that they're not sure of. Their reluctance or lack of reaction may be due in part to the fact that people don't want to stick their necks out in the markets until they really know what our reserve path is or what our monetary base path is. What are the negatives to defining those things publicly? (FOMC Transcript 1/8–9/1980, 9)

Volcker responded with caution to these requests for greater openness and a switch to another information policy. He expressed doubts that a disclosure of information – the adequacy of which the FOMC was still debating – would be very edifying to the public. To put it another way, he rejected the pretence of clarity or exactness on issues which were anything but exact or clear at all. He tried to balance the different arguments and considered different perceptions. He accepted some suggestions made about the public's concern over inflation and how that concern differed from the view of the FOMC. He also admitted that he perceived 'an immense amount of confusion in the minds of the public' (FOMC Transcript 4/22/1980, 22):

> Let me distill a bit what I think I'm hearing and what I'm thinking. The big change we've had – though we've had a lot of changes since

> the last meeting – is that we certainly have some evidence of economic decline that we didn't have before. I for one still think it's a little premature to make very conclusive judgments about what kind of a recession we're going to have. I'd say also that it takes a little while to meet the definition of a recession. We've been fooled before. (FOMC Transcript 4/22/1980, 21)

Volcker behaved with the utmost caution when it came to traditional and new definitions and concepts. Since the crucial economic indicators – like tax refunds and prospective consumption, the car business, imports and exports, and the credit situation – were seen as an atypical pattern of economic performance, he pointed to the uncertainty surrounding the FOMC's decision-making process. Nothing could be judged as familiar or known for a long time:

> All I'd say is that there is some uncertainty, particularly when one looks at the other side and the inflation side. Two months ago everybody was going for leather and wanting to buy in anticipation of inflation; I think that mood has changed. ... And looking at a longer-term perspective, there's no question in my mind that in considerable part inflation is what got us into this dilemma. And it is recognized as a major problem. ... In that sense I don't think we're in a situation where there's any course of action that is risk-free or even in some sense a 'winning' course of action because there's a lot to be lost by a resurgence in inflationary expectations and there's a lot to be lost by accelerating the recession; and I'm not sure that there's any real room between those two contingencies. It has been implicit in everybody's comments that we have to keep our eyes on both [inflation and recession] as best as we can. (FOMC Transcript 4/22/1980, 22)

The open questions regarding these unknown patterns of economic indicators led to extensive contributions in economic literature, indicators later defined as 'stagflation' – the coincidence of inflation and economic stagnation. This new phenomenon occurred at the time the 'monetarist experiment' was undergoing implementation. It was not only hard to figure domestically in the United States, but also internationally. Neither the FOMC nor Volcker could have known what the domestic or international markets were anticipating at that time because all industrialized countries were confronted with this new problem.

The economic indicators represented no overall pattern. Inflation, for instance, had risen during the previous months, and also indicators

of recession had been significantly driven upwards. Volcker referred to the economic indicators as 'attitudes' which fluctuate 'rapidly'. It was precisely these unexplained attitudes and behaviours of the financial markets which created additional uncertainty in the decision-making procedure:

> I do have the feeling in listening to some of the different economic forecasts and comments that our staff, which is sometimes accused of being Keynesian, feels more constrained by the money supply assumption than more monetarist oriented people. And that accounts for some of the differences in view. Assuming that we're all intelligent people around the table, [given the] differences in outlook that have been recited, I don't see how anyone can come to any opinion other than that there is a great deal of uncertainty in this forecasting business. (FOMC Transcript 2/4–5/1980, 44)

Volcker raised the prospect of international problems which were of concern to the central bank's responsibilities because they were beyond the scope of monetary policy and, hence, the FOMC. He said:

> In terms of what we have accomplished or have not accomplished in monetary policy in recent months ... and have suffered a grievous blow from everything that has been going on internationally – whether you're talking about oil prices, or Iran, or Afghanistan and concern about defense spending. There is nothing much we can do about that, but I think in some sense we're back to square one or worse in terms of the public's concern about inflation. ... In fact, I don't think we can deal with the risk of a downturn and ignore the inflationary side, because they're part of the same parcel in some sense. (FOMC Transcript 2/4–5/1980, 44)

The Federal Reserve was aware of both higher prices and unmistakable hints of a recession followed by a higher level of the Federal Reserve funds rate. The FOMC's conference on March 7, 1980, threw light on the procedure of agreement to raise the upper limit of the Federal Reserve funds rate while the lower limit would remain as it was. The divergences were assigned to the lower limits. While some members voted to enlarge the range for the movement of the Federal Reserve funds rate from 14 to 18 percent to the range of 11 to 18 percent, others argued this range was verging on the absurd. The lower limit of the Federal Reserve funds rate indicates the willingness of the FOMC to keep the monetary aggregate

in line with the posture of the monetary aggregate targets. It was argued that 14 percent rather than 11 percent was a proper lower limit. With a recession 'in the air', this level of the Federal Reserve funds rate also threatened a highly probable credit crunch and higher unemployment. Chuck Partee at the FOMC conference call in March 1980 argued:

> It has called for higher rates and could call for still somewhat higher rates in the period to come and we ought to have room to move if that's necessary. Looking a littler further ahead, as the financial panic leads to deep recession I think we'll need considerably lower rates and we ought to keep open the room for doing that in order to get the aggregates that we've said we were going to get. (FOMC Transcript 1980/03/07 conference call, p 6)

Volcker responded:

> We'll strike that last comment – [the 'recession'] word in that last comment. (ibid)

According to the debate in the FOMC the increase of the Federal Reserve funds rate would underline their responsibility for an anti-inflationary policy. The effects on the interest rates and the recession in the United States as well as in all industrialized countries were significant in the following month (see Lindsey et al. 2005):

> The Federal Reserve took short-term rates from around 11 percent in September 1979 to around 17 percent in April 1980. This was the most aggressive series of actions the Federal Reserve has ever taken in a short a time, although the roughly 5 percent increase in short rates from January to September of 1973 was almost as large. (Goodfriend 1997, 13)

Against the historical background outlined above, the Federal Reserve had started to combine the new monetary technique with a new commitment to report its decision to the public. The Federal Reserve tried to combine the new commitment with the strategy of 'base-drift', that is, of changing concepts and definitions to be reported to Congress. A 'base-drift' emerges if there is a deviation from the monetary policy goal. The public had already been confused by the declared new monetary procedure, therefore the new commitment to reports based on changing definitions led to a greater uncertainty and confusion.

However, I think the textual evidence of the debates in the FOMC do not support the interpretation that the FOMC deliberately tried to confuse market participants by its 'base drift'.

While Poole proposed the Federal Reserve should enlarge the corridor of the monetary target in order to avoid big jumps, Goodfriend identified the roots of the 'base-drift' as a credibility problem of the Federal Reserve (Goodfriend 1989; Poole 1996). The Federal Reserve was irritating the public. In contrast to Goodfriend, Charles Walsh diagnosed that 'base-drift' was an accurate answer to the monetarist view of monetary policy which systematically ignores changes in money demand (Walsh 1986). Only within a monetary view is such a 'base-drift' credible because it is required:

> The most likely explanation of these changes is political rather than technical. The Federal Reserve had decided that inflation had reached crisis levels and had to be controlled at almost any cost. As many authors have noted, the new operating targets were a useful smokescreen that obscured the link between the Federal Reserve's actions and the painful increases in interest rates. (Bernanke/ Mishkin 1992, 12)

Nevertheless, the details of 'this useful smokescreen' (ibid) remained obscure for reasons due not just to the complexity of the monetary technique, but rather to the lack of knowledge concerning these new techniques which the Federal Reserve itself was confronted with. To declare a monetary growth rate strategy and also declare the replacement of the Federal Reserve funds rate by the non-borrowed reserve was without doubt a clear goal, but there was no way to implement such proposed policy rules (for reasons outlined in the previous pages). Although it is argued in the literature that the Federal Reserve did not explicitly explain the details of its declared monetary strategy, it should be noted that the Federal Reserve's information policy was as precise as it needed to be regarding the function of the Federal Reserve funds rate which was not replaced.

With regard to the question I raised at the beginning of this chapter, 'monetarist experiment' or 'smokescreen'? Brunner (1981) described the period of the Federal Reserve, using the terms 'mystique', 'secrecy' and 'central banking as an esoteric art' to point out its missing ability or willingness to remove the veil of deception. According to Brunner, the central bank's mystique arises out of its avoidance of clear descriptions of communicative interaction with financial markets. Against the

historical background as outlined on the previous pages, the Federal Reserve's information policy was restricted by its attempt to act independently from policy, and its limited knowledge of the newly introduced technique (Muchlinski 2001a).

Lindsey also admitted the existing lack of clarity of the new techniques and methods regarding the concepts needing to be defined and applied in targeting the money growth rate. The terms and concepts were not precisely defined: for instance the concepts of 'rule', of 'discretion', or even 'monetary target', 'monetary aggregate', 'M1', 'M2', and so forth. Lindsey posited that the term 'mystique' is embedded in the monetarist experience and linked to that context. Nevertheless, Lindsey accepted that the Federal Reserve and Chairman Volcker were communicating in an adequate way regarding the difficult tasks of targeting and defining the monetary growth rate by steering the money supply. As the textual evidence suggests, this experimental episode at the end of the 1970s, and the FOMC's inclination to 'monetary mystique' and 'secrecy', were linked to the problem that the FOMC had difficulty anticipating the reactions and the understanding of the public to its disclosed information (see also Tabellini 1987):

> The FOMC argues that the Directive is written in 'terms of art' that are vague and cannot always be accurately interpreted. But this problem could be dealt with by making the language of the Directive more explicit and intelligible. ... The FOMC argues that because it has no experience predicting market response with disclosure of the current Directive, policymaking with disclosure would be difficult. (Goodfriend 2003, 173–189)

The process of working out the meaning and understanding of information requires interaction with the audience to which the information is addressed, for instance the media, analysts, politicians, and agents of financial markets. The audience, therefore, is interested in different information. Whereas politicians are focused on information related to political matters, the analysts pay more attention to information relevant to the movement of certain economic variables.

Greenspan explained that the understanding arises out of the communicative interactions between both inside analysts of the Federal Reserve and outside analysts, that is, key players of the financial markets. The results of this information are used to refine the FOMC model to estimate and judge the likely results of its policy – the understanding and meaning. Greenspan provided a description of 'risk management

policy' by emphasizing that in times of panic, recession, or liquidity crunch, the central bank should immediately lend liquidity 'to all that bring good securities quickly, freely, and readily' (Greenspan 2004, 38). It detracted from the wisdom of the 'open window policy' (Bagehot, 1873), introduced as the iron law of central banking not to act in that way.

Blinder emphasized that whether or not Volcker did pursue the declared targeting of monetary growth rate, 'money-supply targeting can be hazardous to a nation's health' (2005, 4). Blinder argued that Volcker and his colleagues overlooked the fact that the success of money policy depends on a central bank's *interactions with the markets*. Therefore the so-called monetarist experiment could be described as an epoch in which the Federal Reserve Bank was becoming suspect because of contradictions which arose out of its declared strategy, its perceivable – and contradictory – monetary practices, that is, interest rate changes, and also perceptions of all this by agents in the markets, who demanded a consistent explanation of what was going on instead of such a 'wishy washy' strategy.

Blinder (2006, 12) maintained that the metaphor used by Brunner merely depicted a caricature of central banking which encapsulated the key message of that time: 'Say as little as possible, and say it cryptically. Attitudes toward transparency have changed dramatically since then, and central banks around the world have opened up.'

Blinder emphasized that the Greenspan era provided plenty of examples of consistency in the meaning and understanding of the central bank's policy. The central bank let the bond market do its job regarding expected changes in interest rates. Interaction also implies that the market does not intervene, that is, does nothing. In describing Federal Reserve policy from January 1996 to June 1999, Janet Yellen and Blinder once labelled this non-active behaviour, or silence, as 'forbearance'. Although the unemployment rate fell under the Non-Accelerating Inflation Rate of Unemployment or NAIRU rule, the Federal Reserve did not raise the Federal Reserve funds rate. From this it can been seen that remaining passive and silent can be an accurate way of acting and can have greater results than trying to act in the ways described in economic textbooks (Blinder and Reis 2005).

Central banks at times practice not speaking for a while in order to avoid speculation about changes of interest rates (Ehrmann and Fratzscher 2008). These times of selective disclosure policy or relative silence – lasting about seven or eight days – concern the monetary policy issues before the meeting and shortly after the meeting of the Monetary Policy Committee (MPC) of the Bank of England and FOMC

and are described as the 'purdah-guideline'. The authors emphasized that the effect on market variable in the purdah period depends on the characteristics of the last statement in the pre–purdah period and the statements during the post–purdah period. The statements during the purdah period are defined as conditional statements according to the effect measured by changes of the levels of interest rates in the money markets. In other words, the mode of the communication policy of the MPC and FOMC is a *changing one*.

In my view even the terms 'mystique' and 'communication' seem to lack clarity. Whereas Brunner associated 'mystique' with the missing ability and willingness to explain monetary strategy in detail, I would rather propose defining 'mystique' as the central bank's way of communicating with the market in a manner different from what was then expected. We are used to saying 'X is a mystique' because we have no understanding of what is going on, and perhaps we do not want to understand it. The proposition 'X is a mystique' also indicates something that is supposed to contradict our norms. This is also true regarding the 'esoteric nature of the art' of central banking. Therefore, 'monetary mystique' cannot be assigned to non-communication but rather to the view that the meaning should be discovered beyond the context in which the action takes place. The meaning of words or sentences and of understanding is rooted in communicative interaction, or action (respectively non-action) in context. It was Paul Watzlawick and his co-authors who revolutionized thinking in terms of communicative interaction (Watzlawick, Beavin et al. 1967). Their important conclusion is that *it is not possible to avoid communication*. Even if a central bank hides itself behind 'the secrets of a temple' or 'mystique' or 'silence', it nevertheless adheres to a certain kind of communicative interaction or style, because a so-called non-action is also to be perceived as an interaction, that is, the avoidance of interaction. It is additionally important to accept the relevance for economics of this research in order to perceive the differences central bank interactions make and to illuminate the need for shaping a central bank's actions.

To summarize: 'Monetary mystique' refers to the monetarist experiment. 'Monetary mystique' is not identical with non-communication, but rather addresses the view that meaning and understanding do not arise *beyond* interaction with agents of the financial markets and the central bank. Moreover, 'mystique' is not identical with 'secrecy'. 'Secrecy' is important according to the modern paradigm of central banking. As I will outline in the next chapter, the achievement of transparency and credibility can be defined only as a *degree of transparency* or *degree*

of credibility. Therefore 'secrecy' is inherent to both. The terms 'mystique' or 'monetary mystique' coined by Brunner imply the assumption that the meaning and understanding of actions arise *beyond the context of central bank practice*. It is only this assumption that generates 'mystique' or 'monetary mystique'. A central bank which is supposed to act beyond the market has no success. The reason for this is simple: every action or non-action, any decision or non-decision, manifests itself within a particular pattern of interaction. It is not credible, then, to posit that a central bank acts as an isolated institution or with a hidden agenda.

1.2 The new paradigm of the modern central bank

> A central bank is invested with enormous power over the economy; and, if it is independent, that power is virtually unchecked. This authority is a public trust assigned to the bank by the body politic. In return, the citizenry has a right to expect – no, to demand – that the bank's actions match its words. To me, that is the hallmark of credibility: matching deeds to words. (Blinder 1998, 63–64)

This chapter outlines the implications of the modern paradigm of central banks, which can be characterized by the consideration 'matching deeds to words' (Blinder 1998) and 'we do what we say and we say what we do' (Issing). This formulation concerns the evolution of the meaning and understanding of the communicative interactions of central banks within their politico-economic and social context. I should immediately point out that the concern of this book is not, in fact, with questions such as *why*, *how*, *where,* and *when* a central bank should be transparent. Extensive work has already been done on these issues, which need not be repeated here (Blinder et al. 2008; Thornton 2002). To sum up this issue (which has opened up an extensive debate in the literature), transparency should enhance the effectiveness of monetary policy, that is, price stability, growth, and employment. Some authors maintain that the announcement of the Federal Reserve funds rate, being crucial to transparency, enhances understanding of the central bank's strategy and, hence, its credibility with respect to low inflation (Ferguson 2001; Poole 2003). Others argue that communication creates transparency (Bernanke 2004a; Blinder et al 2001; Fracasso et al. 2003; Freedman 2002; Friedman 2003; Jansen and de Haan 2006; Kohn 2005a; Muchlinski 2005; Schmidt 2005; Schmidt and Ullrich 2006).

There are comprehensive volumes in the current literature on the subject of transparency, dealing with its various aspects in great detail. Most are concerned with the considerations of a central bank's information policy regarding the political, economic, procedural, policy, and operational dimensions of a central bank (Cukierman 2002; Eijffinger and Geraats 2002, 2005. Information policy as a crucial component of transparency is also expounded on by authors particularly concerned with forecasting (Berger, de Haan and Sturm 2006; Chortareas, Stasavage, and Sterne 2002; Ehrmann and Fratzscher 2009; de Haan and Sturm 2009; Ullrich 2006). Expected changes in the Federal Reserve funds rate affect the prices of bank loans, bond rates, and mortgage rates and, hence, will in the long-run influence house prices, wages, and expectations about inflation in the economy. Therefore, as a means for an improved information policy, transparency is welcome. A few contributions focus on the institutional framework of central banks and how transparency could improve the efficiency of monetary policy (Amtenbrink 1999; Cecchetti and Krause 2002; Issing 2008).

Since the transparency of a central bank (i.e. an institution) is tied to its objectives and its mandate, the question of *how* a central bank discloses information to the financial markets has been discussed (Poole, Rasche, and Thornton 2002). Some authors draw attention to different forms of articulation, for instance written information, upon which the central bank relies when giving information to the public (Fracasso, Genberg, and Wyplosz 2003). Other contributions focus in particular on the decision-making process, for instance Blinder and Morgan (2005), and Ehrmann and Fratzscher (2005b). However, I will refer to some of these prior contributions because the new paradigm cannot be discussed without them. In my view the consideration 'matching deeds to words' and 'we say what we do and we do what we say' is the *key* concept to understanding a central bank's transparency and communications. This key concept should not be restricted to questions of information policy, but rather includes communicative interacting and understanding. For reasons I outline in this book, I assert that meaning and understanding are rooted in the context, in the mode of communicative interaction. In my view, the new paradigm of central banking implies a compelling need for the development of a theoretical approach to drawing attention to language activities, meaning, and understanding. A central bank signals its verbal participation within a context and reflects the reciprocal relationship with the market, which must be interpreted. Credibility and transparency are connected through the use of language or the way of acting, but not by a supposed

mechanical procedure (Muchlinski 2002a, 2005, 2008). Transparency is linked both to the communicative interactions of the central bank with the financial markets and to the perception of these interactions by agents. Since the concept of transparency is not ontologically definable like the concept of a stone or car, for instance, an institution cannot be transparent *by itself,* given the fundamental research of cognitive sciences. The concept of transparency and the meaning of a transparent central bank are basically linked to a person's perception, which means in terms of the financial markets and central banker, to the *perceived* transparency of the central bank. As Issing (2005a, 504) emphasized:

> [F]or the reality one perceives really depends on how one looks at it. If anything can be learned from Alice's Adventures in Wonderland, it is surely this. ... Buiter is therefore not alone in suffering from cognitive dissonance and bafflement.

I propose to define transparency as a result of verbal and non-verbal interactions and of reciprocal perceived reaction by the central bank and the agents in the market towards the changing parameters of the context. Since transparency is not ontologically definable it always implies an interactive process, dialog, or communicative relation. Therefore, transparency also implies misunderstanding or miscommunication (Dascal 2007). Blinder (2004, 6) argues: 'I will say that a central bank is transparent if its actions are "easily detected", its policies are "readily understood" and its pronouncements are "free from deceit".'

I would like to add that being readily understood requires pronouncements to be expressed in everyday language and not in a coded language. Contrary to a model world, transparency in the modern view of central banks refers to the understanding of verbal and non-verbal interactions. In a mechanical analogy the expectations and preferences of market participants are modelled as being driven by fixed rules and as encapsulated mechanical standards. Transparency and the effectiveness of monetary policy are not results of a deductive reasoning based on the stimulus–reaction of a model world in which the policy ineffectiveness proposition, combined with the premise of the neutrality of money, dominate reasoning. In such an artificial world interaction is not necessary; moreover, pronouncements, language, and communication are meaningless. From the viewpoint of effectiveness and democratic accountability, economic preferences are lexicographic. According to the modern view of central banking, transparency and credibility are rooted neither in model premises nor in deductive reasoning: rather,

both concepts are linked to the mode of action, that is, to the use of language. The Federal Reserve Bank's way out of 'monetary mystique' documents that it has already turned to giving attention to this issue, as Ferguson acknowledged:

> The language indicates the Committee's sense of the balance of risks in the outlook against the background of the Committee's long-run goals of price stability and sustainable economic growth. Specifically, it indicates whether the Committee believes that the risks are 'balanced with respect to prospects for both goals', 'weighted mainly toward conditions that may generate heightened inflation pressures, or 'weighted mainly toward conditions that may generate economic weakness.' (Ferguson 2001, 5)

Transparency is defined neither in absolute terms nor in itself. This concept encompasses different dimensions of central bank practice. There is a consensus in the literature that central banks need to talk about their objectives and methods, that is, forecasts, models, tactics, and decisions. As Greenspan (2001a) emphasized:

> To earn and maintain that trust, the Federal Reserve must communicate to people about what we do and why we do it. Outreach efforts such as this are important because a central bank in a democracy depends on the trust and confidence of the citizenry. These displays represent one innovative example of how the Federal Reserve fulfils its responsibility to reach out and educate the public about the important mission and work of its central bank.

Poole (2003) put it thus – 'How, not whether', and went on:

> It is hardly surprising that central bankers are more talkative than they were just a decade or so ago, and more concerned about how to improve transparency and communication with the market. Perhaps only one issue is settled: Transparency is important but is hard to accomplish because miscommunication is so easy. Clearly, more talk does not necessarily mean greater transparency.

The ongoing discourse deals with transparency as a demanding task for any independent central bank, indeed for any public institution in a democratic society. As far as it concerns the various tasks of a central bank, its goals, methods, decisions, and decision making,

transparency implies attention to the *degree of transparency* which supports the central bank's efforts to be effective and to fulfil its mandate. A demand for full transparency makes no sense to those authors who adhere to the modern paradigm. The step towards a greater transparency is neither a shift towards full or optimal transparency nor towards a simplified view on how a central bank is aiming to exercise its mandate. The road towards transparency implies the continuity of communicative interactions by the central bank in trying to make itself understood and to grasp how the agents of the market understand the information released by the central bank. Issing (1999, 507) has stated that,

> complete transparency of the underlying information set, as well as the thinking and ulterior motives behind central bankers' decision, is logically and practically impossible to achieve. ... This reflects a deeper (philosophical) recognition of the limits of knowledge and the impossibility of providing and communicating anything like a full description of reality: Reality is never transparent. What we see from any one angle is always only part of the picture'.

Issing also shed light on the role of perception and understanding. At this point an informative discourse between Buiter (1999) and Issing (1999) brought to light the awareness that the meaning and understanding of the concept of transparency and accountability is rooted in different views *on how* the institution – the central bank – acts or should act and be regulated in praxis. A central bank is based on constitutive laws. However, as the discourse on credibility and transparency underlines, the performance of an institution cannot be established solely or even mainly through laws. The performance and acceptability of an institution arises from its practices and its social acceptance, hence the interdependence of agents, structures, and contexts which are configured by people's communicative interaction. Referring to Buiter's demand for an enlarged information policy in the European Central Bank, Issing argued:

> [M]ore words do not necessarily mean more information, and more information does not necessarily and by itself contribute to greater clarity. ... Transparency could perhaps best be understood not as an attribute *per se*, but the degree to which we do what we say and say what we do[,] ... whereas accountability means we do what we are supposed to do. (Issing 1999, 508)

Buiter put forward the demand that transparency must be the response to the public's questions and its right to be informed by the central bank. The question remains as to where to draw the line between the public's right to know and the transparency and accountability of an independent central bank. The public's right to know does not reveal *if* or *what* the public actually understands. Although exponents of the modern view have endorsed the development of communication between a central bank and financial markets, they have kept a distance from the view that a central bank should also reveal its intention. Concerning the need to also communicate a central bank's intention, they have argued for caution:

> For stock markets, one argument is that communicating intentions on the future path of interest rates could go a long way toward stabilizing expectations. ... Hence, noting that central banks do not really have any information advantage over markets, we remain agnostic on the desirability of communicating such intentions. (Blinder and Goodhart et al. 2001, 16)

Given this quotation, it should be noted that communication is not tantamount to revealing one's intention. Announcements or communications reveal neither intentions nor thoughts. It does not make sense to insist that a central bank should communicate its intentions – for reasons I will explain in Chapter 2. If one talks about the intention of XY, one has to be aware that the intention is embedded in a context. Intentions are not to be interpreted as mental states. The question then arises: why shouldn't a central bank talk about considerations which are related to this context? The context surrounds the actions of a central bank and also of the market participants. A central bank should aim to share with the market its considerations of the context and its perceptions of the future.

The demand for a greater transparency does not mean that a central bank should act as if in a glass house. Therefore, 'secrecy' is needed – a term inherently connected with 'creative ambiguity' (Blinder and Goodhart et al. 2001, 13; Issing 1999). A major concern of the Volcker regime was to defend its independence against influences by politicians and the public. The FOMC was trying to develop a strategy of communication which was compatible with its need for secrecy. The strategy of 'base-drift' is interpreted in the literature as 'constructive ambiguity', hence as a part of a central bank's strategy to act *through* the market. This strategy can also be described as 'creative ambiguity'.

Lindsey (2005, 229) introduced the notion that 'constructive ambiguity', as linked to the Volcker era, is neither identical with 'opaqueness', nor with 'non-transparent'. At that time, the Federal Reserve experienced how to act with limited manoeuvrability regarding two dominant paradigms of the time: monetarist and Keynesian approaches to monetary policy. Lindsey emphasized that 'constructive ambiguity' and 'mystique' have acquired a particular meaning for central banks as a result of this era. I propose interpreting this as protective behaviour in order to proceed with an institutional task that cannot be implemented if that institution acts as if in a glass house (Muchlinski 2005). I would like to add that the meaning of these terms is linked to certain circumstances. A good example of how the term 'constructive ambiguity' has accrued its meaning can be shown through a reading of the transcript of the FOMC conference call on June 23, 1983. The FOMC had declared that it was targeting the non-borrowed reserves and monetary supply growth rate. The debate in the above conference call was about the current borrowing level, which was higher than expected, and its implication for the Federal Reserve funds rate. However, it was decided not to publish estimations of the borrow level. The central issue of the conference call was whether a required change would be in line with the published directive or not:

> Vice Chairman Solomon ... 'I think it's because we never mention in our record, as I remember, what the borrowing assumption is'.
> Chairman Volcker ... 'Oh no, we would not cite that anyway. It would be some language to the effect that we're operating consistently with a slight increase in reserve pressure. That's all it would say'.
> Vice Chairman Solomon ... 'Okay, if it's not published, it's all right. But if it were to be published, then that would sound like a further increase in restraint and that is beyond what the majority decided last time'.

Volcker made an attempt to balance the considerations of the members of the FOMC meeting regarding the existing and already published directive. As long as suggested changes remained on the bottom line of the directive it was not required to rewrite the directive.[5] Broadly speaking, Volcker preferred to inform the market of the decision-making procedure by way of a 'reconfirmed' procedure, or as based on consultations, because it was important to defend the existing FOMC directive. It was assumed that changes in the directive were interpreted by the public as serious changes and, hence, grave deviations. The FOMC

became concerned about losing its credibility:

> Chairman Volcker ... In that connection, what I would be inclined to do – although it could be done another way – is not, as you say, rewrite the directive because I think this is generally within the scope [of the existing directive]. But I would include in the written record that there was a consultation and that we confirmed that a slight increase in pressure was appropriate.

Regarding the argument of Vice Chairman Solomon, as cited above, Volcker made clear:

> No, it [further increase in restraint] would be stated as consistent with the directive. And we have a directive that says 'slight increase'. All we're doing is consulting about what a slight increase is, in these terms. I think it's consistent with what we've done at times in the past. As I say, we have alternatives all over.

The alternatives – further consultations or a complete publishing – were also discussed and carefully weighed. Volcker was not convinced of the need to go public with a comprehensive pronouncement containing all the details of the considerations, but this did not mean he objected to transparency or communication. Regarding the structures of the arguments put forward on the 1983 conference call, which can roughly be interpreted as being representative of argumentative traits of the Volcker era, I propose that Volcker tried to safeguard the FOMC meetings from the glare of public scrutiny. This strategy might be interpreted as a plea for a degree of transparency.

The Federal Reserve implemented 'constructive ambiguity' as an attempt at setting an accurate interest rate. This echoes the characteristics of the central bank's landscape, that is, uncertainty. However the question of whether 'constructive ambiguity' is a correct or useful response is still open to debate. The roots of 'constructive ambiguity' are found in the Volcker era. For example, the outlined debate at the conference call on June 23, 1983, focused on the need to be as transparent as possible while avoiding absolute transparency. The need for a degree of secrecy, or the plea for a degree of transparency, was mentioned as being essential for the FOMC to implement its strategy:

> Chairman Volcker ... That is my instinct. I don't know quite why I feel that way, but it just seems natural to say we have this under review.

> We have a pretty vague directive, so we're just indicating publicly that we've kept it under review between meetings and reconfirmed the idea of a slight increase in pressure. But the emphasis would be on 'reconfirmed'. (ibid)

Volcker emphasized the importance of informing the market that the FOMC is concerned with issues also deemed to be relevant to the market. He pointed to selective information as a way of letting the market know what the FOMC was debating. However, this strategy was interpreted as ambiguous:

> Chairman Volcker ... Any other comments? In the absence of a comment I will interpret it as a consensus, which is the way the record of the consultation will be written.
>
> Mr. Guffey ... Mr. Chairman. Roger Guffey. Do I understand that what you plan to show publicly is that the Committee met and confirmed the slight firming that has already taken place?
>
> Chairman Volcker ... I wouldn't word it like that way. I would just say that we met, we reviewed the business situation and the strong news that was reported. We reviewed the aggregates and they looked a little stronger. In the light of all these facts, the Committee consensus was to confirm its decision that a slight firming in reserve pressure is desirable.
>
> Mrs. Teeters ... You're not going to take a reported vote on it?
>
> Chairman Volcker ... No, I wouldn't have a vote. It will just be reported as a consensus that a slight firming was consistent with the directive we already have.
>
> Mr. Guffey ... What has already happened?
>
> Chairman Volcker ... Well, in fact, it has already happened, but his. ...
>
> Vice Chairman Solomon ... Well, I must be dense. It seems to me that what you're doing is leaving it open to ambiguous interpretation, which may be just as well. But it could either be a slight firming, which doesn't go beyond the firming that was in the last directive, or it could be a slight additional firming even though it's still consistent with the last directive. Am I correct that it is open to both of those interpretations?
>
> Chairman Volcker ... I think probably so, and I'm not sure I see the damage in that ambiguity.
>
> Vice Chairman Solomon ... I'm not sure either, but I think it is ambiguous. Okay. ...

Chairman Volcker ... Not hearing any other business before the house, we will stop. Thank you.

Vice Chairman Solomon ... Mr. Chairman, your voice fades. The Washington end fades very, very frequently. Maybe somebody ought to take a look at the system again.

Chairman Volcker ... We're going to take a look at the system for various reasons. The more we look at it the worse it seems to get. But we'll try once again.

Vice Chairman Solomon ... Is that the Federal Reserve System or the communication system?

Speaker (?) ... Both!

Chairman Volcker ... That comment refers to the communication system. Okay.

End of the session (FOMC Transcript June 23, 1980).

From today's viewpoint there is a consensus in the modern central bank literature that a central bank cannot disclose all information to the public, or talk about every decision or the decision-making process needed to achieve its mandate. In principle central banks should be transparent about their decisions and the proceedings of monetary policy meetings as well as about their own views of future developments. Transparency and credibility do not focus merely on providing or maximizing information. Since both concepts can only be defined by a *degree of transparency* or *degree of credibility*, then *secrecy* still remains as the inherent implication of both concepts. 'Secrecy' is not identical with 'mystique' for reasons I outline in this section. Secrecy is still required for special issues of central banking as empirical findings have suggested.

A central bank must maintain a degree of secrecy surrounding its relations with the commercial banks and the government. Transparency is only achievable to a certain degree. Therefore, secrecy will always be an inherent factor in the pursuit of transparency. With respect to the experiences of the Volcker era outlined in the previous chapter and above, central banking is seen as an interactive procedure between the FOMC and the financial markets. Therefore I propose to connect 'secrecy' and 'creative ambiguity' with being elementary to a transparent monetary policy. 'Secrecy' and 'creative ambiguity' is an appropriate response to certain confidential information within the financial market and to the need to interact with financial markets.[6]

As already summarized with regard to the modern view of central banking, monetary policy *cannot* be successful as a measured acting

against the market. The success of a monetary policy and the implementation of its mandate depend on a central bank's capability in interacting with the agents in the market convincingly. Therefore, the central bank's way of acting is in practice subject to scrutiny and perception (Friedman 2003). Any change of the Federal Reserve funds rate, that is, the nominal short rate, will change other economic variables with a longer lasting horizon than the market normally focuses on. The monetary transmission channel is driven by the changing expectations of market participants. The focus of central bank transparency must be concentrated on this expectations-building process in order to influence its long-lasting horizon of price stability:

> With a more transparent central bank, we argue, market expectations that are so critical to the transmission of monetary policy – e.g. through the term structure of interest rates, the reactions of stock markets and exchange rates, and wage and price setting – will reflect policy changes better and faster. (Blinder, Goodhart 2001, 2)

Focusing on the expectations-building process also implies investigating the interdependence and communicative interactions between the Federal Reserve Bank and agents in the markets. A central bank's power determines the short-term interest rate, whereas the long-term interest rate is in fact the crucial aspect on which market participants place their attention. As Blinder (1998, 30) expounds:

> The interest-sensitive components of aggregate demand react mainly to the real long rate while the central bank controls only the nominal short rate. In other words, the interest rate that the central bank can control doesn't matter (much), and the rates that really matter cannot be controlled.

Of course, this wisdom has been acknowledged for a long time, as the reference to Keynes in the previous chapter shows. Nevertheless, during the so-called monetarist experiment, many tried to ignore it. According to the FOMC transcripts from the Volcker era, the public did not trust the declared policy of substituting nominal interest setting by monetary growth rate targeting. Discussion of the effects of communicative interactions has caused the scientific community to become wary of traditional concepts of interaction in relation to economic institutions. In guiding the expectations of economic agents, a central bank is part of its own backdrop because central bank communications and the policy

of information disclosure concerning its own risk assessment – by, for example, the Federal Reserve – are interpreted as self-commitments of the central bank. More precisely, the central bank aims at sharing expectations with the agents of the markets focusing on its mandate.

The reason for this is that a central bank's power is asymmetric. It is strong verses the market in the case of a strategy of 'tightening money', whereas it is weak in the case of 'easing money'. A central bank cannot implement a policy of easing money in times where the agents of the markets do not possess an optimistic view on the economy. If a negative 'state of confidence' (Keynes) runs through the market, the central bank is weak in its capability to influence market expectations.[7] The real demand for guiding market expectations by central banks suggests a strategy which cannot be rooted in a uniform model or rigid rule. Such a rigidly fixed rule is, for the sake of simplification, identical with the assumed cognitive capacity of market agents (Greenspan 2003; Issing 1996; Muchlinski 2003a, 2003c).

Bernanke (2004a), among others in the literature on central bank communication and transparency, gives great attention to the question of whether a fixed rule implies higher effectiveness of monetary policy:

> The problem is that a number of contingencies to which policy might respond is effectively infinite (and, indeed, many are unforeseeable). While specifying a complete policy rule is infeasible, however, there is much that a central bank can do – both by its actions and its words – to improve the ability of financial markets to predict monetary policy actions. With respect to actions, the central bank should behave in as systematic and as understandable a way as possible, given the macroeconomic and financial environment. That is, although monetary policy cannot be made by a mechanical rule, policy can and should have 'rule like' features. Obviously, the more systematic and the more consistent with a few basic principles the conduct of monetary policy becomes, the easier it will be for the public to understand and predict the Fed's behavior. However, because the world is complex and ever changing, policy actions alone, without explanation, will never be enough to provide the public with the information it needs to predict policy actions. Words are also necessary.

The theoretical debates based on rigid premises which are not linked to the contemporary world have never reached the realm of central bank

practice, which focuses on the effectiveness of monetary policy in practice. Central banking as a practice needs to be based on the language and communication of the practice. A central bank must be able to act flexibly, but this does not imply acting without committing itself. Self-commitment is linked to transparency, independence, and accountability. Transparency implies understanding of what a central bank is, in fact, doing (Issing 1999; Blinder 1998). Blinder stated that 'communication is not precommitment' (2008, 918). Therefore, 'matching deeds to words' does not imply that communications constrain future decisions or actions of the central bank.

The Federal Reserve Bank's road out of 'monetary mystique' is described by Blinder and Goodhart et al. (2001, 67):

> Prior to 1994, the Federal Reserve did not announce its target for the Federal Reserve funds rate – the principal decision made at each FOMC meeting – even after the decision was made. Instead, it would normally enter the money market unannounced, leaving it to professional Federal Reserve watchers to figure out whether it was deliberately changing the funds rate or simply carrying out a technical ('defensive') open-market operation. Only the largely symbolic changes in the discount rate were publicly announced, and they were consequently treated as momentous events – 'ringing the gong', they were called.

Announcing the target for the Federal Reserve funds rate in 1994 was one important step taken among others (Kohn and Sack 2003). On the matter of the importance of its disclosure policy and communicative interaction, the Federal Reserve has been pursuing a new strategy of communicative interaction since 2000, after it founded the 'working group on the directive and disclosure policy'. These changes can be categorized as 'risk management rather than optimizing' in order to solve economic problems, instead of an establishment of rules. In order to improve its transparency the FOMC explicitly distanced its strategy from a rigidly fixed rules approach in favour of discretion and fine tuning. Since inflation expectation is not a 'jump variable' but rather a 'slow-moving-variable', the FOMC tried to achieve a neutral interest rate 'to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates' (Blinder and Reis 2005, 21). During the Greenspan era, the FOMC made a transition to a comprehensive new approach on monetary policy, described as 'Greenspan-gradualism'. This entails 'interest rate smoothing', the 'reversal aversion'

combined with the strategy of publishing the 'risk bias'. It has also transformed forward-looking information policy.

This radical shift in the policy announcement of the Federal Reserve funds rate can be set against the historical background of both the Volcker era and the observation of the new type of inflation the United States was confronted with starting in the early 1990s. The transcript of the Federal Reserve Open Market Meeting on May 18, 1993, for instance, provides evidence of discussions as to whether the Federal Reserve was dealing with stagflation or whether rising prices were driven by inflationary psychological processes caused through changes in prevailing psychology. Greenspan commented:

> That's because in all of our analyses of inflation we endeavor to find the transmission mechanism by which the actions of workers in the wage bargaining process and of managers in price mark ups take place. The conventional wisdom in our models is that (the transmission) is largely induced through changes in psychology (1993, 9–10).

The argument of the assumed embodied inflation expectations entered the game because price movements normally have their basis in real world changes. The new phenomenon confronted the FOMC with the question of whether the underlying inflationary expectations can have real effects. Greenspan emphasized that if at first we recognize a change of fundamentals and, hence – as the so-called causality – we then observe a change in psychology, it is not convincing to argue that it means a change in people's attitudes has occurred (1993b, 39).

The path to greater transparency was motivated by the need to understand these new observations in different ways than had been the case in the past. In order to understand the changing economy in the early 1990s, the Federal Reserve was compelled to reflect upon and to rethink its traditional methods and instruments carefully. The Federal Reserve moved beyond the 'rules-versus-discretion' viewpoint because it lacked an understanding of the new phenomena. The Federal Reserve has not become attached to the dichotomy of the rule-versus-discretionary-model, but to different types of discrete models. It also evaluated and exploited past patterns and observations in order to discover historical regularities – and still does so. One crucial new perception and experience of this time was that new technologies led to unexpected changes and new phenomena in the price movements than had previously been the case. There was no possibility of relying on a single model or rule

in order to analyze the changing environment. The success of a central bank depends on a certain pattern of acting and ways of doing in response to changing contexts. Inasmuch as the Federal Reserve has started to think about its different kinds of communicative interactions with the markets, it has been developing a distinct view on *why, when,* and *what* a central bank could be communicating to markets. Moreover, the Federal Reserve made a radical change to its way of guiding market expectations by its 'bias policy' (Blinder and Goodhart et al. 2001). Three main aspects should be mentioned here:

1) The FOMC published its 'balance of risks' in order to describe its own view on the current macroeconomic performance and also the near future according to the Federal Reserve data and information.
2) It began reporting to the public after every meeting, regardless of whether a change of the interest rate was made or not.
3) The statement of the FOMC became more comprehensive in composition.

These major steps towards greater transparency were supplemented by a further significant change in 2002, when the Federal Reserve started to make announcements immediately after each meeting, including naming names. A crucial fifth step was implemented in 2005 by the release of the minutes after a three-week delay and before, not after, the next meeting was to occur. Before 2005, the minutes of the FOMC meeting were available following a six or seven-week delay, in other words after the next meeting. The minutes provide basic insights of the Federal Reserve's view of the current state of the economy, its prospective view, and also insights into the votes.

To sum up, there are many factors in the communication efforts of the Federal Reserve that have improved the possibility of anchoring expectations. Because of the radical changes in the Federal Reserve Bank's policy of transparency, and because of greater openness and disclosure (Bernanke and Kuttner 2003), market participants are now able to predict what the FOMC will do at its next meeting. Empirical studies have shown that particularly the short-run predictability of monetary policy has been improved (Lange, Sack, and Whitesell 2003; Poole, Rasche, and Thornton 2002; Thornton 2004). Since the Federal Reserve Bank is aiming at the long-run perspective of price stability, the crucial question is whether the communication of the Fed also contributes to predictions of what the FOMC will do in the long run. The disclosure policy of the Federal Reserve is a response to the uncertain landscape

which surrounds central bank policy. It is also a response to the perceived need to improve its communicative interactions. The Federal Reserve was trying to balance a need for a greater degree of transparency with effective monetary policy. The disclosure policy is pictured by Greenspan (2002, 5):

> Accordingly, as you know, we moved to the immediate disclosure of our policy actions and, over time, to explaining our decision and our sense of future risks directly after each meeting. In addition, we now publish full transcripts of our meetings after five years. Through these disclosures, together with congressional testimony, speeches by Board Governors and Reserve Bank Presidents, and the publication of the System's sizable research output, we endeavor to keep the public well informed.

It is not merely disclosure policy that has altered during these changing times. Since its power to influence in the long run concerns only the nominal magnitudes, the Federal Reserve Bank also changed its reasoning with regard to the process of building expectations. The communicative interaction therefore includes the central bank's questioning as to *how* the agents in the market *perceive* the price movements and *where* this perception comes from: is it rooted in data compatible with the Federal Reserve's data? Or is the perception rooted in a different interpretation of the material disclosed to the public? The Federal Reserve Bank not only discloses information to the public, but in trying to perceive how the public might receive and understand this information, it positions itself reflexively in juxtaposition to this information. This reflexive approach to its own disclosure policy is an important part of the modern view of central banking. As an institution the central bank is part of the structures and institutional facts it has itself created by its communicative interactions with the markets.

At this point the guiding of market expectations implies not only information disclosure by the central bank (such as the track report of the FOMC, bulletins, monthly reports, speeches, statements, minutes, and so forth), but also an attempt to understand how the markets perceive the information, that is, how the meaning and understanding of this disclosed information arise. It is assumed that the market participants, especially the analysts, try to reach a comprehensive overview of the central bank's policy by collecting the information (Demertzis and Hallet 2002; Demiralp and Jarda 2004). If central banking is described as guiding market expectations, then it is based

on communications, and, hence, on language activities. The modern view of central banks should also expound upon and emphasize the role language and communication play in economic interactions as interactive practice. Central banking as the guide of expectations cannot be separated from central banking as an interactive procedure or communicative interaction. Last but not least, the modern paradigm of central banking has already rejected the surprise-inflation bias, as introduced by Kydland and Prescott (1977) and Barro and Gordon (1983):

> In case of the modern incarnation of the rules versus discretion debate, based on time inconsistency, I have argued that things are starkly different. In my view, the academic literature has focused on either the wrong problem or a non-problem and has proposed a variety of solutions (excluding Rogoff's conservative central bankers) that make little sense in the real world. (Blinder 1998, 50)

Regarding the Barro-Gordon world, Cukierman (2002, 16) added that '*that* credibility problem of monetary policy is a thing of the past'. He argued:

> [T]he quadratic objective function originally postulated by KPBG carries the rather unintuitive implication that, given inflation, an upward deviation of employment from its desired level is as costly as a downward deviation of the same size. It is hard to see, why policymakers, or social planners for that matter, would object, given inflation, to a positive output gap. As a matter of fact it's quite likely that, in the range of positive output gaps, the quadratic was postulated mainly for analytical convenience rather than for its descriptive realism.

Cukierman demanded that central banks should be transparent with their economic model in order to explain the monetary transmission process. Modern central banks are often opaque regarding the implications of their models, premises, and conclusions. This opacity contradicts the current consensus of being open about the objectives and the desirable organization of central banking institutions. Whereas price stability seems to be an accepted goal across different views and theoretical approaches of central banking, the way of explaining the model implication and structures used for operational objectives of the monetary policy are not.

From the viewpoint of the Bank of England, Vickers (1998) outlined the approach as follows:

> It should go without saying that the MPC's objectives are given by the Act and by the remit set by the Chancellor. There is a large literature on inflation bias, but it is simply not applicable to the MPC. We have no desire to spring inflation surprises to try to bump output above its natural rate (wherever that may be). Quite apart from the obligation to fulfill our statutory duty, we have the strongest professional and reputation incentives, which in my opinion are incapable of being enhanced by financial incentives, to get as close as we can to the inflation target.

There seems to be no dispute about the inaccuracy of rigidly fixed rules or of simply relying on deductive arguing of the model view among central bankers. The connection between monetary policy strategy, its need to guide market expectations and the market responses came to the attention of central banks later – after the rational expectations hypothesis had lost its conviction. The reliance on the rational expectations hypothesis was a replacement of the illusion that the economy could be seen as a stable point of gravitation. Neither the Barro-Gordon model nor the concept of time inconsistency (Kydland/Prescott) could explain the phenomenon of stagflation because no central bank had supposed the public would act on the basis of the rational expectations hypothesis. A second twist in this hypothesis and the so-called 'Lucas-Critique' started with an emphasis on central banking practice (Muchlinski 1999a). As we have just seen, the reliance on a fixed rule of a monetary policy regime did not provide a way out of the problems central banks were confronted with. In an early paper, Blinder (1987, 135) went on to qualify his objections:

> The important thing is to make sure our models are congruent with the facts. Lucasians, it seems to me, reverse the sequence. They want to begin with fully articulated, tractable models and worry later about realism and descriptive accuracy. ... [T]he issue is how religiously we must adhere to frictionless neo-classical optimising principles until that glorious day arrives.

Secondly, the argument that a transparent central bank becomes 'hostage to market sentiments' (Jensen 2001) – because a fully anticipated monetary policy by the market participants is ineffective – has been rejected by the modern paradigm.

Thirdly, the asymmetric information argument regarding a central bank and the public has been revised, since communication has been accepted as important to transparency. However, the asymmetric information argument is not a striking one, because understanding and meaning are not based on information delivery (Muchlinski 2005). Bernanke (2004a), among others, appreciates communication as a mode to 'make information symmetric', a method to improve the private sector's ability to create adequate expectations. Since the Federal Reserve Bank has been moving little by little towards a new 'forecast based policy', the private sector is compelled to base its own forecast on a greater variety of economic parameters. Respectively, the private sector has to perceive a wider branch of the statements of the FOMC, different publications like the Blue Book and Green Book, the speeches of the chairman and vice chairman, and the press releases, in order to grasp the message of the Federal Reserve Board and to integrate that message into the private decision-making process.[8]

A particular consequence of the 'forecast based policy' is admittedly that the private sector has been bearing greater risks than before. The 'forecast based policy' also implies the possibility of minimizing financial risks as long as the public engages in communicative interactions with the Federal Reserve. Compared to 'forecast based policy', the traditional 'simple feed back policy' was endowed by only a few observable economic parameters – such as unemployment rate, inflation, wage structure, business orders, exchange rate, and so forth – and economic adjustments were judged to be easier regarding the informational constraints. According to the 'simple feed back policy', the development of the private sector's expectations seemed to be simple. However, simplicity is not always the best way to reach a goal, because it entails also the risks of travelling down wrong paths or being misguided. The current 'forecast based policy' acknowledges the uncertain landscape of a central bank's decision-making process:

> The view that less information could help to deal with the information asymmetry – the public does not know as much about the central bank preferences and intentions as the central bank itself – is surely paradoxical. (Blinder and Goodhart et al. 2001, 15)

An important reason for 'secrecy' is the admitted fact of the *asymmetry of time* horizons regarding different agents, motives, expectations in different markets and the central bank. The goal of price stability is a long-lasting objective which a central bank can try to achieve only by

operating in short-term horizons, which may conflict with the interests of market participants. Asymmetry of time horizons is a key feature of modern central banking. It is rooted in the divergence of monetary policy decisions, for example, setting the short-term nominal interest rate while influencing a long-term interest rate, which is compatible with the central bank's mandate of price stability evolving through the long-term transmission process.

The crucial element here is the difference between the market and the public regarding the time horizons. The phenomenon of time asymmetry implies that every decision and action of the central bank has to be discussed within this time asymmetry. The reason is that markets act within a short-term horizon, more or less a few months hence, whereas the Fed's attention is drawn to price stability after several quarters. Real rates (e.g. real wages, real interest rates) are results of market processes over time. Blinder expounded (1998, 60):

> It takes an amazingly strong constitution to wait that long. In stark contrast, the market provides a kind of giant biofeedback machine that monitors and publicly evaluates the central bank's performance in real time. So central bankers naturally turn to the market for instant evaluation.

Given time-horizon asymmetry, any central bank is compelled to respond to it in order to achieve its goal and mandate. A central bank cannot achieve its goal by surprise actions but only through the success of an initiative to guide the expectations in the money market to a coherent result. In light of the asymmetry of time, central bank decision making requires, in practice, the judgment of observations and the evaluation of different empirical sources in context, seeking to discern historical regularities as well divergent observations, rather than following a universal model by virtue of deductive reasoning.

1.3 Monetary policy as a language analogy

> A monetary strategy is like a language. Like a language it provides tools and a frame for reasoning, and a vehicle for communication. Winkler (2000, 23)

Economists are trained in microeconomics, macroeconomics, and metrics (Athey, Katz et al. 2007). They do not, presumably, study economics in order to consider questions such as 'why and how does the use of

language create social facts or institutions?' or 'does language require language?' I will return to such questions in Chapters 5 and 6. The constitutional role of language has already been accepted in the social sciences. Language does not work through artificial rules or signs, but through everyday language as used in practice and context. I want to deal briefly here with the issues of whether language is a self-identifying category of institutional facts – that is, whether or not there is circularity in arguing. I want to add certain aspects still missing in the current debate on central bank communications. If monetary policy works *through markets* (Blinder), that is, in guiding expectation-building, then interactive relations need to be set out precisely. This chapter provides additional reasons why monetary policy should be conceptualized as a 'language analogy', a term used by Winkler (2000) which has been increasingly accepted in the academic community.

In my view, focusing on the use of language and the communicative interactions of a central bank implies the following:

a) The world which surrounds a central bank is neither a fixed nor invariable world.
b) Uncertainty is the defining characteristic of that world.
c) A central bank acts within a democratic and institutional environment, not in social isolation.
d) The central bank's actions are due neither to an ordering of logical possibilities nor a mastery of probabilistic calculus independent of the central bank's practice and environment.
e) There are no such things as simple methods, linear mechanisms, or fixed rules by which to achieve a central bank's mandate when it must operate within changing environments and contexts.
f) The central bank's language is embedded in institutional practices, for it is this which gives meaning to its utterances.
g) An utterance or proposition can be vague. It can have a meaning which differs according to differing uses of language in differing contexts. Therefore. for the central bank to be accused of being vague in its utterances, statements, or announcements is attributable to the use of everyday language.

Two key propositions are relevant here: First, language is not identical with communication regarding its functions. Second, language provides a system of mutual orientation for both speaker and listener, a system that enables them to configure a context for communicative interaction. Furthermore, language functions themselves are based on

practice and custom. The function of a language is rooted in its elementary reference. It goes beyond being viewed as merely a medium of transforming information (Trabant 2008). For example, to use a language without a reference to its previous use will not allow the meaning of a word, phrase, or sentence to evolve. These have no private meaning: their meaning emerges through their use in practice. Language activity implies the use and application of sentences and expressions. We do not learn, or grasp, the meanings of words or sentences in isolation.

Using language structures thought and reality, because the use of language matters as an interactive procedure. This use creates institutional facts. Moreover, a word does not just refer to a mental state of an individual, nor to his or her intention, 'for then it means: *that* is how we use it' (Wittgenstein 1978 § 247). The mental state does not accompany the meaning of a word or a sentence. As Wittgenstein (1978 § 329) expounded: 'When I think in language, there aren't "meanings" going through my mind in addition to the verbal expressions: the language is itself the vehicle of thought'.

The prevailing view in the literature on central banking refers to the presumed mechanical symbols or signs as the means to 'exchange the already given meaning', or to 'exchange information'. Most branches of economic sciences are inclined to focus on language as a medium of exchange in relation to a given meaning, or the settling of information in order to optimize economic results. They ignore, or perhaps despise, the fact that language is elementary for the acquisition of knowledge and scientific work because language is not neutral as to thoughts (Trabant and Ward 2001). Language is elementary for common actions because it is a precondition of human interaction, dialog, discourse, and discussion (Tomasello 2002). Modern language sciences and cognitive sciences emphasize the constitutive role language plays in creating institutional facts, norms, rules, meaning, and understanding, as well as shared social values (Trabant 2009). Communicative interactions and language activities are not patterns, like mechanical reflexes according to the stimulus-response mechanism model. Communicative interaction is not simply the result of a transmission of information. The traditional view on central banks contrasts sharply with modern research in language and cognitive science (Kober 2002).

Market interactions are driven by language activities rather than by the mechanism of a pendulum or according to natural laws (Maennel 2002). The analogy to natural science is a misleading one. If we take seriously the critique of the 'car analogy' below, it follows that we cannot rely on such inaccurate images. Meaning and understanding are *not*

given ontologically. They are not composed of different properties, like a machine or a car. Bernanke (2004) objected to models employed for the sake of simplicity rather than for the sake of understanding. The 'car analogy' makes no sense:

> The FOMC decision process may appear straightforward. A commonly used analogy takes the U.S. economy to be an automobile, the FOMC to be the driver, and monetary policy actions to be taps on the accelerator or brake. According to this analogy, when the economy is running too slowly…, the FOMC increases pressure on the accelerator by lowering its target for the Federal Reserve funds rate, stimulation aggregate spending and economic activity…. What could be simpler than that?

The modern view of central banks is built on the view that communication matters because the central bank influences expectations by forward-looking decision-making (Blinder et al. 2008). Changes in the overnight rate affects the actions of the agents, that is, spending decisions and, hence, the pricing and of course employment decisions. A central bank influences expectation-building and, hence, decision making. Therefore, the central bank needs to explain its own view on the current and future performance of the macroeconomic reality.

Communication does not occur for its own sake, because it is connected to transparency and the independence of the central bank in democratic societies. Woodford (2005, 4) pictured the central bank as a 'manager of expectations', endowed with the power to set 'the future path of overnight interest rates, and not merely their current level'. He was opposed to the mechanical analogy because 'central banking is not like steering an oil tanker or even guiding a spacecraft' (ibid). According to the new paradigm of central banking, it is time to acknowledge the constitutive role of language activities in central bank theory. The guiding of expectations in the market cannot be separated from the use of language and communication.

As stated in previous paragraphs, the meaning of thoughts does not refer to a mental state or intention. If we acknowledge the modern view of central banking, the question 'does the central bank really intend, or believe, what is said?' is hardly relevant. Blinder gives an example regarding demands to publish the macroeconomic forecast by the Federal Reserve: 'One objection that central bankers occasionally raise is that the staff's forecast may not correspond to the beliefs of the actual decision makers' (Blinder 2004, 19). To be sure, if we accept

the modern view of central banks, it follows from this that such an objection would be meaningless because we do not assume a divergence between the statements of the central bank and its intention or beliefs. Whereas the considerations and contributions of classical economists often emphasized the language aspect, and also investigated the role of language in use, current economic work is predominantly couched in formal language. However, certain critiques on the predominant formal language approach to economic questions have already reached the agendas of economic meetings (Akerlof 2007). The new institutional economics emphasize the interdependencies of communicative interactions (Erreygers and Jacobs 2005; Maennel 2002). By language, I do not mean coded language.

The link between monetary policy and communication is important for transparency, that is, for both the effectiveness and accountability of a central bank. Communicative interactions should not to be confused with rhetoric (McCloskey 1983; Backhouse 1993; Henderson 1993). A central bank communicates in order to implement its mandate. Not only the disclosure of information and explanations but, furthermore, 'words are also necessary' (Bernanke 2004a, 6). A central bank's communications encompass information policy, but are not tantamount to that policy. 'Inevitably communication involves a large amount of detailed information on the central bank procedures, data, decision-making process' (Blinder and Goodhart et al. 2001, 10).

Any communication starts with the use of language, written or spoken (Trabant 2009). This links a central bank's communication to practice and environment. Any decision-making process and communicative interaction must be anchored in a reference. This reference should be linked to the contemporary world, not to unrealistic premises nor to logical syntax. The inherent connection between the use of language and the anchor of reference sheds light on the role language plays in communicative interaction. To picture a central bank in a prisoner's situation, in which communication and statements do not take place makes no sense at all (Blinder 1987).

Let us now turn to the important issue of central bank transparency, and communication needing to be linked more closely to the modern view of central banks. Winkler (2000, 15) proposed a differentiated the view of transparency focusing on 'the twin roles of a monetary policy strategy: information efficiency and communication'. He asserted the need to evaluate the implications of transparency, which touch on the communicative relationship between the central bank and the public. The latter refers to media, politicians, and agents in the financial

markets. I would like to mention Winkler's approach to differentiate communication and language. It is evident of the constitutive role of language in economics and theory (Muchlinski 2008). This is also true for central banking and communication.

Contrary to the traditional model of central banks, Winkler emphasized that transparency is first of all a 'social phenomenon' because it is addressed to independent institutions, central banks, which are part of democratic society. He (2000, 14) defined the monetary policy strategy as

> a systematic framework for organizing and structuring information and analysis rather than a specific monetary policy reaction function prescribing direct 'mechanical links' of policy decisions to particular economic variables.

At this point the demand for a central bank to 'aim at information efficiency' came into the game. A central bank needs to

> provide a framework for communication (that is, a vehicle for information transmission) both externally – in explaining monetary policy to the public – and internally (at least in the case of decision-making by a committee, but also in interaction between staff and policy-makers. (ibid)

The fundamental assumptions of this new approach by Winkler to central bank communication are certain considerations: clarity (C), honesty (H), and common understanding (CU) (Winkler 2000, 17).[9] Given also the assumption of 'bounded rationality' (Simon), clarity goes beyond merely the maximizing of available information. Clarity implies the strategy by central banks to structure and simplify information. Regarding heterogeneous agents in the market, a central bank has to differentiate its information, which can no longer be viewed as a homogenous good. The danger of confusion from multiple public messages or greater asymmetry of information has forced the central bank to provide differentiated information.[10] The result is that the traditional assumption of 'common knowledge', which the economist is used to working with, will become meaningless because different agents or groups in the financial market will get different information that they will also perceive and interpret differently. The common knowledge assumption has been created for the sake of simplifying model building in economics. It is based on the consideration that information is available to all agents at all times and that all agents are motivated to use it.

It also stops the infinite chain of reasoning. As Geanokoplos (1992, 54) described it:

> An event is common knowledge among a group of agents if each one knows it, if each one knows that the others know it, if each one knows that each one knows that the others know it, and so on. ... Thus, common knowledge is the limit of a potentially infinite chain of reasoning about knowledge.

Winkler introduced an internal and an external dimension of communication. The process of communication should be differentiated into a vertical and a horizontal dimension. This distinction gives a first impression of the problems any central bank has to deal with: the perception and attention that market participants do, or do not, pay to statements or information released by the central bank. The evolution of meaning and understanding is based first of all upon the perception of the central bank's voice, words, and sentences (Muchlinski 2005).

How, then, is understanding possible? 'Without this sharing of reactions to common stimuli, thought and speech would have no particular content – that is no content at all' (Davidson 1991, 159–60). Understanding depends on how market participants in fact interact – verbally and non-verbally. Davidson (1982, 327) argued that

> [t]o understand the speech of another, I must be able to think of the same things she does; I must share her world. I don't have to agree with her in all matters, but in order to disagree we must entertain the same proposition, with the same subject matter, and the same standard of truth. Communication depends, then, on each communicant having, and correctly thinking that the other has, the concept of a shared world, an interactive world. ... The conclusion of these considerations is that rationality is a social trait. Only communication has it.

Honesty indicates that the meaning of a central bank statement cannot be an external one. Davidson can be read as supporting Winkler's view: 'If all we have to go on is the fact of honest utterance, we cannot infer the belief without knowing the meaning, and have no chance of inferring the meaning without the belief' (Winkler 2000, 31). Winkler defined honesty as 'the degree to which the representation of information employed in external communication corresponds to the actual structuring of information adopted internally. ... Conflicts may, however, arise between internal and external communication needs' (ibid, 20).

Avoiding the traditional premises of common knowledge, Winkler introduced the importance of 'common understanding' regarding a central bank's context and environment. Since monetary policy acts on the basis of rules, these rules can be interpreted as serving a 'coordinating function in organizing public discourse', hence as communicative interaction (ibid, 23). He emphasized: 'transparency rests on the degree of common understanding between the two and is thus a social phenomenon'. To express a central bank's statement in formal language or coded language would impede common understanding. Everyday language is vague and imprecise, which evinces context and environment. Vagueness is characteristic of everyday language. Nevertheless, a central bank's need to focus on special information and to investigate certain economic developments, that is, the monetary transmission process, which differs extremely between countries, or prices of goods, markets, currencies, the rate of economic growth, and so forth – and, furthermore, the central bank's need to create and communicate certain data according to an economic environment – clearly describe its role as a monetary institution. As monetary institutions, central banks do have comparable monetary strategies in order to achieve an effective monetary policy.

At this point, it should be emphasized that language is not a vehicle to transmit ready-made meaning or informational content from a sender to a receiver. The receiver is not an empty box (the reasons are outlined in Chapter 3). Winkler discusses this point through a graphic presentation. He differentiates between white and grey boxes in order to show the meaning of the perceived information by the public cannot be controlled by the sender, the central bank. The distinction between grey and white boxes should indicate that the antique 'conduit metaphor' is not compatible with modern central bank theory and practice (Bernanke and Kuttner 2003, Blinder 1997). Consequently, Winkler takes the view that

> the notion of transparency as common understanding not only refers to information and modes of interpretation shared between central bank and the public. Communication takes place not between two monolithic players but between multiple senders ... and multiple receivers. In such a setting, a central bank's announcements also perform additional internal and external coordination functions. (ibid, 24)

To sum up Winkler's approach: In accordance with the modern view of communication (Tsohatzidis 1994), Winkler indicates a view of

central banks as senders of information, differentiated from the public as the receiver. Central banks provide information or data that has to be perceived and interpreted. Winkler emphasizes the need to change, in the literature of central banking, certain assumptions: the model of communication and the premises of common knowledge. The avoidance of these assumptions opens up another theoretical perspective on the communicative interaction of a central bank with its heterogeneous audience. Moreover, it moves towards the distinct perceptions through language because central banks do not provide the meaning and understanding of the delivered information. In the following chapter, I go on to argue that communication and language activity do not, in fact, matter as methods of transforming information going from the central bank to the public.

2
A Conceptual Framework for Central Bank Communication

> A game, a language, a rule, is an institution.
>
> Wittgenstein 1983, 334

In this chapter I want to move towards a workable definition of communicative interaction between the central bank and financial markets. This chapter deals with a comprehensive view of communication. Communication is not a linear transformation of information, hence not a linear transformation of a given meaning from a sender to a receiver. The release of information by a central bank implies the creation of non-linear communication structures. I want to propose a non-linear conceptual framework for central banking and communicative interactions. Since communication is based on interaction between at least two persons or institutions, this interaction contains different modes of perceiving, and processing of, information and, also, understanding. The conceptual framework introduces communication as a procedure of information processing, interactions among people and institutions in different contexts. It excludes the view that communication is based on coded language or mechanical adaptations as described by the standard model of communication.[1]

The non-linear conceptual framework I want to propose is a composition of three dimensions. It implies a dynamic relationship between the dimension, 2.1, information, 2.2, interaction, and 2.3, context. These dimensions change according to agents, preferences, times, and situations. This conceptual framework focuses on the interdependence between people's – and institutions' – communicative behaviour in relation to acquired knowledge and shared knowledge, or persuasion.

A treatise on central bank communicative actions, meaning, and understanding involves the need to consider the creation of the meaning

and understanding of central banks' actions. In this chapter I examine modern language and cognitive science research, which are important for central banks because they emphasize perception, adaptation, and context of decision making and action.

The academic concern, or everyday observation, that people's actions convey information and affect behaviour had been neglected in economic modelling prior to the paradigm shift towards information economics (Akerlof 1970). The results of modern language and cognitive science should not be neglected in macroeconomics. Regarding the importance of central banking in both domestic and international economies, central banking is about more than setting the short-term interest rate and guiding market expectations. Central banking is an important part of the culture of, emergence of, and maintenance of democratic institutions in society (Amtenbrink 1999; Issing 2008; King 2004). Any language approach to central bank communication, discourse, and writing needs, therefore, to give attention to a central bank's role in democratic society rather than to list a few labels concerning a central bank's goals.

2.1 The information dimension

I turn here to the first dimension of the conceptual framework, which should be introduced as *information transformation*.

Theories of information transmission – also called the classical model of communication – were sketched by the famous 'conduit metaphor' introduced by Lasswell in the 1950s (Lasswell 1948; Reddy 1979). Lasswell pioneered research on public communication in humanities and social sciences which, until that time, had been a domain of technology. The formula given by Lasswell exemplified the view that the process of conveying information can be pictured as a just-played billiard ball. Given this metaphor, information is interpreted as a sent message, and, according to the sender's intention and meaning, reaches the receiver accurately. In this model of an input-output transformation, the receiver is the double of the sender. The receiver is an empty box. Moreover, information is seen here, *not a related object*. Consequently, there is and will be no communicative interaction needed. The sent information entails the speaker's intention and meaning to be grasped, that is, understood as such, by the receiver.[2]

Theories of the transmission of information stating that information processing could be modelled like a billiard ball appear persuasively simple. For the sake of simplification they seem to provide clarity on the

information-sending process. Moreover, the modelling of information transmission treats it like sending a letter in the daily business of a post office. In a broader sense of the meaning, the postal carrier takes the letter from the sender to the receiver. But this simplified model does not provide a picture of what the receiver gets. What the hearer perceives, reads, and understands is neither identical with the piece of paper the sender sent, nor what the postal carrier delivered. Transmitting a message should not be confused with transporting it. Sending information cannot be modelled as the fall of an apple from the apple tree.

I now turn to an additional aspect of the classical model. Lasswell's formula of the 'conduit metaphor' has influenced ongoing research on communication. His view on communication as transmission of information between sender and receiver is based on the premise of the linearity of information. Any information is sent as an absolute entity. This premise also provides the required structure for the development of methods for the measurement of communication. Lasswell's model of an input-output transformation was driven, first and foremost, by a breakdown of the whole process of communication into distinct phases. Further underlying assumptions are the premises of uniqueness and exactness of information, and that any information can be measured. The inherent persuasiveness of this classical approach to communication is that information is not only an absolute given but also an objective entity. The presumption is required to explain communication modelled on an input-output transformation. To structure the model, Lasswell put the following question: 'WHO says WHAT in WHICH channel to WHOM with WHAT effect?' (Lasswell 1948, 37). If we follow his idea of breakdown or deconstruction, it seems practical to differentiate communication into absolute entities, and to read this as the presupposition of measuring a linear transmission. Merten (1993) emphasized that modern theories of communication still adhered to the Lasswell formula for the sake of simplification. While the focus is on the linear relationship between sender and receiver, the information itself is an absolute magnitude that can be quantified.

The Lasswell model is built up as a metaphor of putting a billiard ball into play. What is metaphor? Lasswell answered: 'Metaphor is pervasive in everyday life, not just in language but in thought and action. Our ordinary conceptual system, in terms of which we both think and act, is fundamentally metaphorical in nature' (Lakoff and Johnson 1980, 3). Lasswell, then, moved to 'physical metaphor': 'Briefly, "physical" metaphors involve the projection of entity or substance status upon something that does not have that status inherently' (Lakoff and Johnson

1980a, 461). This metaphor is not helpful in explaining the evolution of the meaning of the information, nor its understanding. Lasswell model neglects the response of the receiver, the situation and the context of the utterance, as well as the relational characteristic of any information.

A second important feature is the assumption of the neutrality of language, which is described in its role as the 'veil of thoughts'. Given this view of the function of language, it seems clear that the effects of communication are to be interpreted as causal – effects that are measurable, absolute, and objective-given entities. It is claimed that there exist no differences among information, language, and communication. A key term of the traditional view is 'the conduit metaphor'. In the classical view, communication is a metaphor of a communication machine (Shannon and Weaver 1963, 1947).

> Most theories of communication are based on the CONDUIT metaphor, in particular, all theories that view a language as a code and communication as sending of a message in that code from a speaker to a hearer. The medium through which the message is sent corresponds to the conduit'. (Johnson and Lakoff 1982, 9)

Any approach to communication which is based on the 'conduit metaphor' makes a claim as to the effectiveness of communication without drawing attention to understanding, and sees an identity with the mere sending of a message.

The classical model of communication in which language is neutral, that is, functioning as a label to name thoughts or objects – and in which information is already given and waiting to be re-allocated – is based on certain assumptions that can be described by a system of metaphors. This system is rooted in metaphors like rules, methods, and instruments of natural sciences. Communication is explained by moving and removing messages, which are taken as objects, things, and facts from the real world. Words and sentences do have meaning *in*dependent of contexts, situations, and the knowledge of the people who use them. In the classical model, communication is a medium for transmitting signals or signs within such systems as channels or receptacles. The transformation procedure is modelled as a container in which words are chosen to be transmitted to the receiver. The impact and consequences of the use of language or language activities are modelled like tennis balls. According to engineering communication, the view of the 'conduit metaphor' implies the exchange of given information between participants in order to balance the information pragmatically.

Any kind of information transmission between people and machines, or mutual transmission between people and people, is to be interpreted as communication.

New refinements on this semantic approach to language are provided by Lakoff and Johnson (1980), Johnson-Laird (1987), and Steube (1995). In their later work, Lakoff and Johnson (1980) explained language as an element of conceptual cognitive capability. Meaning is linked with concepts which are themselves elements of complex cognitive spheres. These spheres organize the knowledge of the world. Meaning is a result of interpretation. In Johnson-Laird's view, meaning refers to the procedural semantic. Semantic procedures provide the context of mental models for the rule-based interpretation of utterances. The meaning of the word or sentences does not represent psychological states. Steube focused on the interaction of text and structure and on the framework of an action. She inquired as to which strategy of textual work the speaker and the hearer apply to communicative interaction. The success of communication will also depend on the continuity of the analysis of the situation by both speaker and hearer.

Current research on language sciences and communication theories show that these works have already avoided the 'conduit metaphor' by introducing the notion of information as a property related to objects and people, respectively. The idea of successful communication without people interacting with one another or the assumption of the possibility of neglecting interactive processes has been abandoned. As Chaffee and Berger (1987) have explained:

> Communication science seeks to understand the production, processing, and efforts of symbol and signal systems by developing testable theories, containing lawful generalization, that explain phenomena associated with production, processing, and effects.

Another important feature of modern research, such as cognitive science and communication science, is that they are conceptualized as interdisciplinary approaches. In addition, the variety of distinct theories on communication is embedded in the heterogeneous fields of communication research. The International Communication Association provides different criteria in an attempt to systematize current communication research. Consequently it categorizes various sectors of communication, for example, political communication, mass communication, health communication, public relations communications, and so forth. Alternatively, communication can be categorized according to

various interest groups or subject categories; for example, communications law and policy, visual communication, gender communication, and so forth. Furthermore, it differentiates between sections and interest groups, and between separate levels of communication.

As Berger, Roloff, et al. (2010) outlined, it makes sense to distinguish, on the one hand, between a pure *intra* level of two individuals, and on the other hand the *inter*-individual level concerning communicatory relationships among people, or among people and the organizational level focusing on people's interactive communication in an organization, or finally drawing a societal level combined of, and proceeded by, the communicative interactions and properties of people in and within institutions of society. The latter can be described as a systemic approach which underlies the communicative interactions among people and institutions as an interrelated interdependency.

The supposition I would like to make for the purpose of the present analysis is: any kind of published paper (FOMC statements, protocols, minutes, monthly bulletin) implies an offer to communicate. Inasmuch as both written and spoken sentences are to be seen as a kind of offer of communication, both are to be described as a language activity. A written and published paper from the Federal Reserve, for instance a FOMC statement, presents itself as a product of text composed of language. The difference between a written and spoken communication is that the latter is a flux of words or sentences, whereas the former is created or fixed in a certain occurrence (event). The date of its creation refers to a certain point in the past which nevertheless will have effects on the present and into the future. The effects of any written text will usually remain perceivable beyond the concrete situation in which it was composed and completed. Any written text carries its own unique identity, in the form of an expression or utterance. Understanding does not succeed by adapting to the author's intention: rather, it reflects an agreement on a practice. According to the systematic approach to communicative interaction, communication is not to be seen as an act of transmitting the speaker's or text producer's intention to the listener or reader.

Let us briefly set out the key elements of a communicative situation between the central bank and the financial market. We suppose that any communicative situation consists of a reader or recipient, a writer (text producer) or author of a text, and the knowledge or information embodied in the utterance or document. The reader of a written text will be at best supported by the gestures, mimes, symbols, intonation, and prosodic emphasis by the text producer. The coincidence of time in

the current situation – presenting the text by its author, and the audience that is listening – will supposedly lead to a better understanding. The reader of a text is able to check his understanding right away, while the author of the text moves on with his presentation. The written text supplemented by gesture, mimes, symbol, intonation, and prosodic emphasis and the immediate reaction to it by the reader will enhance understanding. Depending upon the reader's acquired knowledge – that is, his epistemic background and his experience – the recipient of a text will be able to identify the producer of a text either explicitly, or by referring to certain characteristics found in the text. This provides the possibility of assessing the written text, inferring meanings, and improving understanding on the part of the reader.

A presupposition for understanding a written text is the context of the production of this text. First of all, there is the context of the use of language, that is, the linguistic practice – a language-game as I will introduce in Chapter 5 – which is relevant for both the spoken and written communicative situation. In a spoken communicative interaction, a person is able to add the perceived elements of knowledge, the mode of the presentation, and the habitude of the author, as well as the particular history of the production of the text. All this will facilitate the discovery of any special social or terminological orientation in the text. For instance, in the case of a written paper by the FOMC of the Federal Reserve it is important to recognize who presented it and when (Thornton 2004); by the European Central Bank (ECB), as Ehrmann and Fratzscher (2005a; 2006; 2007a), Jansen and de Haan (2006), Rosa and Verga (2007) – among other authors – in their empirical investigations document. The time of presentation *and* the time of the production of the paper shed light on its meaning and importance. Understanding depends on a coherent view of the whole. The surroundings of a written or spoken text also entail the epistemic presupposition of an understanding.

Regarding theories of understanding, we need to differentiate between the concept of 'contextualism' as opposed to 'foundationalism'. Contextualism refers to cultural norms, to theories of discourse ethics and certain types of justification (Haack 1993). The distinction between both views – 'contextualism' and 'foundationalism' – concerns the means of justificative truth and correctness of a written text, for instance by referring to a particular class of beliefs which should be interpreted as determined by naturally given or intrinsic epistemic entities ('foundationalism') or by relying on beliefs built up from the context. The latter implies the context will serve as a producer of sense.

Regarding the constitution of the meaning, it is also important to focus on the surroundings of a text. This implies the mode of communication, that is, spoken language, whereas the specification of the topic of the text and its context is composed by the constitutive elements of the text production as such. To understand a text does not mean to register the words and what is written in black letters on the paper rather than to grasp and understand the potential, the non-identical, perception of the sentence. This sheds light on the importance of the recipient and his or her understanding, or, as Issing (1999) outlined, on the perception. Without a doubt, the understanding of a sentence has much more in common with perceiving what is going on in reality, or with context.

The historical line of traditional theories of understanding relies first on suggested correlations between objects and names, or of object, mind, and name as a kind of representation. Furthermore, it refers to the idea of a translation of objects into names and labels, or to the idea of transformation or metamorphosis of so-called input-output relations. Those concepts of understanding are devoted to the failures of classical models of communication and their presupposition: the neutrality of language. A second historical line of those theories of understanding focuses on the subject only, on the individual mind and mental state of a subject. To understand was now conceived of as a form of mind-constitution which excluded the outside world. Whereas the first historical line outlined the idea of representation or translation, the second historical line worked on the idea of a private constitution of the understanding as a procedure of a subject's mind. The evolution in these lines of analysis marked, therefore, a paradigm shift from supposed objectivism to supposed subjectivism. Both, however, have to be seen as a naïve form of simplification of understanding.

In contrast to a written paper or text, any spoken utterance from a text producer or author will only occur at a particular moment of time, due to the flux of spoken words and sentences. Communication is the use of language in practice. The use of language is inevitably connected with a way of acting. An act of communication does not create a simple causality between the communication and the subsequent results. The use of language set in motion a change of the knowledge. Communication is not to be confused with information because the communicative act leads to a change of the amount of knowledge. The attempt to explain communication by referring to a monocausality of information given by the sender to the receiver is not satisfying in the light of the underlying presumption of this model of communication. Any postulated

causality in social sciences is based on changes of content, but not on a change of a causal connection. The meaning of a written and produced paper or the meaning of an utterance (expression) is not driven by such causality.

The communicative way of proceeding is a composition of different modes of action. Nevertheless, as explained below (and referred to already above), meaning is not to be discovered by decomposition of the sentence into words but rather by the way of articulation or via expression (*Äußerungshandlung*). A central bank's role of guiding market expectations is inherently connected to communicative interactions. Considering its public mandate, a central bank is a key player. From that point of view, a communicative strategy of the central bank is not identical with a strategy of selling products. The central bank does not sell a 'product' because the creation of money in its functions as a medium of deferred payment, unit of account, and store of value depends on its acceptability by the public. Money functions as money because the role of the central bank has been accepted by society. There is no bilateral relationship which creates money in its functions. Money acquires its acceptability through a trilateral relationship in which debtors and creditors build up the first order of this relationship and a third party, the central bank or monetary authority, functions as the legitimate instance. Money cannot be defined by lawgiving or by a law, since a central bank must gain in credibility and reputation as a third party by fulfilling its mandate of price stability, hence through its reputation and credibility.

The following quotations briefly exemplify the crucial aspect that money is not defined by an object, truth, silver, or gold, but rather by confidence in its prospective functions as a medium of deferred payment, unit of account, and store of value, hence in its function as a public good. Here, the analogy with language makes sense considering that language in its function cannot be interpreted as a private language, 'language is necessarily a social affair' (Davidson 1992, 262). Language finds its role out of a trilateral relationship or a 'share world' (Davidson 1991, 156):

> I believe Wittgenstein put us on the track of the only possible answer to this question. The source of the concept of objective truth is interpersonal communication. Thought depends on communication. This follows at once if we suppose that language is essential to thought, and we agree with Wittgenstein that there cannot be a private language. The central argument against private language is that unless

> a language is shared there is no way to distinguish between using the language correctly and using it incorrectly: only communication with another can supply an objective check ... a standard of objectivity in other domains. (ibid, 157)
>
> The publicness of money resides essentially in its general acceptability, which make the value of money balances held by each individual depend not only on his own possession and market prices, but on the holding of other persons. (George Grantham et al. 1977, 345; in Spahn 2009, 6)
>
> Because money is a claim on the economy as a whole rather than on a single individual, there is not need to acquire information about the individual who offers it in exchange. ... It is information costs that lie at the bottom of any difference between money and other assets. ... The institution of money can act as a substitute for trust. (Douglas Gale 1982, 187f, 239; in Spahn, ibid, 4)

A central bank shapes market relations in order to establish a medium which will possess all necessary features of the credibility of money. There are no symmetric relations between a central bank and the agents in the markets. A central bank's goal is to participate in, and to contribute to, establishing the sense of market activities. The concept of the market is rooted in space and time. A central bank will coordinate its own expectations about the future path with the agents' expectations based on their future view and goals.

The current literature emphasizes the relevance of central bank communication. It has been examined by different methods involving the measurement of the words, different types of communication, and different types of information the central bank gives the public. Regardless of specific technical aspects and problems of these measurements, which authors debate in their research, the conclusions of current empirical studies seem to have achieved a consensus: communication helps fulfil a central bank's mandate. Another consensus is also conceivable: that is concerning the efforts to reflect and investigate communicative interactions between the central bank and agents in the financial markets more intensively.

In this section I would like to introduce arguments for differentiation among language, communication or communicative interactions, and information. According to the modern view of language, the commonly characterized feature of language, communication, and information is that these concepts do not refer to objects or things (Tugendhat 1976, 161f.). Things or objects, like cars, stones, and books have their

own bounds or districts, which can be easily identified, recomposed, weighed, and measured. But this is not true for language, communication, and information. Neither language nor communication nor information are to be identified as objects. Information and communication are often seen as a given fact rather than as something which requires implementation among people in order to be judged or assessed. Furthermore, language, or information, is not identical with communication. Language does not exist as a list in a catalogue. This is also true beyond the obvious fact of the existence of dictionaries.

As discussed at the beginning of this book, central bank communication should enhance the effectiveness of monetary policy. A central bank's communication regularly encompasses inflation reports, talks, minutes, statements, speeches, and monthly bulletins by a central bank. It implies written and verbal language. The communication of a central bank is also interpreted as the disclosure of given information by the central bank to the public. In empirical studies, the release of information is often discussed as 'dismantlement' (Buiter 1999; Ehrmann and Fratzscher 2003). What does the measurement of the communication of a central bank estimate? Does it measure the transmission of given information? According to literature, it is supposed to measure whether and how the sending or providing of information has initiated any, or a particular, effect in the activities of the market or in agents of the market. The measurement tries to establish and document an increase or decrease of market transactions or changes to interest rates.

From the viewpoint of the classical model of communication, the primary goal of communication is the effectiveness of the exchange of information between the sender and the receiver. The measurement of the effectiveness is desirable and feasible. The striking feature of the classical models of communication is the heritage of Aristotle's view on rhetoric, which has also been interpreted as a model of communication. Aristotle constructed two models of thinking. One model entails absolute but not relative or relational entities. The second model describes the procedure of communication as rooted in the intention of the speaker and the assumption of the causality of the effects of rhetoric or communication, respectively. The classical model of communication is based on both principles as sketched in these two models. The most famous successor of this model of causality, which is oriented towards absolute entities, hence to positions and not to relations, is the early theory of Lasswell.

In the literature we find a distinction between two approaches to communication, information and language, both of which are based on

the 'conduit metaphor' (Fiehler 1990, 104f). The first approach is found as metaphors in daily life. This also casts light upon the multiplicity of aspects ascribed to communication:

a) communication as a means of conveyance of goods;
b) communication as a battle of argument, as a defense, as an attempt to campaign against another person;
c) communication as an act of eating (feeding), excreting, and digesting;
d) communication as a procedure for constructing a house or a speech, to underpin an assertion or break it down;
e) communication as a method of weaving, dwelling on thoughts, and getting tangled;
f) communication as an act of painting a picture or delineating the ambience; as an illustration of one's mental state or one's thoughts, which otherwise would remain hidden;
g) communication as a process of growth-like flowers in a garden, as a creeper climbing a wall;
h) communication as flux or movement.

This short list of examples might give an idea on the variety of the uses of communication in different situations in daily life. As we follow this approach to communication, we are able to grasp that communication seems to have many uses in different life situations. Nevertheless, this approach fails to describe communication properly because of the underlying assumption that communication is interpreted as corresponding to objects or entities and their attributes.

The second approach to communication, also based on the 'conduit metaphor', underlines the role of language alleged to be neutral because it gets its relevance as a 'veil of thoughts'. Furthermore, it shows that communication is a central instrument for conveying information between the sender and the receiver. Communication serves as a rational procedure for transmitting information from the sender to the receiver. It also allows the balancing of existing gaps of knowledge between both agents. Supposing a gap of knowledge is an important assumption in order to give relevance to communication. In this, communication is not linked with understanding but rather with the attempt to balance given information.

Both these approaches are based on the 'conduit metaphor'. It is for this reason that communication is interpreted as an exchange of given information, in order to reciprocate information which should balance

the different internal states of both the sender and the receiver. But with this enlarged concept of communication, exchange and reciprocity, the process of communication itself has not become any clearer. The aspect of reciprocity has not removed the classical view of communication because it remains an epiphenomenon. It is misleading to argue that a process of communication is nothing more than an exchange of given information or an exchange of a given meaning. Nor can communication be explained by referring to an assumed symmetrical or reciprocal distribution of information or meaning. Insofar as the investigation of communication is focused on the idea of the measurable effects of the communication rooted in the linear transmission from a sender to a receiver, but neglecting the context in which the communicative action takes place, the incompleteness of models of communication still remains. Communication does not refer to immobile objects. The understanding of communication does not succeed by an appeal to reciprocity but only by investigating the communicative interaction in given contexts.

As I will expound in the following chapter, communication encompasses relations and procedures which are systematically changeable through the communicative interactions. Additionally, it needs to be recognized in the attempt to quantify and to measure communication that communication has no dimension which can be precisely stated, like the dimension of electricity or magnetism. Fiehler (1990: 192f.) pointed to the mathematician Norbert Wiener, who explained in 1948 that communication is understandable only as a systemic relation and not as a linear procedure. Wiener himself referred to the logic and the paradoxes of communication. Bertrand Russell gave striking examples on paradoxes of communication. One famous example is the following: if a Cretan says, 'all Cretans are liars', an example Watzlawick et al. (1967) also discussed as a paradox of communication.

In technical engineering terms, any communication implies interchanges in order to convey data, information, symbols, and signals in the specific situation in which the communication takes place. The goal of this interpersonal communication is similar to the role communication has in the 'conduit metaphor' approach. According to the 'conduit metaphor', both the mundane and scientific concept of language, information, and communication is that of a physical entity for transmitting information, signs, or symbols between different systems. In this engineering view of communication, the term information is used as a synonym for knowledge. Granted the premises that any linear transmission of information will enhance the body of knowledge, balanced by

the sender and receiver symmetrically, nothing could be more desirable than the continuity of the linear communication. Reality, information, and meaning are already given and need only to be equalized between the sender and receiver, like water in a river. The modern approach to linguistic sciences emphasized the *in*significance of the 'conduit metaphor' (see Trabant 2003).

In their later work, Johnson and Lakoff (1982, 9) emphasized the uses of the 'conduit metaphor' in situations in daily life:

> These are situations in which the following conditions hold: (1) These participants are equally competent speakers of the same dialect of the same language, and individual variation is insignificant. (2) Relevant to the subject matter and the context, the participants share a) the same cultural assumption, b) the same relevant knowledge of the world, c) the same relevant background assumptions about the context of the utterance, d) the same understanding of what the conversation is about, and e) the same relevant conceptual metaphors and folk theories.[3]

What should be right for communication seems also to be appropriate to language, too. The classical view did not differentiate among words, sentences, language, communication, and information. Moreover, it draws no attention to processes of understanding. Language is identified as a system of rules or convention, as an instrument of thoughts, as a medium of transmission of experience, information, and knowledge, as an organism, or as the amount of infinite words.

Of course, different conceptual approaches to language, information, and communication provide different understandings. Language, information, and communication are not defined by the exactness or non-vagueness of the concept, nor by its numerical elements or quantities. In contrast to such a view of exact and non-vague terms, language, information, and communication get their meaning out of situation and context as related issues. The view of the vagueness of language and of meaning necessarily avoids the adherence to objective criteria of truth (Graff and Williamson 2002; Raffman 1996). To put it more precisely: language, information, and communication are not absolute objects or entities which are independent of their use.

In contrast to such a classical model of communication, any communicative act is inevitably connected with the exertion of efforts to understand. The misunderstanding arises out of the conception of language, communication, and information as absolute object which could

be quantified, measured, and objectified as things. Articulation, that is, expression and utterances, are not understood because they are measured and quantified. Wittgenstein (1983) emphasized:

> Nothing is commoner than for the meaning of an expression to oscillate, for a phenomenon to be regarded sometimes as a symptom, sometimes as a criterion, of a state of affairs. And mostly in such a case the shift of meaning is not noted. In science it is usual to make phenomena that allow of exact measurement into defining criterion for an expression; and then one is inclined to think that now the proper meaning has be *found*. Innumerable confusions have arisen in this way. There are, for example, degrees of pleasure, but it is stupid to speak of a measurement of pleasure. It is true that in certain cases a measurable phenomenon occupies the place previously occupied by a non-measurable one. Then the word designating this place changes its meaning and its old meaning has become more or less obsolete. We are soothed by the fact that the one concept is more exact, the other the more inexact one, and do not notice that here in each particular case a different relation between the 'exact' and 'inexact' concept is in question: it is the old mistake of not testing particular cases. (Wittgenstein 1967 § 438)

Inasmuch as the effectiveness of the communication of central banks should enhance the effectiveness of monetary policy, it is obvious that investigations and contributions on their communication and language are mainly concentrated on those instruments and methods of measurement which are predominantly applied to economic questions (Kohn and Sack 2003; Ehrmann and Fratzscher 2005a). Nevertheless, it makes sense to enlarge the view on economic interactions which goes beyond such methods. If language, sentences, and words are extracted from their use in practice, they will lose their meaning and will be nothing more than empty concepts. Wittgenstein (1978 *PI* § 96) explained:

> Thought, language, now appears to us as the unique correlate, picture, of the world. These concepts: proposition, language, thought, world, stand in line one behind the other, each equivalent to each. (But what are these words to be used for now? The language-game in which they are to be applied is missing.)

The meaning of a word or sentence arises out of the use of colloquial language, but not by supposed correspondences of the objects

to the world. The use of language is not a result of constructing a superstructure, but a consequence of the development and changes of concepts due to changes in the society and sciences. Language-based knowledge is not composed of atomic entities. Words and sentences are not empty boxes or empty containers which can be filled in with meaning.

The implication of the conditions outlined and premises encapsulated in the classical view is that the function of language is to conduct and transfer thoughts or mental states from one person to another. Writing and speaking should be seen as analogous to inserting a coin into a machine: according to the classical view, when people write or speak they insert their mental state or thoughts into words. Words, therefore, are nothing more than the veil of thoughts. Consequently, words merely accompany thoughts by containing and transferring it from the sender to the receiver. A further strand of this scientific approach to communication stated that communication is a method for constructing and negotiating facts of reality and social life. According to this view, communication is a method of creating reality.

2.2 Constitutive process of information processing

I now turn to *information as information processing*. As a key assumption, *information* is regarded as *a related object*. More precisely: information refers to people or other objects and, more importantly, different structures of communicative actions. The acknowledgement of *information as information processing* implies that information is not given ontologically but rather that we must consider *information as a related object*. This does not mean focusing on a person's intention or mental state but rather paying attention to a person's interactive activity and procedure. Information is not a natural phenomenon like trees or stones.

The concept of *information as information processing* draws attention to certain assumptions about a person's cognitive ability to learn, adapt, understand and, hence, configure their environment (Planalp and Hewes 1982). It refers to persuasions as a particular inherent moment of any communicative interactions and to the environmental structures of the discourse (Sucharowski 1996). Any information is perceived, recognized, and understood by people (Pretty and Cacioppo 1986). Actions convey persuasions. There is, of course, a convincing example of a successful interdisciplinary approach in economics and science. Take, for instance, the new paradigm of information economics, which acknowledges fundamental research in cognitive science to refine

economic modelling of information (Kahneman 2003a, 2003b). In an earlier paper Akerlof (2002) stated:

> Cognitive psychology pictures decision makers as 'intuitive scientists' who summarize information and make choices based on simplified mental frames. Reliance on rules of thumb that omit factors whose consideration have only a small effect on profit or utility is an implication of such cognitive parsimony.

Working out a non-linear conceptual framework of central bank communication requires the introduction of communication as a multidimensional approach. The key assumption inherent in this view states that information processing is a result of people's process for selection, perception, and adaptation. Furthermore, it is based on the process of docking information to an acquired knowledge base. This knowledge base is changeable by the learning process of the individual.

According to modern cognitive science, any information processing is called a cognitive procedure driven by the central nervous system (Cacioppo 2002). Of course, neither economic theories nor theories on central banking or monetary policy are concerned with the functions of the central nervous system – not even the central nervous system of the central banker. This is admittedly beyond the realm of economic research. However, economic theories are applied so as to work with assumptions of information processing, which are often modelled as a linear transformation of information processing or linear modes of causalities. It is hardly convincing, however, to model information processing by an analogy with the mechanism of causality by neglecting the important factor of related people – or groups of economic agents – institutions and norms to which it is related. The car analogy should be substituted by the language analogy.

A person acts for a purpose and on volition. This is also true for institutions as interpreted by modern organizational or institutional theory. Institutions are seen as learning, acting, and changing (Noteboom 1999). To argue that the reason for the activity is arrived at by the operation of a pendulum is an inaccurate premise for economics as a social science. People act from a complex set of hierarchically ordered wishes that appear to each economic agent or institution as rational at the time the actions are taken. Acting without reason is not rational at all. To presume actions to be a mechanism without reference to reasons is not an accurate premise for the communicative approach to the modern paradigm of central banking as discussed in this book.

Moreover, research in cognitive science indicates that modelling a person's perception and understanding as a black-box mechanism is misleading. I refer here to Goldstein and Gigerenzer, who introduced a heuristic approach to social sciences.[4] Heuristic methods are strategies that steer information searching and processing, and cannot be handled by logic and probability theory. In contrast to Kahneman and Tversky (2003) and Gigerenzer (2002), Gigerenzer and Goldstein presume a different concept of rationality is needed in order to work out the information processing and decision-making procedures under uncertainty. Goldstein and Gigerenzer's (2002) interdisciplinary research acknowledges the cognitive capability of people. They call the environment that surrounds economic decisions and behaviour an 'ecological environment' (ibid 2002, 85). The social environment is described as an ecological one because the individual act within certain surroundings is rational in order to achieve a goal.

Goldstein and Gigerenzer in particular introduced 'the recognition heuristic' to explain how an individual exploits the structures of information in the changing environment by using memory and perception. The authors asked the participants in their experiment the following question: 'Which city has a larger population: San Diego or San Antonio?' While 66 percent of Americans answered correctly, 100 percent of Germans answered correctly that San Diego is larger. The surprising result of their experiment was that during the four-week testing phase the accurate answer was given less frequently by participants although they had comparably more information, memory, or the opportunity to talk in the last phase than in the starting phase of the experiment. The recognition information acquired during four weeks of experimentation was used as a substitute for the genuine recognition information. From the experiment Goldstein and Gigerenzer (2002) concluded that more information, knowledge, or data is not always better in solving a problem.

The demand to maximize or optimize the store of knowledge, information, and data is not a true demand in social sciences (Künne 1993). Moreover, it is often not possible. Mathematical optimization often does not provide any empirical validity. Heuristic studies, for instance recognition heuristics, are concerned with questioning how agents make decisions and judgments in a concrete situation. They do not depend on optimization or maximization of the utility function or working out a mathematical proof. The recognition heuristic is ecological because it draws on a relationship to the environment and not to mathematical or logical rules. Gigerenzer (2004, 62) described an interesting example

which enlightens us about the rules of formal models in decision making based on using everyday language:

> A decision theorist from Columbia University was struggling whether to accept an offer from a rival university or to stay. His colleagues took him aside and said: 'Just maximize your expected utility – you always write about doing this'. Exasperated, the decision theorist responded, 'Come on, this is serious'.

Heuristic thinking is crucial for decisions and judgments that are not measurable and computable or if measured and computed would lead to serious problems of interpretation in terms of reality. One has to decide: Is the decision-making process computable or not, and how can the likely outcome of the mechanical procedure be linked to the contemporary world? To put it briefly: the recognition heuristic is not a general method applicable to any kind of question because of the conclusion of the Gigerenzer experiment, that is, 'that a recognized object will be chosen over an unrecognized object'. The Germans chose San Diego because they had more knowledge or information about it than about San Antonio. Application of the recognition heuristic, and of everyday language, is suitable if ignorance or lack of recognition is systematic. This is also true for interaction between the central bank and financial markets. Gigerenzer (2004, 64) gave the following example:

> If you learn to fly an airplane, you will be taught a version of it: When another plane is approaching, and you fear a collision, then look at a scratch in your windshield and observe whether the other plane moves relative to that scratch. If it does not, dive away quickly. For the pilot, the goal is to avoid a collision, whereas for the outfielder, the goal is to produce a collision. The nature of the heuristic is the same.

He resumed:

> Evolved capacities can make a heuristic simple, while the structure of the environment can make it smart. (ibid)

Goldstein and Gigerenzer (2002, 76) outlined the need to acknowledge that decision-making and judgment are based on an acquired knowledge base, so-called 'evolved or learned capacities of an organism'. The acquired knowledge base is embedded in social acting and

practice. Heuristic methods exploit the evolved capacity and the structures of the environment. Heuristic methods are often incompatible with measurements and computer programs, as fundamental research in psychology indicates, for instance, the gaze heuristic. Catching the ball in a game does not require calculating or computing a particular rule about how the fielder should move in order to catch the ball. The goal of optimization does not fit the need in practice. According to the recognition heuristic, the authors concluded that forecasts based on the heuristic model will not lead to optimization since the logic of heuristic methods is variable:

> The gaze heuristic, for instance, predicts that players catch the ball while running, which follows from the fact that the player must move to keep the angle of the gaze constant. Similarly, when the ball is thrown to the side of the player, one can predict that the player will run a slight arc. ... (see Shaffer et al. 2002 in Gigerenzer 2004, 64)

What can be concluded from this recognition and gaze heuristic for central banking? The evaluative procedure on which any decision-making process is based is inevitably rooted in an acquired knowledge base. It is also due to differentiated modes of judgment of the information in different contexts (Gigerenzer 1996). Regarding this research I would like to emphasize that information processing is neither a linear procedure (because of distinct responses and reactions by people in different environments) nor a process beyond communication interactions and the use of language. More importantly, it is the language and communication-*based* information processing that creates such complex results.

Information processing is a cognitive process involving a person's selective perception, different modes of adaptation and understanding based on bounded rationality (Kahneman and Tversky 2002; Gigerenzer and Selten 2001a, 2001b), and it is precisely this cognitive process that is not an invisible or inner, mental process, but rather one of discourse and communicative interactions, which, I should remind the reader, are driven by the use of language because language is not neutral to cognitive or heuristic procedures. Gigerenzer et al. show in their heuristic approach to social phenomena that recognition capacity guides the understanding and meaning of information perception. They also expound that information is perceived through recognition ability, experience, and selective perceptions, which also depend on

the context and cannot be delegated to rules or criteria beyond that game or practice. It is important to open up the debate beyond deductive modelling by integrating cognitive science results considered relevant to central banking as a conceptualized language analogy. This research in cognitive science is important for macroeconomics in order to understand how meaning and understanding evolve. As revealed by the history of information economics, the interdisciplinary approach to macroeconomics has provided theoretical developments. Nevertheless, a great deal of work has to be done if we are to understand new phenomena in financial markets and behavioural finance (Fudenberg 2006; Mullainathan and Shleifer 2005).

Expanded a little, the issue outlined a bit further, that is, information as processing information and, hence, as a related object, includes drawing attention to the limits that constrain a person's attention and information processing. A pioneering work has been introduced by Festinger (1957) who defined it as people's 'cognitive dissonance'. This 'cognitive dissonance' theory is based on the observation that a person's perception is both incomplete and selective regarding the acquired knowledge base, experiences, preferences, interests, plans, and cognitive capacity.

Moreover, people are inclined to avoid divergences of cognition for the sake of a pleasant state of mind. If, for instance, a passionate smoker reads information about the danger of smoking, this will create cognitive dissonance in the person. According to the 'cognitive dissonance' theorem, the smoker seeks a reduction of cognitive dissonance. How could cognitive dissonance be reduced? The person could stop perceiving and reading the dissonant information. Alternatively, the person could attempt to discover other information to reject the information that smoking is a danger. Or the person could develop a ranking on the probability of dying as a consequence of smoking in comparison with other causes of death, for instance accident, hurricane, lightning, and so forth.

The important question of which strategy is eventually chosen to reduce cognitive dissonance is embedded in various social aspects, motivations, emotions and interactions – and still open in social research. While cognitive dissonance theory has been influencing scientific procedures since its arrival in the 1950s, research on motivations, efforts to reduce cognitive dissonance and the different ways people choose to achieve a better or pleasant state of mind has been investigated by social psychology, cognitive science as well as economics to this day (Harmon-Jones and Mills 1999).

As already mentioned, one striking result of cognitive research is that the cognitive or learning procedure never starts from zero. In contrast

to a machine such as a car, it is not possible to downsize the knowledge and experience back to zero by turning the key. Any conveyed information will therefore dock to the acquired knowledge base and experience of a person, the so-called cognitive representation. The cognitive capacity and information processing of a person cannot be explained by referring to the person as an empty box that should be filled up with information. This would run counter to the research of cognitive, language and learning sciences. Moreover, it would contradict the assumption that information is an interrelated object as modelled by the research of cognitive and language sciences. Perceptions, meaning, and understanding are not mechanical outcomes of a linear transformation of information. This is accepted by modern sociology, organizational theory, and new institutional economics (Streit, Mummert and Kiwit 2000; Streit 2009). It should, therefore, not be neglected in the literature on central banking and monetary policy. I would like to emphasize that economics as a social science uses everyday language to develop theories and hypotheses. Economics is also the result of language-based and communicative interactions.

The heuristic methods outline the procedure of adaptation and reception based on the acquired knowledge base, emotions, and behaviour, which are configured and reconfigured by distinct experiences, cognitive procedures, and interactions with people and/or institutions. Modern cognitive and learning sciences describe information processing as both a receptive and a constitutive process (Snyder and Stukas 1999; Sullivan, Snyder and Sullivan 2008). A procedure in the receptive mode of information processing enables understanding by a person's ability to steer their attention and perceive information against the background of their acquired knowledge. This receptive mode is accompanied by a process of personal selective evaluation and reflection on the information.

The constitutive process of information processing describes the roles of cognitive representations of intention, facts, and feelings, which all have been mostly learned by the individual. According to recent research in scientific debates there is no existing controversy about that: Learning is dependent on emotions, feelings, and memory. There is a consensus to accept the individual as a learning person and not an empty container. Moreover, the understanding of information is linked first to the acquired knowledge of a person and impregnated with particular issues of judging. Secondly, the assessment or judgment of the information is connected to the first aspect and dependent on the relevance of the information. The latter is not supposed to be known.

To sum up part 2.2 concerning the constitutive process of information processing and information as a related object: information processing as a constituent procedure is inevitably impressed with an individual's cognitive capacity, acquired knowledge, experiences, and expectations. It follows from this that first and foremost the behaviour of agents involved in the financial market cannot be forecast by the delivery of information from the central bank without considering how this *information as a related object* will be acknowledged or understood by the public.

2.3 The interaction dimension

I turn now to the second dimension of the conceptual framework of communication. Although it may be somewhat irritating to differentiate interactions from context because all kinds of interactions take place in a changeable context, I would nevertheless propose this distinction for the sake of clarity. Interaction can be distinguished into theories which deal with the interdependence of *structure and actions* and theories which focus on *understanding* and judgment. As I have already emphasized, the modern view no longer presumes that central banking works against the market but rather *'through the market'*. The aim of this chapter is to link this (*through the market*) to communicative interaction, hence to language and speech. The consequence is that central banking must focus on the interactions between structures and action. Since interactions are based on the use of language, the central bank must analyze the communicative interactions.

2.3.1 The interdependence of structure and action

The central bank's context is an ingredient of the communicative interactions among agents in the financial markets. This context is also framed by the phenomenon of 'double contingency' regarding the interdependency of the agents' expectations. The term 'double contingency' emphasizes a pattern of social interaction of two interdependent persons – as a minimum. It emphasizes that communication is in no case a one-way street. Paying attention to communicative *interactions,* that is, to the 'corresponding person', is implied by 'double contingency' (Parsons 1961). The consequence is that views of communication in which meaning and understanding are supposed to be given as representations of the sender's mind or the sender's mental state are insignificant.

In the light of the 'double contingency', I would like to add that communicative interactions of agents are described as social interactions

that arise out of people's articulated interdependency. The expectations, wishes, intention or information are *articulated* expectations, *articulated* wishes, and *articulated* information – and, hence, related to others. Expectations, wishes, intention, and information are not hidden mental states (Muchlinski 2006).

The theoretical framework to approach communicative interactions also entails the acknowledgement of *intersubjectivity* (Fullbrock 2002). The term intersubjectivity is not restricted to the interactions of people. Current research in organizational theory and institutional economics emphasizes the interdependencies of institutional structures and communication as a mode of intersubjectivity – for instance, 'structuration theory' as propounded by Giddens. 'Structure is not "external" to individuals…; it is in a certain sense more "internal" than exterior to their activities in a Durkheimian sense' (1984, 16). According to Durkheim, sociological and social procedures are not rooted in psychological states. They are rooted in social interactions. Individual agents and collective agents communicate through their actions and interactions. By this they also build and rebuild structures in social context. Giddens: 'Structure, in its broadest sense…should be understood as rules and resources, recursively drawn upon and reconstituted in the process of interaction.'[5] He argued similarly to Wittgenstein, who had emphasized that the term rule as applied to a social context is not bounded by definition; that is, rules exist not by definition, but by practice. Following a rule and acting in context therefore implies *creating the rule by acting.*

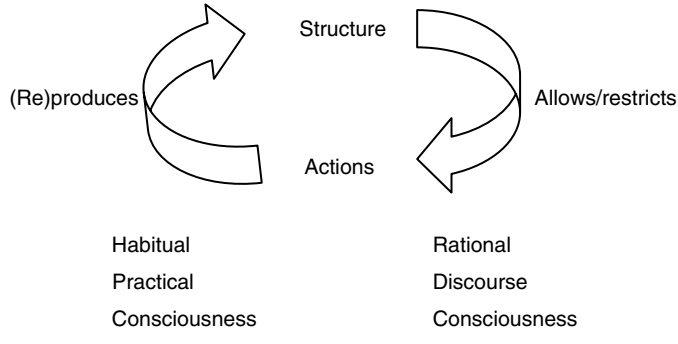
Social practice implies acknowledgement of the modes of acting, that is, the language activities and knowledge of procedure in social practice:

> In analyzing social relations we have to acknowledge both a syntagmatic dimension, the patterning of social relations in time-space involving the reproduction of situated practices, and a paradigmatic dimension involving a virtual order of 'modes of structuring' recursively implicated in such reproduction. (Giddens 1984, 17)

Acting agents do not merely produce but rather reproduce and shape the situation. By acknowledging their own experience and acquired knowledge, they configure the paradigmatic environment which frames further actions.

In contrast to macroeconomics, where conveying information through communicative acting has been neglected, the sociological approach to research of organizations and institutions in the 1970s

defines the actions of institutions as social practice or social interactions (Sydow and Windeler 2000). The communicative interaction of agents in organizations, institutions, and markets encompasses hermeneutic principles and interpretative schemes. The following diagram shows that structure is not externally given, rather it is dependent on actions and vice versa. This interdependency is of great importance for the approach to communicative interactions of central banking according to the modern paradigm of central banking. Giddens (1984) emphasized the interdependence of structure and acting that I wish to depict in the following graphic:



Giddens termed the interdependence of structure and action as the interdependence of 'micro-action' and 'macro-structure'. The agent's decision-making and interaction is framed by a macro environment that is influenced by the action. The graphic above makes it clear that the action is embedded in customs or habits and is also rational. Moreover, a particular action is based on habitual action in practice. Habitude encompasses the *body of knowledge*. This *embodied knowledge* or acquired knowledge frames rational action and is influenced by the habit. The relationship between the structure and the action is a gradually changing one. Whereas the habitual action is embedded in custom – that is, education, acquired knowledge, experience, and learning capacity – the rational action is oriented towards seeking a common goal in practice. The interdependence of structure and action also implies the interdependence of cognitive capacities. Practical consciousness is based on custom while discourse action is framed by modes of strategy and interactions.

The action necessarily takes place *in* social contexts which create and configure social structures, rules, resources, and institutions. By acting,

agents always focus the pattern of structures in social systems on reflective action. Giddens described this analogy with the use of language by following Wittgenstein's approach to language. The constitution of social reality and its maintenance by social interactions are based on acting and the use of language. For instance, Gidden's 'structuration theory' emphasizes the significance of the constitution of social institutions, rules, and resources by social interaction. It focuses on the interdependence of agents and institutions in practice. It is based on epistemic and theoretical meaning and inevitably connected with the use of language in practice. Giddens (1986) outlined his consideration on the use of language and action with clarity:

> Structure here presumes the idea of an absent totality. To understand the sentence which the speaker utters means knowing an enormous range of rules of a syntactical[,] ... semantical (and pragmatical) kind which are not contained within the speech act but are nevertheless fundamental to understanding it or to producing it. It is a parallel idea of structure (as an absolute totality) which I hold to be important as a concept for the social science as a whole, and as basic to the notion of duality of structure.

Reflexive action of agents in social contexts implies that agents neither analyze the grammar rules of language before using the language nor analyze the rules and resources in which social institutions are embedded before acting.

The act of sharing reactions, knowledge, and judgments among group members is not comparable with sharing an apple or bread by slicing it into equal parts. To diminish the whole into its parts implies eliminating it rather than creating the meaning and understanding in the communicative interaction. Sharing is not based on an explicit agreement or written document such as a consensus. Sharing is a procedure involving acting in the particular context and, hence, by the use of language.

What follows from this regarding agents in the financial markets? First: agents perceive and reflect their action in practice by adapting it to their wishes, motives, and expectations to develop meaning and understanding in a situation.

Second: agents use their base of acquired knowledge, experience, and emotions to recompose it through distinct experiences and cognitive procedures. They recompose a huge variety of perceptions, knowledge, and experiences in order to maintain their ability to act in a situation.

By acting, the agents form and reform their ways of acting and, hence, inevitably, the social structures.

I would like to add to Gidden's view a few considerations. The sociological point of view is relevant to economics, particularly to central banking *through* markets, because hermeneutic principles and interpretative schemes imply stepping beyond the view that concepts or the meaning of words and sentences, hence the understanding, are ontologically given or fixed. Economics and economists are used to working with quantitative methods and models which are based upon on exact definitions, deductive reasoning, and measurable entities. Any interpretative or hermeneutic approach is supposed to be superfluous or undesired. There seems to be a prevailing sense in most branches of economics that it has nothing to do with words, language, discussions, communication, and understanding. Interpretation is not needed because of the measured facts and data. However, facts, data, and measurements have to be described and interpreted as methods and, additionally, the means of their creation need to be explained.

As I have shown in Chapter 1, the measurement of monetary growth rates, or monetary aggregates, and the number of projected paths of monetary targeting were declared to be precisely defined. Nevertheless, it was insufficient to understand the new technique. In particular, the Volker era documents the switch to debate on whether and how the communication and language of a central bank should play a role.

For the sake of illustration I would like to move to another paragraph in the FOMC transcript of 1979. Volker explained that the projected path of monetary growth rates also implies the necessity of judging the development of the Federal Reserve funds rate and the decision-making of the public. Moreover, a deviation from the path implies the need to inform the markets about the implications of the new technique:

> I think we would attempt, probably not very successfully, to avoid telling the market if we hit the [constraint] in more normal circumstances or precisely what the range is. But they're going to by smelling around for it just as they do now and I don't know how successful we would be in avoiding that entirely. All I'm saying is that perhaps we can try to disguise the operations by doing them at a quarter point less or letting the rate go a quarter point or a half point above [the constraint] for a day or so. But the market is going to be feeling for where the top or the bottom of that range is if [the rate] goes persistently in one direction or another. And if it does, we can get in a situation, as I said earlier, where it's just going to lock itself against

> the upper level or the lower level and stay there. (FOMC Transcript 10/6/1979, 26)

Volcker accounted for the consideration that communication and discussion would change the situation compared with delivering information to the market. The FOMC sought to avoid an interpretative or hermeneutic approach by the market participants to its own strategy, a strategy which was neither fully explained nor described at that time, but was rather a 'smokescreen':

> There is an immediate advantage in the publicity; there is a disadvantage not very far down the road if people read this as a commitment and in fact we are not going to be able to live up to that commitment. (FOMC Transcript 10/6/1979, 27)

This FOMC quotation shows that discussions and language are elementary to the interdependence of structure and action. In contrast to other areas of macroeconomics, the modern view of central banking demonstrates that the interdependence of structure and action cannot be avoided. In fulfilling its mandate a central bank cannot ignore the market reaction as a response to its own action. It is important to acknowledge this interdependence and to leave behind the notion that central banking works on a linear input-output-relation between a central bank and the public. The 'base-drifts' of the FOMC, introduced under the Volcker era, document the constitutive role played by language and communication. Inasmuch as the traditional model view did not serve as a framework for monetary policy in times of stagflation, Volcker stepped beyond purely deductive reasoning models of monetary growth rate targeting and the premises of the monetarist view. As noted in Chapter 1, he assessed that era as a 'monetarist experiment in practice' and, hence, supported the view that money is not neutral.

The fear that talking to the public could be understood as a commitment to particular further decisions (as stated by Volker in the above citation) had been on the agenda of the Federal Reserve for a long time. Talks and communication, or at least explanations of HOW, WHEN and WHY the Federal Reserve was acting, were for a long time interpreted as an 'open mouth policy'. Communication and talks were interpreted through the lenses of the Barro-Gordon and Kydland-Presscott model view as impediments because the FOMC gave reasons to anticipate its monetary policy strategy, whereas the model view maintained that only unanticipated monetary policy matters. The Federal Reserve was

accused of not being able to act efficiently due to lost credibility and being merely a 'hostage to market sentiments'. Since it is impossible *not* to communicate through 'monetary mystique', the FOMC was compelled to learn to communicate its own strategy and view. Therefore, the FOMC – and of course other central banks which are not examined in this book – must respectively be seen as a learning organization or institution. The learning organization is a familiar figure in the modern literature on organizational learning and institutional economics (Sydow, Schreyögg and Koch 2009). This literature is concerned with questions such as how individual learning could become institutional learning and how interactions and communication create knowledge on an institutional level. The question of if a central bank should develop its strategy along a path of dependence or not is still in debate.

More critical is the idea that cognition and knowledge are *embodied* in structures, that is, organizations and institutions, which allow or restrict rational actions (King 2004). Organizational literature can be traced back to Weick (2009/1995), who introduced the organization as a 'sense-making system'. The sense-making procedure is seen in the interdependence of structures and actions. This also refers to the investigation of organizational evolution (Sydow 1992).

The intellectual roots of a learning institution are in analytical philosophical, for example, Gottfried Frege (1892), Bertrand Russell (1914), Ludwig Wittgenstein (1958) and psychological science, for example, Piaget (1974). In economics it is rooted in Hayek (1952). The reference to embodied cognition can be expanded by a reference to embedded recognition. Both frame the approach to communication as a communicative interaction. Whereas Wittgenstein emphasized the meaning of words and sentences, Frege and Russell introduced the distinction of sense (connotation, intension) and reference (denotation, extension). According to Frege, the 'sense' is the way in which something is 'given'. Given does not mean it is given like an object, such as a stone or car, but that it is given *by perception*. The reference is towards something which is given – perhaps one could say, established – *by* perception and, hence, it refers to an 'indeterminate' reference.[6]

Regarding the patterns of action, we can conclude that meaning and understanding comprise communicative interactions. According to the literature and central banking, it is not surprising that the implications of communicative interactions are recognized unavoidably in cases where communicative interaction fails unexpectedly. One illustration is when Bernanke, who was expected to bring clarity to the Federal Reserve's monetary policies as the new chairman, got into hot water

when he explained to a journalist in a private conversation that he had not turned dovish on inflation. This incident, which occurred during a time when financial markets were especially sensitive about tight monetary policy, provoked market uncertainty and media criticism.

A lot of media criticisms were also on the agenda during the Volcker and Greenspan era. Greenspan's way of communicative acting – his use of language – provides a good example for new and distinctive communicative interactions with financial markets. A lot of work needs be done here in order to evaluate it precisely. The 'Greenspan prose' (Sicilia and Cruikshank 2000, Woodward 2000), as his use of everyday language is labelled in the literature, initiates the perception of the Federal Reserve's environment by agents in the financial market. One important aspect should be underlined here. A significant pattern of Greenspan's communicative interactions was that he did not communicate through a coded language. Let us resume with this consideration here: since the Volcker and Greenspan era, the financial market has been learning how important the use of language is according to the pattern of monetary policy actions and how important it is to understand miscommunication.

Attempts to define the notion of communicative interactions are often linked to a description or to a definition of *mis*communication: a. lack of clear or adequate communication; b. an unclear or inadequate communication. (Coupland, Wiemann and Howard 1991) Similar to the term communication, the term miscommunication is imprecise and ambiguous. Due to everyday language, neither exactness nor non-ambiguity of the language in use is achievable (Taylor 1992). What follows from the misleading nature of communicative interaction can be seen for itself: 'By studying what has gone wrong when communication breaks down, we seek to understand a process that goes unnoticed when it is successful' (Gumperz and Tannen 1979, 307; Gumperz 1982).

Let us conclude this short consideration about miscommunication thus far: The process of understanding seems to be a process in which no doubts about the meaning of utterance emerge. Communication is always based on the reciprocity of space and time interrelated to people. One can refer here to the epoch-making work in social sciences and humanities on communication by Paul Watzlawick and co-authors (Watzlawick, Beavin and Jackson 1967). The authors investigated different kinds of situations, modes and forms of communicative interactions. Their results are persuasive if, for instance, we look to the history of the Deutsche Bundesbank until the launch of the European Central Bank (ECB). The Bundesbank (2000) communicated through a persistent

avoidance of explaining its decisions and policies to the public, that is, it communicated non-interactively. Even in the case of people or an institution, represented by its speaker or chairman, deciding not to respond – which according to Coupland et al. (1991) is interpreted as a non-*action* or non-*response* – this behaviour will be understood as a *particular* kind of communicative reaction regarding the theory proposed by Watzlawick et al. However, the miscommunication cannot be solved by a model of linear information transformation. As modern language scientists explain:

> 'The language use and communication are in fact pervasively and even intrinsically flawed, partial, and problematic. To this extent, communication is itself miscommunicative ... ', i.e. it is a misconception of what communication should be. (Giles and Coupland 1991)

Communication and language cannot be treated as an exact, unambiguous, measurable entity, which could be sent by a linear transformation. Therefore it is not an appropriate demand in social sciences. Consequences of this demand are expounded by Eisenberg and Phillips (1991).

This feature of communication is to be seen above all as an interactive process among the speaker and the other people involved, for instance the chairman of the Federal Reserve and the institutions in financial markets, respectively. Communication is an interactive procedure which inevitably also changes the communication structures and relationships among the participants.

What can be rationally presupposed regarding information processing is the following: Irrespective of their distinct motives, preferences, and different ways of perceiving and responding, agents in the market – like other people – are endowed with approximate similarities of responding or reacting. Otherwise no communicative structure in the world, no language, could be implemented and, hence, no success in communication could be achieved. To put it more concisely, no learning would be possible – not even the learning of a language. Agents in the markets act as real agents, who have certain motives, persuasions and perceptions of norms. Economic agents – like others – are compelled to perceive, learn, adapt, and also understand the actions of others in the market. They must perceive what happens from the actions and reactions of other participants in comparison to their own actions. The agents act on the communicative interactions, that is, on meaning and understanding. The agents' preferences are related and

embedded in interactions with other agents and, hence, they contribute to the evolution of norms.

Akerlof argued macroeconomists still neglect the fact that the preferences of agents are *not* fixed entities as presumed in macroeconomic theories. Whereas norms guide economic interactions, preferences and, hence, economic interdependencies, macroeconomics does not deal with such norms. What is important to note here is that norms and preferences are not rooted beyond economic interactions. While psychology and sociology deal with motives and preferences, these issues are not discussed in macroeconomic theory. Akerlof (2007, 19) puts it succinctly:

> Such preferences are a central feature of sociological theory, but they have been all but totally ignored by economists. Inclusion of such norms in utility functions makes Keynesian views of the macroeconomic consistent with maximizing behavior – the maximizing behavior of real people. It simultaneously invalidates each of the five neutralities.

Agents build up their expectations regarding market development, their preferences, and habitude. It is important to acknowledge that people assimilate their knowledge, reactions, and judgment in interaction with one another. Agents have no choice but to do so. What is correct for academic habitude or the rules of the game in an academic discipline is also true for the interactions in distinct realms, such as the interaction between the financial market and central banks.

Akerlof (2007, 4) refers to Bourdieu's work on habitus. Here I provide some brief textual evidence from Bourdieu's work. His work provides an accurate approach to different parts of societies, their cultures and capital. The expression capital is related to capability and capacity to develop skills and resources (Calhoun 1993). Bourdieu's (1984, 2005) analytic apparatus is composed of conceptual tools such as habitus, field, and capital. He described capital as a resource, that is, as a form of wealth that yields power to people – according to their adherence to certain classes, that is, the social position they hold. Bourdieu articulated the importance of the immaterial forms of capital such as cultural, symbolic, and social capital. He emphasized the possibility of converting one of these forms of capital into another. This mobility is part of his key concept habitus. He focused on a multiform kind of convertible capital or capability of participating in a game. Bourdieu outlined social reality not as the interdependencies of structures and actions,

but as a matrix of perception that occurs against the multidimensional background of different individual habitudes framed by social circumstances. He explained:

> The social world can be conceived as a multidimensional space that can be constructed empirically by discovering the main factors of differentiation ... by discovering the powers or forms of capital .... It follows that the structure of this space is given by the distribution of the various forms of capital, that is, by the distribution of the properties which are active within the universe under study – those properties capable of conferring strength, power and consequently profit on their holder .... These fundamental social powers are, according to my empirical investigations, firstly *economic* capital, in its various kinds; secondly *cultural* capital or better, informational capital, again in its different kinds; and thirdly two forms of capital that are very strongly correlated, *social* capital, which consists of resources based on connections and group membership, and *symbolic* capital, which is the form the different types of capital take once they are perceived and recognized as legitimate. (1987, 4)

Unlike cultural capital (education) or social capital (people's connections or networks), economic capital is 'immediately and directly convertible into money' (ibid). What directly follows from this to central banking as interactive procedure and macroeconomics is the following: agents in the market also aim to transform symbolic, social, and cultural capital into money, that is, higher earnings. Admittedly, this is a narrow view of economic motives; nevertheless, it is the reasonable view.

Bourdieu's treatments of cultural capital deals with two key issues: the 'social space' and the habitus. The social space is defined by the objective social position a person holds and by their 'lifestyle', which depends on the base of economic capital, cultural capital, and norms. Norms are differently defined and accepted as embedded norms in various social positions. He emphasized the interdependence of these different kinds of capital and people's endeavours to attain, arrange, and rearrange them. Bourdieu argued that a 'lifestyle' is rooted in the daily experiences of the individual regarding their dependencies on a particular social position. It is like an individual shaping their life. More importantly, 'lifestyle' indicates the preferences of the person and, hence, their social position. Preferences are perceived by others through actions. Preferences are part of the interactions and are rooted

in social position. Preferences and norms guide the interactions of people such as what should be read, consumed – goods, culture, material things – bought, learned, or done.

The concept of habitus indicates that lifestyle is influenced both by the social surroundings and the individual's interests. The objective moment or social surrounding encompasses historical patterns of the distributions of various resources and the trajectory of various agents in different social fields. The individual is driven by his/her own interests to attain a social position. These individual interests are both socially impressed and historically configured. The concept of habitus is a source for a strategy and linked to the social position as sketched in the previous paragraph (1984, 19). Playing a game is also a strategy to organize and coordinate social activities. Bourdieu's theory of interaction implies a way of developing and shaping the practice. Bourdieu defined habitus as follows:

> The source of historical actions, that of the artist, the scientist, or the member of government just as much as that of the worker or the petty civil servant, is not an active subject confronting society as if that society were an object constituted externally. The source resides neither in consciousness nor in things but in the relationship between two stages of the social, that is, between the history objectified in things, in the form of institutions, and the history incarnated in bodies, in the form of that system of enduring dispositions which I call habitus. (Bourdieu 1990, 190)

The concept of habitus is the *modus operandi* based on the past and acting out in present to shape a person's future within a social realm. The habitus,

> functions at every moment as a *matrix of perceptions and actions*, and makes possible the achievement of infinitely diversified tasks ... and (as) an *objective event* which exerts its action of conditional stimulation calling for or demanding a determinate response, only on those who are disposed to constitute it as such because they have a determinate type of disposition. (Bourdieu 1977, 83)

Bourdieu was concerned with the question of how different people act and struggle in different projects in order to improve their relations and different forms of capital to imitate the social fields they are part of. He explained that the pattern of social behaviour remains stable over a long time. Although the habitus is not a given, it cannot be changed all

the time. It is part of the acquired knowledge base due to the recognition and learning capacity of the individual:

> Each agent, wittingly or unwittingly, willy-nilly is a producer and reproducer of objective meaning. Because his actions and work are the product of a *modus operandi* of which he is not the producer and has no conscious mastery, they contain an 'objective intention' ... which always outruns his conscious intention. (1977, 79)

To sum up this excursus I would like to emphasize that norms and preferences are not changing all the time, because they are not given externally to the individual. As part of the individual which is embedded in social actions and structures, norms and preferences consist of inertia. Like the 'lifeworld' of Habermas, a habitus cannot be sold; that is, there is no way out of it but rather a continued reflection on the relation between the rules *and* history of institutions *and* the acquired knowledge base including persuasions, preferences, and motives. Whereas Bourdieu proposed a more pessimistic view on the matter of whether a habitus is changeable or not as time goes by, Habermas emphasized – according to his terms of lifeworld and language-based action and, hence, linguistic commitments resulting out of it – that any changes in lifeworld are part of the agreement and the discourse.

In Bourdieu's view, the coordination of social actions is described as a theory of action, which also draws attention to the concept of 'field' or the 'social space' impregnated by economic, cultural, and social 'capital'. However, at this point I would like to add that acting implies acting with others in the same field to attain social coordination based on communicative interactions.

2.3.2 Understanding and judgment

The previous paragraph can be amplified by an economic example which describes the importance of the agent's economic interactions, understanding, and judgment.

The assessment of knowledge about current market variables and the expectation-building process cannot be achieved by a deductive calculation, but by assumption. As Keynes argued:

> The existing market valuation ... is uniquely correct in relation to our existing knowledge of the facts which will influence the yield of the investment, and that it will only change in proportion to changes in this knowledge; though philosophically speaking, it cannot be

> uniquely correct, since our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation. (Keynes, C.W., vol. VII, 152)

As Keynes explains, the agents in the market do not act as atomistic entities, but as aiming for an 'average opinion'. The perception of the 'average opinion' provides the basis for the decision-making procedure in the context of uncertainty (C.W., II, 156). The term 'average opinion' links individual knowledge to others. More importantly, it links the individual acting within the social context as an actor in the market. Gaining knowledge of the 'average opinion' of other agents is based on communicative interaction and, hence, on the language in use. The reliance on the 'average opinion' implies the agent's intent 'to devote our intelligence to anticipating what average opinion expects the average opinion to be' (ibid). What at first glance seems to be trivial has to be reflected upon as an elementary force in creating economic reality. Therefore, I propose the acknowledgement that some areas of economic realities are also created by communicative interactions. The financial markets in particular are driven by expectations of the future prices of heterogeneous market participants. These expectations are not mental states or thoughts, but rather actions in different contexts, that is, decision-making procedures in markets.

From the viewpoint of a Keynesian macroeconomic the financial markets reliance is based on 'average opinion'. It implies that one's motivation to make a decision to buy or sell financial assets will be always compared with the supposed knowledge and information other agents in the financial market are supposed to be endowed with. The Akerlof argument comes into effect here because the decision to buy or sell depends not only on one's own motivation but rather on comparisons with other agents or people. The individual interacts by focusing on his or her knowledge in comparison to the supposed knowledge of other agents. Keynes outlined the decision-making by the metaphor of 'beating the gun' in the

> 'battle of wits to anticipate the basis of conventional valuation a few months hence ... ' to describe the requirement of interaction in the market (Keynes C.W., VII, 156). This 'battle of wits' is anchored in conventional judgment of market procedures, 'it can be played by professionals amongst themselves.' (ibid)

Without such presupposed similarities between interacting agents in the financial markets or other epistemic and linguistic communities,

there could be no meaning and understanding at all. This is also true for the conveyance of information in a public sphere by a public institution (Littlejohn 1999). For example, the information given by a central bank to the public is addressed to different agents in the financial markets, different experts of the media and politicians. All of them have different motives and preferences. The release of information implies the creation of non-linear communication structures. A certain feature of the decision-making procedure and interaction in financial markets is that we share reactions, judgment and knowledge of other people in the linguistic community – or a professional language-game (Keynes). The term 'average opinion' is also addressed to an epistemic and linguistic community because knowledge is only linked to other people by language-based activities. Haas (1992, 3) defined the epistemic community as a combination of formal and non-formal characteristics:

> An epistemic community is a network of professionals from a variety of disciplines and backgrounds, they have (1) shared normative and principled beliefs, ... (2) shared causal beliefs ... , (3) shared notions of validity – that is, intersubjective ... criteria for weighing and validating knowledge in the domain of their expertise; and a common policy enterprise. (Haas 1992, 3)

In addition to those formal criteria, an epistemic community can be identified by certain personal criteria that members of the epistemic community are supposed to have in common:

> Members of an epistemic community share intersubjective understanding; have a shared way of knowing; have shared patterns of reasoning; have a policy project drawing on shared causal beliefs, and the use of shared discursive practices; and have a shared commitment to the application and production of knowledge. (Haas 1992)

The linguistic community can be described by a reference to analytical philosophy. Wittgenstein noted this in his *Remarks on the Foundation of Mathematics* (1983). He wrote:

> 'Language, I should like to say, relates to a *way* of living. In order to describe the phenomenon of language, one must describe a practice, not something that happens once, *no matter of what kind*' ... 'Interpretation comes to an end'. (Wittgenstein 1983, 335)

This brings us to John Searle (1969), who proposed theories focusing on understanding. Searle's key consideration was that the 'speech act' is guided by different constitutive rules.[7] The speech act theory focuses on different types of speaking activity – for instance, asking, maintaining, requesting, begging, greeting, praying, promising, or proselytizing. In using words, the action itself is implemented. According to the speech act theory, an utterance should be seen as a composition of different components of expression. Although language plays an important role in creating institutional facts, such as money, wedding rings, identity cards, passports, driving licenses, and so forth, the later Searle (in the eighties) denied that all institutional facts are composed or textually composed by language or by speech acts. Sentences and speech acts possess a meaning and also a semanticity. They contain conditions of truth and of fulfilment. The fulfilment is not ontologically enforced, but through acceptance by society. This acceptability can only be created by a commitment from society. Wedding rings, identity cards, and driving licenses are also to be seen as indicators of a particular status, which also implies demands of fulfilment (Searle 1995). Like the later Wittgenstein, Searle also expounded that 'speaking a language is engaging in a (highly complex) role-governed form of behavior'. Speaking a language is not simply the use of words or its additive composing to a sentence as a whole, but speaking a language is 'a part of a theory of action' (Searle 1969, 17).

One striking failure of Searle's view was that his proposed decomposition of the different types of speech acts according to their assumed presumptions, intentions, or consequences should be investigated as a conceptual connection of different kinds of communicative interactions and not as isolated elements. To provide an analysis of a particular speech act, therefore, requires investigating the underlying interactions as a whole, that is, as a procedure arising out of the manifold of interactions. Searle abandoned his goal of analyzing the different relations created by speech acts, mainly because he accepted that it is not possible to judge all speech acts. The creation of speech acts is infinite. Speech acts are created differently in different contexts by different people. They are not listed in a catalogue. However, an understanding of future speech acts is not possible. This understanding is not achievable by a decomposition of a future differentiated sequence of its components. Inasmuch as the use of language is not to be seen as the reconstruction of the mental state or thought, the use of language itself configures the context of actions, the actions of central banks.[8]

Searle stated that speech acts were supposed to entail all possible ways of acting. He tried to differentiate all types of utterances in a classification of speech acts and its presumed effects. Criticism of this classification and its assumptions led to an abandonment of the speech act theory in the 1960s and 1970s. In his later work Searle picked up Wittgenstein's consideration of the rules which permeate our life pattern and tried to develop a conceptual differentiation of his approach to language as a way of acting (Tsohatzidis 2007). Since the investigations by Wittgenstein in the late 1920s, it has been more widely accepted that the way of speaking is also a way of acting. This view acknowledges the constituent role of language.

It is necessary to refer to the acquired knowledge of the world that agents have. It implies that the status of beliefs, persuasions, intentions, and expectations of both the speaker and the hearer are dependent on the context of the inquiry. It follows from this that the meaning of a sentence is neither given by the speaker's intention and mental state, nor by a recomposition of separated words. To share the understanding or judgments of other market participants implies participating in the language-game. Wittgenstein described a 'language-game' in his *Philosophical Investigation* as the way of using language, which is clearly a way of interacting:

> Here the term 'language-game' is meant to bring into prominence the fact that the *speaking* of language is part of an activity or of a form of life. (Wittgenstein 1978, § 23)

This mode of *interaction, that is, sharing the reactions, knowledge, and judgments* of members of a group leads to the evolution of meaning and understanding. Take, for instance, the evolution of a rule. A rule created for the financial market needs to be shared by other agents in the market, that is, it is based on communicative interactions. Only a shared rule can acquire its functions as a rule in practice. I turn to this point in Chapter 5.

The theories of understanding and judgment are also treated as modern constructivist theories in the literature.[9] Modern constructivist approaches have focused on information as a related object (Gastil 1995; Lang 2000). They attempt to explain information transmission as information created based on coordinative efforts by the sender and receiver, which encompasses the inevitable modes of syntactical structures and paradigmatic dimensions. Any information is constructed information since it is a result of communicative interactions. Because of the huge

and heterogeneous variety of constructivist theories on communication, it is not possible to go into detail here.[10] Modern research acknowledges the cognitive limits to steering or controlling a person's attention as a key consideration and leaves behind the assumption of perfection in human behaviour. Moreover, it acknowledges a person's supposed limited information processing capacity.

Theories of understanding and judgment, or modern constructivist theories, emphasize the role of the hearer or interpreter and try to recognize cognitive capability based on the acquired knowledge, experience, and interpretative efforts of participants to process the received information. One of these theories is introduced here as theories concerning *Verständigung* (Habermas).

The translation of *Verständigung* into English is controversial in the literature and need not be discussed here. According to Heath, the term *Verständigung* suggests both understanding *and* agreement (Heath 2001, 320). Whereas it is without a shadow of doubt that the use of language seems to aim for understanding as, for instance, Davidson argued (we communicate in order to be understood by other people), it remains controversial whether the use of language also inevitably aims towards an agreement. In this sense, agreement does not refer to the view that language is used only to bring about agreement. However, it was Donald Davidson (1984, 183–198) who worked on the function of language as both agreement and understanding in his essay 'On the very Idea of the Conceptual Scheme'. I will come back to this issue in later on.

Habermas explains understanding as the means of grasping the epistemic relationship of speech acts. The concept *Verständigung* encompasses both the theoretical approaches to patterns of communicative interactions and to patterns of understanding and judgment by focusing on the communicative interaction of both the speaker and the hearer. According to Habermas, meaning is a result of the interactive acknowledgment of an illocutionary act in which the knowledge of agents is embedded. He discussed two criteria which should be assumed as given in the case of a successful acknowledgment: a) the hearer knows the conditions under which the expressed sentence should be accepted as truth, and b) the hearer knows the conditions under which the speaker possesses certain reasons to accept an expression as truth. Habermas modified the 'speech act theory' as introduced by Austin (1962) by revising the two elements of the speech act theory, the *illocutionary* and the *perlocutionary* element. He combined the modified speech act theory with a model of social action based on language.

Habermas's (1984, 1987) approach to understanding and communicative interaction should be acknowledged as a welcomed complement to economics. He made a shift from a practical analysis towards a communicative analysis. He introduced the 'linguistic turn' in sociology, which is of great relevance to economic sciences as social science regarding communicative interacting in particular contexts, that is, the markets. Until that time the mainstream of sociology had discussed – as the mainstream of economic theory is still doing – the presumed shared motivational aspects (for instance norms, rules, and values), without referring to the constituent role of language.

To be brief: the 'linguistic turn' relegated the traditional scientific view to the past, which stated that individuals act in isolation with individual experiences and intentions guided by individual preferences. The 'linguistic turn' acknowledges that individuals create meaning by interaction, that is, by the use of language. Moreover, it is part of social acting. Rorty described the implications and consequences of the 'linguistic turn' to sciences with reference to Wittgenstein's approach to the constituent rule of language (Rorty 1967/1992; Trabant 2003). The use of language is impossible in private only because it is not possible to use a private language in order to be understood. The use of language is to be seen as a public good; it refers to a 'language-game' (Wittgenstein). Therefore it is important to focus on communicative interaction, which itself is designed and impregnated by the acquired knowledge base, the cognition or recognition capacity and the way language is used in context (Hodgson 1988). Individuals or agents act within language-games. Any use of words or sentence is part of a language-game.

Habermas's approach to understanding is important to innovations in central banking because his modified speech act theory as a model of social action based on language being the 'ultimate source of validity' departed from the image of an isolated agent who acts according to his or her own preferences, wishes, knowledge, and beliefs. Social acting is inevitably within social contexts and institutional structures and actions. The person is embedded with social experience and motivated to gain social acceptance instead of individually maximizing utility only.

Economic interdependence of structures and actions should be discussed using communicative interaction within contexts of the knowledge base. Moreover, acting in economic markets is a way of coordinating action in different markets based on the division of labour, which requires the use of rituals to come to an understanding. The individual interprets social actions, which evolve out of social interactions,

to coordinate or to act. To understand or explain social interactions and economic phenomena, one is therefore required to reconstruct the communicative interactions of economic agents, which are based on the acquired knowledge base, experience, and motives. As already outlined, the acquired knowledge base is not an individual knowledge base, but a combination of individual skills for relating to the social environment.

Moreover, the 'linguistic turn' points to constitutive rule of language use in social sciences to rebuild those theories that explicitly or implicitly still rest on the presumption that language is just to be seen as a mirror of thoughts. Habermas emphasized that individual behaviour and acting should be seen as based on the use of language within social routines, 'epistemic communities' (Haas) and social expectations. As outlined at the beginning of this chapter, the action does not start at point zero. Acting in financial and economic markets is oriented towards both the evolution of new and existing institutional facts, knowledge, patterns of articulation, and interpretation. Actions in markets are perceived in light of the average interpretation, which links individual opinion or judgment to other agents in the market. The underlying premise is that individual action is not rooted in the individual agent, but in learned, socially trained, and constructed routines of interpretation.

Habermas's communicative theory of action deals with the modes of understanding arising out of interactions. Language is discussed in its function as a shared good. Decisions and actions of agents are linked to culture, practice, and institutional facts. A social network provides the background of acting, but is also created by social actions, since it frames selective perception and the use of language, and therefore the sense or meaning. Habermas's approach to understanding and judgment implies the creation or evolution of public commitment based on language interactions. Public commitment comes into consideration because through the use of language a public commitment has been created. Language is not private property. Hence, success in the coordination of expectations is made possible by articulation or communicative interactions. Achievement of a common goal imposes further constraints on the participants. This is exactly what gives importance to elucidating the role of language in economic theory due to engendered public commitments and accountability as well as the need to coordinate expectations of market agents.

As a model of communicative interactions in social science, Habermas's contributions provide incentives to the academic debates on central banking and interactions in economic markets. In focusing on the context of communicative action, he also draws attention to the

need to aim for acceptance and commitment by market participants. Agents in the market are not described as isolated, atomic individuals, but as social persons who aim for mutual accord based on trust, and who strive for a common understanding in order to achieve a common goal. Habermas stated that a speaker's intention cannot be transmitted to the hearer's understanding.[11] He objected to Searle's assumption that the intention of the speaker provides the meaning of speech acts. He developed a map of epistemic connections based on his view on the pragmatism of communication.

Habermas followed the modern view of language science by acknowledging that there is no distinction between the knowledge of language and knowledge of the world. It was Wilhelm von Humboldt and later Ludwig Wittgenstein who elucidated the importance of the use of language regarding the evolution of meaning and understanding (Trabant 1998; Trabant and Ward 2001). Also Wittgenstein explained that language is not a medium which is just the label of thoughts, since 'the language is itself the vehicle of thought' (1978, § 329). Language is not neutral towards thoughts. Since we cannot separate the semantic aspects from the epistemic aspects of language, it makes no sense to look at speech acts as atomic entities or as hidden entities supposedly rooted in the mental states of individuals. There exist no single 'beliefs' or 'intentions' of a speaker which give meaning to the sentence as indicated by Hume (1978) and Hobbes (1991). Hume and Hobbes stated that 'beliefs' and 'desires' have significant roles for the motive and success of an individual's action.

Habermas discussed language as a medium to coordinate the agent's mutual accord in order to achieve a common aim. More precisely, the mutual accord is based on the presumption that both speaker and hearer aim at a mutual understanding as 'the inherent telos' of any communication. Any speech act demands a mutual understanding (Habermas 1984, I, 293). Since people do not communicate in order to be misunderstood or in order not to be understood by the other person, Habermas set mutual understanding as a normative criterion. It is irrational to assume that efforts at communication are motivated by the wish not to be understood. Any language interaction encompasses accountability and commitment because acceptance of the utterance depends on the other person. Habermas outlined that speech acts are 'discourse commitments' and as such mutual agreements. Language imposes constraints because it constitutes social norms or rules. The meaning arises out of the interactive acknowledgement between the speaker and the hearer. The key notion of their

interactive acknowledgement is the 'binding and bonding force of a speech act'. Habermas explained:

> A speaker owes the binding ... force of his illocutionary act not to the validity of what is said but to the coordinating effect of the warranty that he offers: namely to redeem, if necessary, the validity claim raised with the speech act. (1984, I, 302)

These 'binding and bonding effects' underlie all communicative interactions. They are rooted in the constitutive role of language and also in the interdependence of the semantic and epistemic. It is this premise which leads Habermas to describe speech acts as a web of epistemic connections. A speech act cannot be isolated from other speech acts. The epistemic map provides an inherent connection between the meaning of an expression and the validity due to a person's cognitive capability. Speech acts, as an epistemic web, constitute the meaning of an expression.

I would like to add that this epistemic web must be founded on the presumption that speech acts are based on a shared – that is, a non-private – language. Therefore, language is to be viewed as having a constitutive role and not as being a veil of thought within the web of speech acts as stated by Heath (2001, 27). According to Habermas, speech acts are described as the continued attempts to reach an understanding. Reaching an understanding implies accepting language as the 'ultimate source of validity'. As particular elements of communicative actions, speech acts possess a compelling function since they bring about commitment and accountability. Knowing the prerequisite for an acceptance of speech acts is equivalent to recognizing the self-commitment of both speaker and hearer regarding 'validity claims'. Such 'validity claims' are norms, that is, social constructions, but neither values of the individual or individual mental states nor private. As social norms they attain validity through language-based interaction. In contrast to Bourdieu and classical sociology, Habermas (1998, 198) stated:

> If understanding a speech act depends on knowing the conditions for its acceptability then the speaker's illocutionary aim of being understood points to the further aim that the hearer should accept her speech-act offer. The acceptance or the agreement on the part of the hearer is equivalent to recognition of a validity claim raised by the speaker. It is based on the good reasons that the speaker offers in order to redeem the validity claim in discourse (or else on a credible warrant issued by the speaker that she could provide such reasons,

> if necessary.) And the hearer, with his 'yes' to a validity claim he has accepted as worthy of recognition – that is, with his acceptance of the speech-act offer – also takes upon himself, as a rule, certain obligations relevant for the sequel of interaction, such as obligations to meet a request, to trust a confession, to believe a statement, to rely on a promise, or to obey an order.

Validity claims arise through utterance or articulation. They are inherently connected with the use of language. To raise validity claims indicates that a speaker's utterance is not simply a veil of his intention, thought, expectation or desire, but articulation (Muchlinski 2006; Moyal-Sharrock 2007, 2000). The meaning of a speaker's utterance is not compositional. The epistemic connection or the meaning of a speech act is not something which has been added to the speech act later on. The embedded epistemic web is determined by its meaning. As Brandom (1994, 494) stated, 'communication is the social production and consumption of reasons'.

Understanding a speech act implies knowing the reasons for certain validity claims. Habermas wrote:

> We understand a speech act when we know the kinds of reasons that a speaker could provide in order to convince a hearer that he is entitled in the given circumstances to claim validity for his utterance – in short, when we know *what makes it acceptable*. (1998, 232)

What, then, makes it acceptable? Of course it is *not* the intention of the speaker that indicates the acceptability of an utterance. There must be supporting reasons that indicate the acceptability of an expression. The speaker and interpreter are part of the epistemic web which itself is the 'binding force'. The agents are embedded in the epistemic web, and it is for this reason that an utterance is to be seen as a 'weave' because the concepts we use in daily language are not used for a unique occasion. It was Wittgenstein who made clear that a notion is not a pretence which accompanies the intention, thought or expectation (Wittgenstein 1967, § 568, 569). The validity claims occur through utterance or articulation. Raising validity claims also incurs commitment by the speaker through the performative effect of the speech act. According to the epistemic web, any utterance appears to incur commitment with regard to further utterances.

Habermas distinguished the validity claim into three types of commitment: (1) truth, (2) rightness, and (3) sincerity (1984, I, 278).[12]

Whereas truth refers to the perceived world or situation, rightness refers to the perception within a social context and sincerity to an individual's realm of experience. By this differentiation, Habermas outlined his modified approach to speech acts and, hence, communication interactions as a non-linear but rather as a complex relationship based on internal and external considerations of the agents. The commitment to truth or to rightness has also to be understood as a realistic viewpoint according to the social environment. Insofar as the speaker and hearer share this realistic viewpoint if follows from this their willingness to coordinate in order to reach a common understanding.

It is worth noting here that the presumption Habermas proposed is *not* that every speaker and hearer harmonically coincides in their 'lifeworld' or views, but rather that they are trying to be successful as long as they are trying to communicate. The 'telos of communication' (Habermas) aims at the mutual understanding of both speaker and hearer. Therefore the key consideration of Habermas's view is this coordinative interaction based on the 'binding and bounding force of a speech act'.

In the case of 'communicative action ... the consensus achieving force of linguistic processes of *reaching understanding* (*Verständigung*) – that is, the binding and bonding energies of language – becomes effective for the coordination of action' (1998, 221). Whereas Habermas once had ascribed the 'binding and bonding forces' to speech acts, he now addressed it to the process of understanding an emphasis on the role of language as 'shared goods' and as an explicit coordination mechanism. He stated that the meaning of a sentence cannot be found beyond the communicative interaction since any communication interaction is based on mutual commitments in the context.

It follows from this differentiation that speech acts lead to commitments. If agents know the acceptable conditions, they also know the reasons or evidence that both the speaker and the hearer will support, that is, the participants know the conditions under which the statement can be judged to be true and right. Moreover, they recognized the conditions of sincerity. This is why a speech act gets its own claim to validity: because it reflexively refers to its propositional content. Furthermore, it is assumed that all participants in communicative interactions have the ability to judge the epistemic commitment. Habermas defended the outlined differentiation of three types of commitment – truth, rightness, sincerity – as a pragmatic pattern of judgment concerning different communicative actions (1984, I, 319f.).

Habermas basically follows an 'inferential semantics approach' because it is not possible to separate the understanding of an expression from its

circumstances. This argument was made by Dummett (1981). The term 'inferential semantics' is a key notion in language sciences describing the view that the truth of a sentence is not inherent to the words the sentence is composed of, but to the context the sentence relies on. No falsification or verification nor different methods of proving the truth or falsehood are required or judged from the sentence. The sentence refers to the context and not to a catalogue of criteria or rules. Knowing the rightness condition or truth condition of a sentence means knowing the circumstances of the sentence. Knowing implies – as Michael Dummett called it – the 'descriptive content' (1976). Knowing, therefore, implies the *pragmatic point of view* Habermas emphasized in his approach to communicative interactions. The truth condition encompasses the rightness condition regarding the evocation of the meaning of the utterance and the consistency of the validity claims.

By participating in communicative action with speech acts, we get involved through the commitment of our utterances and action ('matching deeds to words'; 'we do what we say and we say what we do'). Later on Habermas (1996) précised that a communicative action implies a mutual understanding as a certain mode of action coordination, therefore the validity claims gains relevance for the creation of social orders, too, that is, validity claims are to be seen as normative. Participating in communication implies social involvement as well as social obligations. The amount of commitment depends on the different kinds of speech acts. Habermas differentiated between the types of speech acts in which a) statements are to be seen as assertive, b) a weak communicative action as expressive and c) a strong communicative action as regulative. In case of any dispute about the three validity claims, the speaker or the hearer is forced to demand a 'rational discourse' according to the 'telos of communication'. The assumption of rationality does not impose the obligation to act rationally rather it aims to achieve corporative acceptance and agreement through any speech act, as long as the presumption that communicating occurs in order to be understood – is actually the case. The rationality assumption is neither an empirical proof nor a description. In daily life we normally do not ask for reasons or justification as a guideline for communicative acting, we share persuasions and 'lifeworld'. This is the way understanding works – a view which is also supported by language philosophers like Davidson and Wittgenstein.

At this point the Habermas concept of 'lifeworld' enters the game. It entails certain assumptions concerning the private, cultural and public part of society as well as its rules and institutional facts. Individuals aim

for mutual understanding by coordinative interaction. The concept of 'lifeworld' materializes the counterpart to the constitutive premise of rational discourse as outlined on the previous pages.

Habermas assumed – as also Davidson et al. – any discourse follows rational criteria because we want to be understood by others. Although different discourses are motivated differently – and of course many discourses are not based on symmetry, but rather on hierarchies and, therefore, asymmetric power – it is necessary to anchor decision-making and action as rational actions. Reaching an understanding implies reference to the 'lifeworld' in order to redeem validity claims. Communicative actions provide a framework for understanding and the force for reshaping the 'lifeworld' in order to diminish the reasons for a dispute (Habermas 1987, II, 63). To achieve any understanding, the speech act must be interpreted as based on a common language and on coordinative acting that allow the speaker and hearer to grasp the meaning, to understand.

I now turn briefly to the role the interpreter plays in Habermas's view. The interpreter is the hearer. Habermas described the interpreter as a participant of the context, in which he/she must imagine the motives of other agents in that context. The interpreter, therefore, must anticipate the objection or agreement of others. Being themselves part of the situation, the interpreter cannot judge beyond the reasons the speaker articulates. The interpreter evaluates the reasons of the speaker according to the context. In short, the interpreter must reconstruct the reasons other agents have put forward in order to understand and work out a 'rational interpretation'. Habermas explains this consideration as follows:

> The interpreter cannot become clear about the semantic content of an expression independently of the action contexts in which the participants react to the expression in question with a 'yes' or a 'no' or an abstention. And he does not understand this yes/no position if he cannot make clear to himself the implicit reasons that move the participants to take the position they do. ... But if, in order to understand an expression, the interpreter *must bring to mind the reasons* with which a speaker would if necessary and under suitable conditions defend its validity, he is himself drawn into the process of assessing validity claims. (1987, II, 115–116)

Without a doubt, Habermas was influenced by Davidson as well. Among other proponents of theories concerning *Verständigung*, Davidson refers to a principle that is explained in the following paragraph.

In the 1980s Davidson emphatically developed the role the interpreter should have within the process of reaching understanding. The success of communication depends on neither the truth of a sentence nor the application of categories of truth. In his later work Davidson suspended the reference to categories of truth. He argued that categories of truth are not to be found in a list or catalogue but only in a theory of interpretation because any criteria of truth is rooted in dialog. This is not a point of controversy between Habermas and Davidson. The success of communication depends on the continuity of judgment of the interpretative theory of truth. Davidson's aim is to develop the understanding of the utterance of the speaker through a theory of understanding. Davidson did not differentiate between a theory of interpretation and a theory of understanding because he assumed the success of communication is identical with the success of interpretation. Davidson introduced his method of interpretation based on the 'principle of charity'. He wrote:

> Since charity is not an option, but a condition of having a workable theory, it is meaningless to suggest that we might fall into massive error by endorsing it. ... Charity is forced on us; whether we like it or not, if we want to understand others, we must count them right in most matters. (1984/1973, 183–198: 197)

This principle of charity is a necessary application for the interpreter to achieve a maximum of agreement between speaker and interpreter. Davidson argued: 'I apply the principle of charity across the board. So applied, it councils us quite generally to prefer theories of interpretation that minimize disagreement' (1984, xvii). This principle should be read as a guideline for any interpretation. Davidson first applied it to his model of a 'radical interpretation'.

What is meant by 'radical interpretation'? Davidson introduced a situation as radical for the interpreter if there exist no common language, no common experience, and no dictionary support in which both speaker and hearer first meet and need to understand what they have observed. Despite this strange – but not impossible – situation, both the speaker and the hearer need to strive for a common understanding. They must develop an understanding of the way one person understands the observation and interpretation by the other person. Davidson (1984/1973, 125–140: 128) wrote,

> In radical interpretation, however, the theory is supposed to supply an understanding of particular utterances that is not given in advance,

> so the ultimate evidence for the theory cannot be correct sample interpretation. To deal with the general case, the evidence must be of a sort that would be available to someone who does not already know how to interpret utterances the theory is designed to cover: it must be evidence that can be stated without essential use of such linguistic concepts as meaning, interpretation, synonymy, and the like.

Insofar as the old concepts are not applicable to understanding the new situation, the understanding of the latter is rooted in the interpretation of the behaviour of the other person. Underlined by the presumption that we talk because we want to be understood, Davidson outlined the situation of radical interpretation to discuss the efforts of both speaker and hearer. Davidson stated:

> Without this sharing of reactions to common stimuli, thought and speech would have no particular content – that is no content at all. (1991, 153–166: 159/160)

What at first glance seems to be a simple behaviourist approach to the human condition neglects the implication of the use of language. Davidson responded: 'I despair of behaviourism and accept frankly (a speaker's) intentional attitudes towards sentences, such as holding true' (1984/1979, 227–241: 231). Davidson did not rely on J.B. Watson's behaviourism and the mechanism of a stimulus-response reaction. Davidson argued that

> 'behavioral grounds are well we have for determing what speakers mean' (1991, 153–66: 162).
>
> What makes this step convincing within in his overall argument is to emphasize that any utterance and therefore judgment is inherently connected with a person an not with a pendulum.
>
> 'We have still to say what evidence is available to an interpreter.' (1984/1973, 125–140: 134).

The evidence cannot consist of detailed descriptions of the speaker's belief and intentions. Furthermore, the interpretation is not dependent on beliefs, desires, and meaning of either the speaker or the hearer, that is, the interpreter. Beliefs, desires, and meaning are not simple cognitive attitudes in Davidson's view. Beliefs, desires, and meaning are interdependent and should be integrated by interpretation, which depends on the 'principle of charity'. In this, Habermas follows Davidson. The three validity claims of Habermas are not a simple cognitive approach, since

they are inherently connected in every speech act. Davidson emphasized the interdependence of beliefs, desires, and meaning as rooted foremost in the 'principle of charity'. This principle encompasses the correction of singular utterances in case of error:

> Making sense of the utterances and behavior of others, even their most aberrant behavior, requires us to find a great deal of reason and truth in them. (Davidson 1984/1974, 141–154: 153)

The principle of charity is rooted in the use of expression or articulation which is relevant to the other person as well. An important consequence of this principle is the indeterminateness of the interpretation, which implies that there is no further given meaning. The interpretation is created in the moment of action. Davidson stated that there exist 'trade-offs between the beliefs we attribute to a speaker and the interpretations we give his words' (1984/1973, 125–140: 139).

In order to explain the role of persuasions of the speaker and hearer, that is, the interpreter, Davidson proposed two further principles to achieve understanding: (2) the principle of coherence, and (3) the principle of correspondence. The principle of coherence should lead to a high degree of logical consistency in speaking behaviour. Davidson called this 'propositional attitudes' (1991, 155–166: 158). By this he basically demanded that both the speaker and interpreter work logically consistently. For instance, the interpreter reconstructs the speaker's sentences consistently by interpreting the sentences *1, 2, ..., n* unquestioningly. That means the interpreter reconstructs the entire utterance of the speaker, that is, the conjunction of the sentences, without any contradiction.[13] If sentence A implies x, and sentence B implies y, then the premise of non-contradiction implies that sentence C implies z. Davidson insisted on the principle of coherence in these terms: a) being consistent regarding both the speaker's and the interpreter's attitudes, both have comparable attitudes; b) the speaker and interpreter should behave consistently regarding their verbal and non-verbal attitudes and, finally, c) the relation of speaker and interpreter is to be described by a 'maximizing agreement'. The latter does not imply that both agree at all times in all communicative actions, but rather that both agree on the discourse they are involved in. Therefore 'maximizing agreement' can also imply a non-agreement as long as both acknowledge that they are participating in a shared world.

The (3) principle of correspondence defines a shared world of both speaker and interpreter, which means both have access to the same

situation or circumstance. Given this, the function of the interpreter is to assign the speaker's utterance to the objects of the world. Davidson explained that the theory of action can be interlocked with interpretation if all three principles, and the above outlined three criteria a), b), and c), are satisfied. Furthermore, these principles – charity, coherence, and correspondence – include two more criteria: (d) the real world exists, and (e) the world is discernible and accessible for both speaker and interpreter.

Another quotation might provide more clarity on the principle of correspondence, because a formal criterion is not meant to bring out the correspondence of a logical deduction as proposed by Tarski (1956) (*convention-T*). Davidson explained:

> Knowledge of the circumstances under which someone holds sentences true is central to interpretation. ... (I)n case of language, although most utterances are not concerned with truth, it is the pattern of sentences held true that gives sentences their meaning. (1984/1975, 155–166: 162)

Davidson emphasized the attitude of *holding* a sentence to *be true or accepting is as true* as crucial for any interpretation (ibid, 161). This presumption also refers to beliefs and persuasions shared by the speaker and interpreter. Both create context through their beliefs and persuasions. Davidson wrote:

> The attitude of holding a sentence to be true (under specified conditions) relates belief and interpretation in a fundamental way. We can know that a speaker holds a sentence to be true without knowing what he means by it or what belief it expresses for him. But we know he holds the sentence true *and* we know how to interpret it, then we can make a correct attribution to belief. Symmetrically, if we know what belief a sentence held true expresses, we know how to interpret it. (ibid, 162)

Both principles – coherence and correspondence – should lead to a comparable behaviour of the speaker. It should allow the integration of a new hypothesis of interpretation by the role of the interpreter, that is, the hearer. The interpreter, who is the dominant figure in the process of understanding, tries to discern the speaker's utterances via a language-based emphatic and cognitive process. Davidson called this non-verbal and 'verbal attributes of attitudes' (ibid, 166). Since the above three

principles are normative claims for achieving an understanding, they are a way of defining an ideal, workable, context for the communicative interaction and interpretation. Davidson outlined his view as follows:

> A theory of interpretation, like a theory of action, allows us to redescribe certain events in a revealing way. Just as a theory of action can answer the question of what an agent is doing when he raised his arm by redescribing the act as on of trying to catch his friend's attention, so a method of interpretation can lead to redescribing the utterance of certain sounds as an act of saying that snow is white. (ibid, 161)

There is no contradiction here to Habermas, Wittgenstein, or Wilhelm von Humboldt. 'Language [is]...intrinsically social' (Davidson 1994). Language allows one to describe the behaviour of the speaker and interpreter, which leads to successful communication (Davidson 1992, 256).

Habermas and Davidson have in common the acceptance of the 'inferential role' instead of the application of categories of truth. Understanding is based on the 'inferential role' because understanding refers to communicative interaction and the context, which are relevant to institutions (North 1990).[14] To sum up this chapter: in contrast to Davidson, I would propose defining the principle of charity as a principle of commitment, which also better expresses the interdependence of the speaker and hearer and steps beyond the predominance of the interpreter found in Davidson's view.[15]

The communicative principles Habermas introduced should be seen as fundamental for all participants in discourse: Every individual is competent to talk and to express his or her beliefs, preferences, and expectations. The result of such a discourse would be that all participants have equal capabilities, rights, and competence. This view of discourse has provoked massive criticism of Habermas's theory of communicative interacting (Moon 1995).

To discriminate between Bourdieu and Habermas, I would like to emphasize that the evolution of the norms and values and, hence, the elaboration of social identity, are not deduced from shared motivation or a shared social situation but rather from a shared world. The crucial point is that this shared world includes language interaction priority and this necessarily leads to another approach to social reality, which is described by the 'linguistic turn'. Regarding economics as a social science one has to consider that people judge economic decisions in certain social situations, which are influenced by norms and

shared values of living, or 'lifeworld'. According to Habermas the latter is to be grasped as the creation of language-based interactions. It is this language-based approach to social norms and 'lifeworld' Habermas consequently worked on, which make a wide distinction between classical sociology and the communicative approach to social science. Therefore, macroeconomics should integrate the concept of habitus to replace 'abstract derivation' (Akerlof 2007) with preferences which are linked to the contemporary world.

Here it should be accepted that Habermas introduced the consideration that individuals are endowed with equal capability, rights, and competence as a normative concept. He did not provide it as an empirical proof. Communicative interaction includes the acceptance of rational action by all participants as *a prerequisite to communication*. Habermas left open how this acknowledgement could be achieved; that is, he did not explain the speaker's or hearer's persuasions, beliefs, or expectations. Here he has argued that the social context as explained in sociology sheds light on how individual preferences, beliefs, norms, values, and expectations are developed and impregnated. For instance, Bourdieu's and Gidden's approach to the interdependence of structures and actions provides supplementary arguments for the economic interaction in markets.

As outlined in this chapter, information processing as a cognitive process concerning an individual's selective perceptions, different modes of learning, and understanding is also important in order to grasp information as a non-linear transformation. The disclosure of information is not to be confused with communicative interaction and language-based heuristic. As it was argued, however, this language-based heuristic is also a supplementary part of economic interaction as well. Decision-making and judgment are language-based and not to be seen as an exchange of mental states. The introduced research in cognitive science is important for macroeconomics in order to understand how meaning and understanding evolve.

The conceptual framework of communication in its dimension as an *interactive procedure* implies that neither the sender, the message, nor the receiver are assumed to be unchangeable through time. The conceptual framework basically refers to the interactive procedure, which is understood as the continuity of changes.

2.3.3 The context dimension

At this point the third dimension enters the discussion: *How* much and *why* does context matter regarding the emergence of meaning and understanding? As I indicated above, the learning process and behaviour

of a person are not determined by the release of information, since the individual actively attempts to adapt, understand, and perceive information through an acquired knowledge base. Of course, if certain information were given by a person or an institution such as, for instance, the information 'fire', we could rightly assume that any person would try to escape the situation immediately. The information 'fire' in the process of understanding is, like other information, dependent on the context – but only in stages. The three stages above – understanding as linked to the acquired knowledge, judgment, and way of acting – would have together been taken into account in that moment of escape. The word 'fire' is independent of any situation understandable as a symbol for danger and no rationally acting person would unnecessarily stay in a dangerous situation. However, significantly different reactions by people could be imagined by using the word 'hurricane' because in some regions the event 'hurricane' is barely imaginable, while in other regions the word 'hurricane' would be understood as analogous to 'fire'.

According to monetary policy, the word 'interest rate rise' is also understood regarding the different contexts and agents with their preferences and motives. The context can be described as the environment or surroundings in which both the speaker and hearer, or group of agents, institutions, or organizations, act and configure or shape the communicative interaction. Here again we confess that the communicative interaction is not purely discussed in isolation from the context. Although it could be conceivable that if the meaning of a word, for instance 'fire', were independent of any context, the responses of people to this word would be diverse. Of course, comparable patterns of responses and reactions by different agents can be imagined.

Regarding this third dimension of the conceptual framework approach to communicative interaction, the context, we must acknowledge that the context (as such) does not cause the behaviour of people, but their interaction, responses, and (re)actions within the context. In doing or acting, people will also create new contexts. Their interactions will shape or change situations.

This 'contextualization' of the meaning should not be confused with socio-linguistic approaches. Contextualization means to recognize the surroundings of a speaker's and hearer's communicative interactions (Auer and Di Luzio 1992). This view also provokes questions such as the following: How can a context be described? Where can we draw the border of a context? These attempts to define a context always necessitate redefining it by creating another context. It is not possible to define

the context itself by reference to exact borderlines unless one creates a further illusion, for instance, defining a context by artificial rules.

We approach the concept of context to describe human actions as a web of the mixed variety of human behaviour or actions. A context is not dice or something tangible. Describing a context requires separating all human actions that are embedded in this context – with the result that we are not able to describe the context anymore. A context is like a web whose patterns are incomplete and varied in different ways. But *how* we describe the woven pattern depends on our perception and acquired knowledge and, therefore, on how we perceive the web selectively (Thomas 1995).

How can we know that we are part of a context? For instance, Greenspan elucidated that the problem of identifying a bubble economy is rooted in the problem of how to identify whether one is in the bubble. We communicate, we act, we discuss, we perceive within a context, but we do not measure in which context we behave and act. We act within a certain space and time, but this is not identical with acting in a context. The context emerges from people's way of acting. Of course, the information given during the open hours of the stock market identify space and time and, hence, the context. But the problem of identifying where the context of the stock market begins and ends still remains. The context is neither given by the location of the stock market, nor by its time of operation.

No exact definition of context is found in the literature (Kober 2002). There are, of course, good reasons for that. Whereas Habermas used the concept 'lifeworld', Wittgenstein used the concept 'world picture'. According to Wittgenstein, the world picture provides a background for decision-making and judgment. 'Above all it is the substratum of all my enquiring and asserting' (Wittgenstein 1979 § 162). We cannot change our world picture, that is, our context, like we get out of or into a car. We cannot jump out of our world picture. We are part of the world picture or context, which is like a web. A world picture is a web of a variety of persuasions or convictions. We share, *or* we do not share, that web of persuasions, beliefs, and convictions with other people. If we try to identify these persuasions by classifying them into different categories, such as α, β, χ, then we approach a web of persuasions using different categories. If we are successful in identifying all kinds of persuasions, and if we have labeled them with our categories, we will nevertheless approach a web of categories, not a context. Hence, we will not achieve a definition of the context we are part of. We could define this web of categories as, for instance, 'C'; this letter will label only a part, however. To name elements is not identical with describing it, and instead is just

the preparation for a description. A word gets its meaning, not by naming, but in the sentence, in the context. 'Naming is so far not a move in the language-game – any more than putting a piece in its place on the board is a move in the chess' (Wittgenstein 1978 § 49).

Davidson emphasized that language must incorporate or depend upon a largely shared view of how things are, that is, a context or web of persuasions.

> Communication proves the existence of a shared, and largely true, view of the world. But what led us to demand the common view was the recognition that sentences held true – the linguistic representatives of belief – determine the meaning of the words they contain. Thus the common view shapes the shared language. (1984/1977, 199–214: 201)

Davidson admitted that he is not the first author who emphasized that shared beliefs are required for success in communication interactions, since there were other authors who worked out this view, for instance, Kant, Humboldt, Wittgenstein, and Frege. Of course, there is no doubt that speaking or communicative interaction always occurs in situations or contexts. What seems to be disappointing here, because of the vagueness of the concept of context, should nevertheless provide more clarity. Regarding the use of everyday language, vagueness does not exclude clarity. As I tried to outline in the paragraph above, we are part of the context or world picture. Although the concept 'context' or 'world picture' remains vague, it is understandable in 'normal circumstances' (Wittgenstein 1979, § 24). We are always part of a context and cannot separate ourselves from it. 'There is no cosmic exile', as Quine wrote (1959, 275).

A discussion about the exact borderline of a context will only arise in those cases in which we are not successful in aiming for a common understanding. It is similar to the notion of misunderstanding (Dascal and Cuycken 1988; Dascal 2007). Only in the case we feel misunderstood are we able to outline approximately what is missing or wrong. But when we feel understood we cannot exactly say *why*. Moreover, it is not necessary to explain or to investigate *why* we feel understood or *why* we understand because *we do understand*. That suffices. For success of communication in the context, it is important to share beliefs and to refer to the 'average opinion', that is, to perceive the interdependencies. According to Habermas, the agents are rational, that is, agents aim for a common understanding, and this implies a coordinative interaction. Aiming via coordinative interactions also provides a

common view of the context world-view. After having outlined some considerations on this point it should be clear: we cannot define a context the way we define a car or the world market. Wittgenstein summarized this:

> 'So you are saying that human agreement decides what is true and what is false?' – It is that human beings say what is true and false; and they agree in the language they use. That is not agreement in opinions but in form of life. (Wittgenstein 1978 §241)

What seems to be a triviality has often been neglected in economic science. Economic interaction as language-based interaction is different from economic modelling. The context of a model is constructed as a deductive means of conclusion and, therefore, it has strict borderlines, composed of exact words, premises and, hence, conclusions. The method of deductive solution of modelling itself defines the context and the content of the chosen model. In contrast to the term context as it was used in our previous considerations, the context of a model is non-ambiguous, non-vague, and stable.

If we assume that we consider and judge the real world by applying deductive logic and methods to it, this lacks conviction. Deductive logic is based on universal and mechanic controlled formal language constructions ('*Convention-T*'). Axioms and deductive rules of reasoning and calculating are used to describe a deductive construction, but they are not representatives for scientific as such. Scientific methods are not restricted to one single method, that is, deductive reasoning.

Acting means that agents shape the context, that is, meta-model views, and also create new contexts by their modes of action based on language activities or communication. An important implication regarding the context or situation is first and foremost that any communicative interactions require the use of language as a public medium, since private language could neither be used to shape situations and contexts, nor create a new one (Capella 1987). Therefore new contributions in the language and cognitive sciences emphasize the interpersonal, organizational, and public sphere of communication in contexts (Noteboom 2007; Muchlinski 2006; Trabant 2008) which are also relevant to economics as social science.

2.3.4 Reflexive communication

Non-classical models of communication are defined as reflexive models of communication (Antos 1999, 102). The term reflexivity focuses on

communicative interactions. Reflexive models of communication initiate and create another space of perception and effectiveness. A reflexive model of communication vigorously defends the non-linearity and the non-causality of communicative interactions. Any given pattern of this non-linearity is an infinite process of reciprocal perceptions which also create a space of mutual recognition. The reflexive model is focused on the mutual recognition space and, therefore, on the context of the communicative interactions. These mutual recognitions in context are, of course, important to the process of expectation-building. The incorporation of the procedure of forming expectations also structures the space of mutual recognition. Since the theoretical upheaval in modern central bank literature occurred, central bankers have become more used to debating in terms of mutual recognition and understanding (Blinder and Krueger 2004, 327–387). However, most contributions are devoted to central bank communication as a process of delivering information by the central bank (Ehrmann and Fratzscher 2009; Gurkanak, Sack and Swanson 2005; Poole and Rasche 2003; Rasche and Thornton 2002).

I turn now to the reflexive model of communication. Reflexive models try to acknowledge the creativity of the use of language. Reflexivity and reciprocity are indicators in order to elucidate the process of understanding. In that respect, reflexive models are based on the repercussive reactions, and the associated dialogue is based on situation, context, and language in use. We could define reflexivity as a presupposition of any kind of communicative interaction. In reflexive models the effort of communication depends on reciprocal perceptions, the self-commitment towards common understanding and actions. It also draws attention to the creation of sense, that is, of the practice and surroundings of the communicative action. The reflexivity of interaction implies the need to make a commitment. Reflexive models of communication stand in contrast to the conduit metaphor, that is, to communication as a linear process and as a one-dimensional procedure.

Regarding the matter of central bank communication, it is clear that the transition of the Federal Reserve Bank towards more openness also implies a further step to self-commitment. Moreover, any dialogue between the central bank and financial markets structures and configures the space of mutual recognition and understanding. It will create further acknowledgement of economic interdependencies among the participants in communicative interactions.

We shall now move a bit further into the question of what characterizes a reflexive model of communication. Concerning the central

bank and its interaction with the financial market, a reflexive model of communication works through three particular steps, as follows (Antos 1999):

a) The central bank (A) acts; it gives information to the public and explains it, that is, the central bank communicates; agents of the financial markets (B) react and give responses;
b) A perceives B and vice versa.
c) A perceives the perception of B and vice versa.
d) In short: A (B[A]) and B (A[B]).

A knows that B will work to establish reciprocal interactive pattern. B responds to A in the established space of perception and interaction. The creation of conditions of reciprocity of perceptions of A and B also implies a web of commitment and, therefore, a new social order. Any interaction based on that reciprocity will create a new social situation which itself is dependent on the situation. The creation of the conditions of reciprocity of the perceptions of A and B – A (B [A]) and B (A [B]) – also evokes a space for forming expectations. Therefore this reciprocal conditionality provides an infinite procedure of reciprocal perceptions and inherent connection of communicative interactions. In a weak sense of the expression – for example, the face to face-situation of central bank and market – it is also possible to describe a central bank's communication with agents of financial markets as a compelling means of further development of the 'face-to-face approach'.

The refinement of internal and external communication of a central bank is a striking example (Winkler 2000). The central bank acts as an individual. This is also true for agents of the financial market because *the market* itself does not act or communicate. Therefore, the creation of conditions of reciprocity of both agents – the central bank and the agents in the financial market – configures the environment.

The conditionality of the mutual perception of A and B lead to a non-causal communication. The commitment is not rooted in a causality of interaction because language does not manifest itself in causality. Language manifests itself in meaning rooted in social interactions as described above. The social interaction with the central bank and the financial market creates social reality. This social reality encompasses the possibility of a reconstruction of the three phases as described above. It also encompasses coordination, interaction, and expectations. It makes it clear that the meaning of words depends on contexts, circumstances, and their variations. The process of building expectations of agents in

the financial market towards further development is dependent on the perceived reflexivity inasmuch as it arises out of a symmetric interaction. One important consequence is that the symmetrical development of interactions between a central bank and agents of the financial market will also lead to a self-commitment towards the other agents of communicative interactions. This self-commitment can be interpreted as a result not only of interaction, but of *reflexive* interactions and perceptions. There is no place for linearity or for the hierarchical transmission of information by a sender to a hearer.

In a reflexive model of communication, the perceived interaction evolves a system of commitment and mutual responsibility. This system can be described as a combination which is rooted in distinct preferences but composed of mutual consensus regarding the overall goals of such reflexive communication. It is more than a simple model of communicative interaction because it draws attention to the evolution of reciprocal commitment in order to shape the financial market as a social reality. The core of the reflexive model of communication lies in this. The evolved commitments by the reciprocal perceptions and communicative interactions configure the social reality.

As explained by the idea of 'face-to-face interaction', central banks' communications continuously generate new situations which the central bank itself shares – and must share – with the agents of the market. There is no escaping from that. It misses the point to argue that the central bank 'enters a situation' which has been created independently and irrespective of its own communicative actions. In contrast to the view of the classical model of communication, the reciprocal perceptions of the agents involved contribute to the situation they all share. The model of reflexive communication emphasizes the role of language, that is, it recognizes the non-neutrality of language in the evolution of social reality.

Interactive communication is an 'infinite process' of reciprocal perception. Communicative interactions and communicative patterns of actions result in and from the use of language and in routines including those of language use. Successful communicative actions will also both provide new routines and perpetuate familiar ones. Routines work as long as no failure, that is, miscommunication, disturbs communicative patterns. Miscommunication, is a vague and imprecise notion, like the notion of communication, itself, as is also true for the idea of a coded language applied to central banking.[16] At this point it is important to distinguish clearly between miscommunication and misunderstanding: In case of a misunderstanding, no agreement on the issue in

question will be possible, whereas miscommunication is inherent in all communication, according to the reflexive view of communication (Dascal and Cuyckens 1988, 219–306).

The presumption of the linearity of communication, and also the view of communication as an absolute and not relational entity, conflicts with the modern view of communication introduced by Watzlawick et al. Watzlawick, for instance, explained that communication shall be characterized by the process of reciprocity inherent in all communicative interactions. This feature of reciprocity is not present in the classical model. The aspect of reciprocity, as well as the communicative interactions, remain in the dark because they are interpreted as so-called epiphenomenon. As epiphenomenon, reciprocity and communicative actions do not, in the classical view, have any relevance for the success or effectiveness of communication. In the classical model the process of communication and of information are not acknowledged as reciprocal interactions in which the meaning of the information has, first and foremost, to be developed. In the classical model of communication, the receiver is an empty box.

Let us summarize both the classical and reflexive models of communication here: models of classical communication focus on the causality, transitivity, and measurement of information being transmitted from a sender to a receiver. A one-dimensional relationship of sender and receiver are at the centre of attention because the sender merely transfers given information and, hence, a given meaning to the receiver. In contrast to that, the reflexive model of communication emphasizes the dynamic use of language, that is, it recognizes the non-neutrality of language as an active component in the evolution of social reality. The principle of reciprocity goes beyond the sender-receiver issue because it draws attention to the situation and the context of the communicative interactions. The reciprocity approach is based on reflexivity and the unavoidable selectivity of perception, both in the recipient of a communication and, indeed, even in the sender of the message regarding its receipt and interpretation by the recipient. It focuses on non-measurable elements such as persuasion, expectations, interpretation, and action, including non-verbal responses and counter-responses. Communicative interaction is based on the understanding of language as an instrument of thought, that is, not of language as neutral vis-à-vis thoughts. Language is not the materialized content of a neuron in the biological speech centre of the brain. Language is a medium for recognizing the world and to shape, conceptualize, translate, encapsulate, and systematize experience and knowledge. Communicative interaction and

language, as Austin and Searle emphasized, are the results of different conceptualizations, but are not the equivalents of things, properties, or objects. Language and communication, as well as information, are constructions and, therefore, conceptualizations of social phenomena.

To summarize the previous paragraphs: The conceptual framework of communicative interaction is not compatible with approaches devoted to mechanical analogies and deductive reasoning. The conceptual framework I have introduced excludes theoretical views of communication such as mathematical or linear theories (Shannon and Weaver 1949), quantitative theories (Schegloff 1993), or marketing approaches. This conceptual framework is aimed at describing the interdependencies of three dimensions – information, interaction, and context – by focusing on communicative interactions. It provides a framework of reasoning for central bank interactions and communication with agents of the financial market.

3
Central Banking and Communication As a Function of Circumstance

> Central banks generally appear to have embraced a common model of the channel through which monetary policy functions, although the specifics and emphasis given to those channels vary according to our particular circumstances. All banks ease when economic conditions ease and tighten when economic conditions tighten, even if in differing degrees, regardless of whether they are guided by formal or informal inflation targets.
>
> Greenspan 2004, 39

This chapter draws attention to the reasons why central banking needed to refer to circumstances. Circumstances draw our attention to the importance of linking a view based on models to the context and circumstances. The so-called *embraced common model* in fact reflects the new wisdom of central banking, since it relies on observation and recognition of changing circumstances. There are at least two main branches wherein the term circumstance can be referred to. Circumstance can be defined with respect to the different monetary policy regimes to which a central bank is committed, and to the mandate. A commitment to a mandate also implies that a central bank acts as an institution.

Central banks are not additional factors of an already given social environment: as was explained in Section 2.1, through reference to the interdependence of social structures and acting, central banks are not simply 'implemented' by their mandate. Central banking is aiming *at reaching its mandate, that is, central banking is a process*. Consequently the communication strategy of a central bank needs to be applied to both

its monetary policy regime and its mandate. This is also true regarding its reputation and credibility. There are also warnings in the literature to keep in mind the goal of a central bank. Consider the following comment by Issing (2005a, 68):

> Any discussion on the communication and transparency of monetary policy that starts off in abstract terms and in isolation of the actual task of a central bank is bound to lead to misunderstandings. Transparency is not an end in itself: a central bank is not established with the primary objective of communicating with the public. Its mandate either stems directly from the monetary system, as was the case with the gold standard, or is specified by the legislator, which became necessary in times of the paper standard.

Issing's reference here to the monetary policy regime and the mandate of the central bank indicates the importance to a central bank's environment and its action of the reliance on communication. In the literature, particular monetary policy regimes have been differentiated and widely accepted as basic frameworks to move in for making further distinction – inflation target, monetary target, and exchange rate target, including different kinds of fixed exchange rate regimes or currency boards (Mishkin 1999). Broadly speaking, a central bank can adapt to an inflation target with or without a numeric specified goal, a monetary target, or an exchange rate target (Mishkin and Schmidt-Hebbel 2001; Shu Lin 2007; Schmidt-Hebbel and Walsh 2009). Some authors argue the monetary policy regime of the Federal Reserve functions as an implicit nominal target. Other authors object to the proposal that the Federal Reserve should adapt inflation targets (Greenspan 2002; Friedman 2004).

Regarding these roughly sketched concepts of monetary policy regimes, one has to ask what kind of consequences can be discussed regarding their communication policy. Blinder and Goodhart et al. (2001, 10) described the choices for central bank communication as being based on simple or complex rule-based monetary policy regimes as opposed to discretion. Simple rule-based regimes are, for example, currency boards and fixed exchange rates, whereas exchange rate peg and crawling peg regimes are examples of less rigid rule-based systems. Contrary to that distinction, a wide-range inflation targeting central bank is a more complex discretionary monetary policy rule. Both simple and rigid rules are supposedly driven automatically and, hence, do not need support by communication, whereas complex discretionary regimes need more communication efforts on the part of the central bank.

This linkage between the monetary policy regime and the classification of various approaches above provides an interesting picture of the place given to central bank communication literature at that time. It should be clear that Blinder and Goodhart's et al. reference to this traditional 'rule versus discretion' approach is to be understood as a first step in linking monetary policy to communication and central bank talk in order to expand upon the traditional view of central banking. This traditional distinction has been configured by the community of science and has dominated debate on monetary policy and decision-making procedure since the 1970s. The dichotomy of 'rules versus discretion' was conceptually a simplified view on the decision-making process of a central bank. This dichotomy was abstracted from context and circumstances, from historical knowledge and from the interaction of structures and actions, hence from about how rules have been developed and how it has been achieving acceptability. This concept of 'rules versus discretion' was due to a model view, constructed for the sake of formal, hence deductive, results. It conforms to formal appropriateness (Muchlinski 2003b, 2003c). Criticisms were made by Cukierman (2002), Ferguson (1999), Issing (1996), King (1997), and McCallum (1997, 1999), among others; for example, James Tobin (1983, 508) stated, 'simplicity gives them their political appeal and power'.

These criticisms, which are mainly expressed by central bankers and central bank literature, addressed the simplified approach to the central bank decision-making process as unacceptable.[1] It is clear that a model does not fit reality because the task of modelling is to evaluate different kinds of interrelations to certain well-defined premises and conclusions incorporated by the particularities of the model view. A model view is anchored to premises and conclusions. A model view encapsulates a logical progression which can be outlined according to a variety of changes regarding the parameters of the model and resulting in various logical conclusions. From my point of view, I find it important that these criticisms seem to slightly redirect economic modelling towards a model perspective which can be linked to economic circumstances and context. Although it is not possible to apply a model perspective 'to' a reality perspective, even with a so-called model projection method or rules of projections, in economics it is nevertheless the task of a model that it must appropriately explain changing patterns of behaviour in changing circumstances or a 'lifeworld'. As was argued in Chapter 2, these patterns are configured by the interdependence of structures and actions. The benefits of the use of modelling in social science are not in delivering formally designed methods of deductive reasoning addressed

to invariant or variant parameters ruled out by mechanical reflexes. Central bankers should work with models which possess explications of central banking in changing environments (see Blinder and Yellen 2001; Ehrmann and Fratzscher 2008).

The Volcker era could be reread as an example of an inadequate formal approach because the 'k-percent-rule' or 'money growth-targeting' ignores the circumstances of the institutional interactions between the central bank and commercial banks regarding the concepts of money, the innovation of fiat money, of money demand and supply in the economy. This 'k-percent-rule' and 'money growth-targeting' could not have been implemented. Earlier a comment by Goodhart (1994) and Vickers (1998) regarding the Bank of England was mentioned (see Section 1.2). I will turn to another example in this chapter, the Greenspan era.

Clarida, Gali and Gerler (2000), and Goodhart (2001b), among others, proposed improving the theoretical concept of 'rules versus discretion' by emphasizing that 'rules' also imply discretionary manoeuvres in the decision-making process of a central bank. As I will outline in Chapter 5, the concept of 'rule' applied in social science does not work as a mechanical analogy (Muchlinski 2003b, 2003c).

Bernanke (2004, 2) referred to distinct concepts he described as *simple feedback policies* and *forecast-based policies*.[2] He explicitly rejected arguing on the basis of the traditional view. He also objected to modification of it into 'instrument rules' and 'targeting rules', as proposed by Svensson (2003). Bernanke stated that he sought to explain his view on the basis of distinct concepts which do not evoke any terminological association with previous debates. Bernanke (2004, 2) made a 'gestalt-switch' towards new categories in central bank literature by arguing:

> Unfortunately, for my purpose at least, this (traditional, EM) terminology is somewhat misleading. First, the term 'rule' suggests a rigid and mechanistic policy prescription that leaves no room for discretion or judgment. ... Today most monetary economists use the term 'rule' more loosely to describe a general policy strategy, one that may include substantial scope for policymaker discretion and judgment. Here I will use the term 'policy' instead of 'rule' to avoid the connotations of the latter. Second, the terms 'instrument' and 'targeting' are products of the intellectual history of the debate and, to my mind, are not particularly descriptive. I will refer to the approaches known in the literature as instrument rules and targeting rules instead as *simple feedback policies* and *forecast-based policies*, respectively.

He emphasized that *simple feedback policy* implies a high degree of ignorance of the structure and activity in the economy. However, *simple* in this context means that agents in the market know that the central bank itself acknowledges only a few indicators and variables, which have been used to model decision-making and expectation-building according to the robustness of results in econometric tests. It is comparable with Taylor's approach to monetary policy (1993, 1999), specified in a simple and robust model.[3] It can be interpreted as a policy relating to a short time projection which is understood immediately and needs no further explications or communications.

In contrast, the *forecast-based-policy* implies a continuous procedure of economic judgments and evaluation. It is related to a mid-term projection of about six to eight quarters. Regarding the interaction between a central bank and agents in the market Bernanke (2004, 5) explained: 'Under *forecast-based approach* ... judgment or special information should affect policy choice to the extent that it affects the forecast or the risks to the forecast.' A particular feature is that the central bank opens up its transparency and communication to the judgments of experts in order to aim at an agreement on the prospective performance of the economy with the market participants. In contrast to the *simple feedback policy,* the *forecast-based policy* refers to a comprehensive set of economic variables which should be explained and communicated to the politicians and the public.

According to Bernanke (2004, 8), communication has become an elementary function in clarifying the Fed's information policy.

> As a general matter, the more guidance the central bank can provide the public about how policy is likely to evolve (or about the principles on which policy decisions will be based), the greater the chance that market participants will make appropriate inferences – ant thus the greater the probability that long-term interest rates will move in a manner consistent with the outlook and objectives of the monetary policy committee.

He emphasized that *simple feedback policy* and *forecast-based policy* are not equally used sources in the decision-making process; the *forecast-based policy* has becoming more important to most of the central banks. To sum up this pattern of judgment, the *forecast-based policy* provides an appropriate link to changing circumstances and the context of a central bank (see Bernanke 2004, 5). Although the Federal Reserve does not base its monetary policy on published forecasts, the *forecast-based*

policy indicates the importance of the interrelated structure of economic variables.

Bernanke gravitated towards new concepts in order to configure the debate on the methods of decision-making and monetary policy, steering it in a new direction. He avoided being captured in a cognitive straitjacket based on a misleading analogy arising out of traditional concepts. Recognizing both policies as sketched above, one might ask how appropriate the *simple feedback policy* is in the purpose of steering market expectations and getting the long-term interest rate to a level which is needed in order to implement the central bank's mandate. In other words, which methods are needed for 'getting the markets in synch with monetary politics'? (see Chortareas, Stasagave and Sterne 2002; Cukierman 2002; Walsh 2002). Also, communication seems to function more as a medium to transmit and explain information given by the Fed.

If we interpret *the simple feedback* policy as a code or rigidly fixed rule, then this policy should be seen as inadequate to monetary policy and its task of steering the market expectations of a heterogeneous group of agents in financial markets. However, if we instead understand it as heuristic thinking or as 'the recognition heuristic' introduced by Goldstein and Gigerenzer, it needs to be connected to the 'ecological environment' (ibid) and circumstances. The assumption underlying the effect of the *simple feedback policy* is that agents in the market are accustomed to diversifying their attention. They are inclined to pay attention to experienced 'rules of thumb' as the experiments of Goldstein and Gigerenzer documented. The agents are in the habit of focusing on information that resembles the acquired knowledge base. However, this cognitive anchoring does not imply that the agent's expectations are past driven or mental states which should be conveyed by language, but rather that they do not act as billiard balls bouncing around without history, experiences, and social circumstances.

A *simple feedback policy* can only be interpreted as a primary step in anchoring the inflation expectations, which then needs to be supplemented by the *forecast-based approach*. In my view this is of great importance to the dominant *forecast-based approach* to monetary policy and the forward-looking behaviour of the agents.

The crucial aspect of market interactions is that the private sector has to estimate the future level of prices and short-term and long-term interest rates in money markets given the historical path of their movements and the dependency of the path of the central bank's decision-making process. The forecasting models of the private sector encompass

coefficients concerning macroeconomic variables which need to be constantly reassessed (Orphanides and Williams 2005). According to the current controversies in the literature, it has been argued that market expectations need to be anchored in a commitment by the central bank (Woodford 2005; Orphanides and Williams 2005). It is not the given level of short-term interest rates that is important, but the expectations of the markets participants regarding the long-term interest rates and, hence, the future level of the short-term rates.

However, does a credible commitment – a 'sound policy' – by the central bank regarding its future path of inflation allow the private agents to stabilize their expectations? Would it minimize the uncertainty in the markets? There is no consensus in the literature on this matter (Greenspan 2002, 2004; Blinder and Reis 2005; Kohn and Sack 2003; Issing 2008). As Bernanke explained, actions and interactions in the financial markets are also driven by expectations which are impregnated by the history of the concepts and categories. The crucial point is that any kind of commitment by a central bank on the future path of price development and interest rate levels needs to be anchored in changing circumstances and contexts in order to be understood as 'a sound policy'. As has been stated, communicative interaction is not a linear process, and information is not 'given' by the sender, but rather through information processing based on the possibility of understanding.

The demand for a commitment is rooted in the abandonment of the traditional view because of its inadequacy in central banking practice. Given the traditional model view composed on the rational expectations hypothesis (REH), no stabilization is needed because the hypothesis works as a stabilizing parameter of the model itself. Based on the 'common knowledge' assumption, the REH implies perfect information, perfect knowledge, and perfect understanding. The demand to stabilize inflation expectations via a central bank's commitment seems to have the function of substituting the model premise of REH with another. However, given this model view, no differing result will be possible. The claim that agents in the market need a central bank's commitment is not convincing because it does not guarantee better understanding, since it is further information which has to be perceived regarding changing circumstances. More information does not automatically lead to a better understanding. A commitment by the central bank could lead to a test by the market in order to prove whether this commitment is credible or not.

At this point the *forecast-based policy* as explained by Bernanke indicates that the Federal Reserve should try to improve the communicative

interaction with the markets. I subscribe to the view that it is necessary to focus on the understanding. In the case of the Federal Reserve Bank there has been a strong demand on the agenda to specify its mandate of 'price stability' as a numerical goal in order to concretize context and circumstances. It was argued that the Fed follows a 'Just-Do-It-Strategy' because it has not yet adapted inflation targeting. The monetary policy regime was then described as 'Inflation-Targeting with an implicit nominal anchor' (Mishkin 1999; Goodfriend 2005), whereas Greenspan (2002) and Kohn (2005b) objected to the demand and also to the above description.

One consequence of the above debate is that the communication skills and efforts of the Federal Reserve Bank needed to be improved – a goal Chairman Greenspan had exercised intensively. I will turn to it shortly. However, Bernanke (2004a) made the point that *times are changing* and the postulate 'never explain, never excuse' does not fit the modern view of central banking.[4] Greenspan (2004, 37) introduced the *forecast-based policy* as the new 'risk-management approach to monetary policy', as an approach to problem solving and as an alternative in optimizing a strategy that, 'emphasizes understanding as much as possible the many resources of risk and uncertainty that policymakers face, quantifying those risks when possible, and assessing the costs associated with each of the risks.'

Greenspan described his work at the Federal Reserve as an 'epistemology', as a science of identifying what is known or unknown or known and unknown for whatever reasons. A remarkable feature of his speeches, for example, is that they were concerned with a broad range of topics describing that landscape.

The 'risk-management approach to monetary policy' was summarized and concretized by Blinder and Reis (2005). The 'risk-management approach to monetary policy' explicitly moves beyond the pure model view on central banking by integrating different risk categories (macroeconomics and microeconomics), different levels of risk (moderate, high, low), and descriptions about the management quality (strong plus lag, weak plus lag, or acceptable lag).

It is based on key considerations that monetary policy should act by gradual degrees and avoid abrupt activity. To be more precise, the 'risk-management approach' is composed of key principles – such as a) 'fine tuning', for example, 'conservatism' regarding the fundamental uncertainty surrounding central banking; b) 'interest rate smoothing'; c) 'reversal aversion'; and d) 'preemptive decisions' – in order to acknowledge changes in the structures and to be able to implement actions right on time.

The principles of 'fine tuning' and 'interest rate smoothing' are to be seen as steps towards soft changes in the level of the nominal short-interest rate according to the specific asymmetry of times which affects long-term interest rates and inflation expectations. Greenspan emphasized that the Federal Reserve should act conservatively and not move suddenly or impulsively to change the direction of the market expectations. What does uncertainty mean? Greenspan (2004, 36–37) clarified this:

> The term uncertainty is meant here to encompass both 'Knightian uncertainty', in which the probability distribution of outcomes is unknown, and 'risk', in which uncertainty of outcomes is delimited by a known probability distribution. In practice, one is never quite sure what type of uncertainty one is dealing with in real time, and it may be best to think of a continuum ranging from well-defined risks to the truly unknown.

The Federal Reserve was tightening nominal interest step by step. However, as the experience of the Federal Reserve in the 1990s showed, inflation contributed to the price bubble. This occurrence cannot be explained by the adequacy of the Taylor rule, but rather by further attempts to understand the changing environment (see McCallum 2000, 2000a). At the time of making a particular decision, however, changes in the environment may not be perceivable as a hard fact, as an index, or as a number.

The principles of 'reversal aversion' and 'preemptive decisions' are identified as being a way of acting soundly to acknowledge changes of structure. For a central bank, changes of nominal interest rates are always important signals to the market. This is also true if a central bank announces a correction of its interest rate decisions once it has made a decision publicly. A spontaneous correction will affect its reputation and credibility regarding further decisions. However, no central bank wants to be accused of being 'behind the curve'. Greenspan does not offer a 'magic formula' but he offers certain considerations regarding the 'risk-management approach' described above. Blinder and Reis (2005, 82–86) concluded as follows:

1) 'Keep your eyes open'. Monetary policy does not work as a rigidly fixed rule. Step beyond old fashioned concepts like 'rules versus discretion'.
2) 'Don't let yourself get caught in an intellectual straitjacket'. There exist many concepts in macroeconomics like NAIRU,

REH, PHILLIPS-Curve, which have been playing a role as selective approaches to economic optimization rather than economic circumstances and problem solving.

3) 'Avoid policy reversal'. Economic procedures are not linear procedures and almost none have reversible traits.
4) 'Forecasts, though necessary, are unreliable'. Forecasts need to be linked to the contemporary world.
5) 'Formal optimization procedures work in theory, but risk management works better in practice – especially as a safeguard against very adverse outcomes'. Acting in practice and circumstances is preferable to optimization.
6) 'Recessions are bad, as is growth below potential'. The Federal Reserve's 'Dual Mandate' is an adequate response to ups and downs in the economy.
7) 'Most oil shocks should not cause recessions'. A modification of the definition of inflation or core-inflation will show a way out of recession.
8) 'Don't try to burst bubbles; mop up after'. Greenspan argued in favor of a 'mop up after' strategy because a central bank's mandate is price stability and not intervention in the procedures of the markets. Additionally it should be acknowledged that a central bank cannot have a pretense of clarity about the limits of a bubble.
9) 'The short term real interest rate, relative to its neutral value, is a viable and sensible indicator of the stance of monetary policy'. Although the Federal Reserve sets the nominal interest rate, the Federal Reserve funds rate, it nevertheless aims for a certain level of the real rate.
10) Blinder and Reis (2005) demanded a transformation of the dictum of Teddy Roosevelt, who stated, 'talk softly, but carry a big stick', into 'talk modestly, but set your sights high' (ibid).

The above summary also underlines the notion that the Greenspan era has influenced the theoretical debates on central banking.

My own thoughts on this are that the importance of the circumstances and context regarding the evolution of the meaning and understanding can no longer be neglected, because it keeps the central bank fulfilling its mandate and ensuring the effectiveness of monetary policy. This can be shown by reference to Greenspan. In the literature the 'Greenspan era' is described as a successful one, although it cannot be described as a 'Greenspan rule' or 'Greenspan model' (Blinder and Reis

2005). However, the label 'Greenspan model' misses the point regarding his way of acting and communicating (Sicilia and Cruikshank 2000). Nevertheless, the absence of any particular rule or method was essential to his success. Greenspan's announcements show, in my view, that he avoided use of a coded language while interacting with the markets.

Greenspan described the context in which the central bank is embedded by referring to three particular features:

a) The political acceptability of price stability a central bank is aiming for. The background of this acceptability is without a doubt rooted in the negative consequences of the monetarist experiment regarding the tight money policy and depression around the globe.
b) The challenges of the globalization process which definitely changes the competitiveness in global financial markets.
c) The new technologies which set high and completely new standards for the traditional concept underlying the monetary policy, for instance, the price index.

Any judgment about monetary policy is also connected with the context and circumstances:

> We were fortunate ... to have worked in a particularly favorable structural and political environment. But we trust that monetary policy has meaningfully contributed to the impressive performance of our economy in recent decades. (Greenspan 2004, 40)

The decision-making procedure of the Federal Reserve is framed by different models, rules, and models of forecasts which have to link to the context and environment. The judgment about changing phenomena in the context requires first of all the willingness to notice changing aspects of that landscape. Secondly, it requires one to revaluate and reinterpret the observations, concepts, and instruments by inductive reasoning. Evaluations of uncertainty and changing circumstances are not possible through reliance on deductive reasoning, since in deductive reasoning there is no uncertainty allowed for at all. Deductive reasoning draws its conclusions from premises and axioms, that is, a model. The necessity of judgment in light of uncertainty (or as Greenspan specified in a reference to Knight, when one is confronted with different or unknown types of uncertainty) means needing to step beyond the certainty of the deductive reasoning of the model world. Another consideration should be recognized: deductive reasoning implies truth or rightness in a logical

form based on logical language and syntax. Additionally, reliance upon a numerical target of price stability would not reduce the uncertainty. Uncertainty of the concrete situation and the unknown future frame the decision-making procedure in the concrete situation:

> Even monetary policy rules that use recent economic outcomes or money supply growth rates presuppose that the underlying historical structure from which the rules are derived will remain unchanged in the future. But such a forecast is as uncertain as any. (Greenspan 2000, 2)

Therefore central banking is inevitably concerned with the requirement to act regardless of the uncertain situation. There is no way to escape it, but it is possible to step beyond the supposed certainty of deductive reasoning:

> We must confront the fact that only a limited number of risks can be quantified with any confidence. And even these risks are generally quantifiable only if we accept the assumption that the future will, at least in some important respects, resemble the past. (Greenspan 2004, 38)

Keynes (1921) would have supported Greenspan's view:

> I have argued that only in a strictly limited class of cases are degrees of probability numerically measurable. It follows from this that the mathematical expectations of goods or advantages are not always numerically measurable. ... If, therefore, the question of right action is under all circumstances a determinate problem, it must be in virtue of an intuitive judgment directed to the situation as a whole, and not in virtue of an arithmetical deduction derived from a series of separate judgments directed to the individual alternatives each treated in isolation. (Keynes, *Collected Writings* Vol. VIII, 345)

By referring to the bubble phenomenon in the 1990s, Greenspan described that at every stage the Federal Reserve was faced with perceptions, facts, and events which none of the members of the Federal Reserve had previously encountered, and which could not be explained by any of the prevailing models, concepts, or categories.

The uncertainty which surrounds central bank action and decision-making process are persistent, and exist at all times. For instance, the

Federal Reserve cannot fulfil its mandate by referring to a price index only. The numerical concept of price stability does not encapsulate the evidence of moving prices throughout all branches of the economy and times. Therefore, one has to ask: what generates a stable price index? The answer is still open to debate. Greenspan (2002, 5-6) argued:

> By price stability, however, I do not refer to a single number as measured by a particular price index. In fact, it has become increasingly difficult to pin down the notion of what constitutes a stable general price level.

That technology-driven price movement requires changing the instruments and modes of perception as well as the concepts to describe new phenomena. The economy is not a mass of invariant entities which are calculable separately and, hence, measurable. The price movements of the so-called traditional industries are calculable numbers. This could not be said regarding the definition of the prices of new technologies in medicine or computer technology. Uncertainty, as the defining characteristic of the central bank landscape, also encompasses these conceptual uncertainties and, hence, problems of measurement:

> But in our new century, the simple notion of price has turned decidedly ambiguous. What is the price of a unit of software or a legal opinion? How does one evaluate change in the price of a cataract operation over a ten-year period when the nature of the procedure and its impact on the patient has changed so radically? Indeed, how will we measure inflation, and the associated financial and real implications, in the twenty-first century when our data – using current techniques – could become increasingly less adequate for tracing price trends over time? (ibid)

At this point, Greenspan repeated his objection to implementing a numerically specified inflation target for the Federal Reserve:

> For all these conceptual uncertainties and measurement problems, a specific numerical inflation target would represent an unhelpful and false precision. (Greenspan 2002, 6)

Bernanke argued that a specification of an explicit monetary policy rule would not fit changing circumstances. 'The problem is that the number of contingencies to which policy might respond is effectively

infinite (and indeed, many are unforeseeable)' (2004, 6). In his speech 'Fedspeak', he drew attention to further empirical findings which have emphasized that central bank statements matter to its policy effectiveness. Communication enlightens and explains the way a central bank works and allows the public to effectively share. Remarkably and evidently, communication has also improved the long-horizon forecasting ability of monetary policy decisions by the private sector. Bernanke (2004, 6) stated:

> With respect to actions, the central bank should behave in as systematic and as understandable a way as possible, given the macroeconomic and financial environment. That is, although monetary policy cannot be made by a mechanical rule, policy can and should behave 'rule-like' features. ... However, because the world is complex and ever changing, policy actions alone, without explanation, will never be enough to provide the public with the information it needs to predict policy actions. Words are also necessary.

According to the above citation, 'words' seem to have the role of enlightening the meaning embodied in the information given from the central bank (sender) to the public (listener). However, whereas Bernanke voted for a 'rule like' monetary policy which put the central bank itself into a certain direction of future policy and, therefore, commitment, Greenspan modified the function of a rule-like policy by stating that the meaning and understanding is not achievable by deductive arguments only. Greenspan has also written,

> I believe we at the Federal Reserve, to our credit, did gradually come to recognize the structural economic changes that we were living through and accordingly altered our understanding of the key parameters of the economic system and our policy stance. The central banks of other industrialized countries have grappled with many of the same issues. (Greenspan 2004, 33)

The perception of changing times, that is, of changing observations – and changing key parameters of the economic system – and the endeavour to improve concepts, methods and instruments provide the basis for understanding and meaning. Meaning and understanding are rooted in the use of language, in practice. Greenspan did not use a coded language. A coded language cannot be used in the context of changing practice. A coded language may be suitable to drive a car or to

the use of a machine. The communicative interaction, that is, the use of language, is embedded in the circumstances, context, and history. The meaning of a sentence is encapsulated in the historical situation and cannot evolve isolated from the context which is, of course*, a changing one*. Changing circumstances and contexts as well as changing times need to improve the understanding of the context and language and expressions used. Any language-game is a result of a common course of action. This common course of action provides 'the system of reference by means' for the communicative interaction as words need to be anchored in their context (Wittgenstein 1978 § 206).

A central bank possesses a huge amount of experience, knowledge, and capability to act, to shape, and to influence the social context the central bank is also part of. A central bank's motivation to act, shape, and influence its environment and context is primarily due to its mandate. However, the central bank's path to fulfilling its mandate is a never ending learning process. At this point the reliance upon a coded language would enhance the uncertainty for reasons I am going to state more precisely in Chapter 5. The role of learning in central bank experience has been emphasized by Greenspan (2002, 2):

> Although we have learned much about managing the financial backdrop to accelerating economic activity, it is essential that we not be deluded into believing that we have somehow discovered the Rosetta stone of monetary policy. A failure by policymakers to sufficiently appreciate the inevitable uncertainties that they confront could result in unfortunate consequences for the economy. While we central bankers do not have full knowledge, we have continued to gain insight – albeit slowly – into how market economies function. That learning process has been aided, especially in the United States, by a vast panoply of data and information from both public and private sources. However imprecise, these readings on the economy have helped us steer monetary policy through an inevitable uncertain future.

Greenspan (ibid) emphasized that the move on this road is not a lonely walk on an island, but an interactive procedure.

> In practice, it is the joining of ideas and data that drives policy in the face of uncertainty. We seek to array the probabilities of future policy outcomes, attempt to gauge the costs of being wrong in our decisions, and endeavor to choose the policy paths that appear to offer greater benefits and fewer risks.

Regarding the uncertainty surrounding the central bank's actions and decisions, Greenspan and the FOMC chose a discretionary policy because it is not possible to define economic parameters as precisely as would be needed to guide a rule-based monetary policy. Reference can be made again here to the classification by Blinder and Goodhart et al. (2001) introduced at the beginning of this chapter. The example of the so-called monetarist experiment throws a clear light upon that problem. The effect of uncertainty surrounding the central bank's practice is described by Greenspan (2001b) as follows:

> Faced with this inevitable uncertainty, a central bank's vigilance against inflation is more than a monetary policy cliché, it is, of course, the way we fulfill our ultimate mandate to promote maximum sustainable growth. ... Monetary policy, as we currently practice it, endeavours to lean the propensities for economic overshooting, from whatever source, by changing interest rate. But we are unlikely ever to be entirely successful. For example, it is not possible to foresee how far risk premiums will fall or when that decline will adversely alter psychology.

Therefore, the changing environments in which the central bank is embedded also implies the requirement of changing responses and strategic actions:

> With the virtually unprecedented surge in innovation that we have experienced over the most recent half decade, many of the economic relationships embodied in past models no longer project outcomes that mirror the newer realities. (ibid)

Although the economic commentator, Forbes, has asserted that Greenspan has guided the financial markets by 'his Delphic, ambiguous, often impenetrable prose' (*The Wall Street Journal*, February 1, 2006), I would rather interpret it as a way of acting or of communicative interaction. Greenspan described or reported on the decisions, the inclinations, and views of the Federal Reserve Bank through the use of everyday language, that is, the language in context. He avoided the pretension accompanied by the use of a coded language and, hence, the deceptive appearance of acting in a realm of certainty. He guided the communicative interactions, that is, the expectation-building process among the agents in the financial market by use of everyday language.

In Chapter 1 it was shown that the traditional assumption about central banks neglects matters which are in fact important for the

fulfilment of their mandate. Not just the concept of credibility, but also the concept of transparency, are based on economic interaction and linguistic communicative actions. Both refer to the mode of action, that is, 'matching deeds to words'. There is no hidden agenda which allows an independent central bank to implement the effectiveness of monetary policy as if driving on a one-way-road (Freedman 2003). The central bank being located and constituted within social structures acts as an institution in the social world and not the physical world. Therefore, its verbal and non-verbal interactions are not based on natural laws or rules, but on the continued evolution of compositional rules concerning the construction of utterances, institutional arrangements, actions and facts. Acting within a societal framework also implies reactions and responses. It is important to emphasize that central banks contribute to the structures of the societies of which they are part. The credibility of the Federal Reserve has been gained by the employment of flexible responses in accordance with changing contexts and changing perceptions of the economy as a whole. The concepts of monetary policy-derived actions referring to mechanical procedures of adaptation should in that sense be relegated to the past.

I now turn to a basic investigation carried out by Kohn and Sack (2003) which provides a *striking* example of how a central bank's communication interaction with the financial market has been considered. This was pioneering work on the Federal Reserve Bank's communicative interaction. Many other comparable studies have followed since.[5] Valuable research on the measurement of the European Central Bank's communication has also been carried out, but will not be presented here. Research in the literature on central banking has been beginning to measure the effects of communication in the financial markets. Ehrmann and Fratzscher provided the pioneering work and the communication strategies of both the European Central Bank and the Federal Reserve Bank. Their empirical findings support the view that communication is *the heart of central bank transparency and accountability*.[6]

Empirical investigations document that the speeches, testimonies, and FOMC meetings matter (Kohn and Sack 2003). However, private information is a certain factor in how the Fed's announcement affects the markets (Morris and Shin 2002). Nevertheless, it has been emphasized that

> the nature of the information being transmitted remains unclear. A communication about the information that relates to the insights of future policy decisions or the state of the economy – is distinguished

> form a communication that serves to coordinate the actions of private agents operating with imperfect public common knowledge. (Chirinko and Curran 2006)

The problem of central bank communication is first at all to measure how markets incorporate information. If a central bank's statements, or 'talk', do have any effect on the expectation-building process, this can only be estimated empirically.

Kohn and Sack (2003, 2) expressed the issue as follows:

> This work is a first step in a research program to provide central banks with useful evidence on what kinds of 'talk' are most successful for realizing the potential benefits of transparency. ... Lastly, our results speak to the issue of whether central banks can 'talk down' (or 'talk up') particular asset prices that they feel may be incorrectly valued.

Since limited knowledge and uncertainty surround every decision, it is hardly possible to answer the question of how, when, and in which manner statements of the FOMC, and testimonies and speeches of the chair of the Federal Reserve, have the function and effect of shaping the expectations of private agents. Current empirical studies shed light on these questions (Bernanke, Reinhart and Sack 2004; Kohn 2005).

Kohn and Sachs (2003) investigated *how* and *if* statements by the Federal Reserve Open Market Committee, as well as testimonies and speeches by the chairman, are able to significantly affect economic variables. Their claim is that only empirical investigation can provide an answer to this question. Based on a contribution by Freedman (2002), the authors differentiate three types of communication: a) the FOMC statements (so-called 'risk bias' or 'balance of risk assessment') which are released to the public immediately after the meeting of the FOMC, b) the testimony by Chairman Greenspan, and c) the speeches by the chairman. They then try to measure the effects of these three types of communication on the transparency of the Federal Reserve and the public's understanding.

The underlying questions are: Is there a link between the 'new language' strategy the FOMC started in January 2000 and the effectiveness of monetary policy? Are there significant effects on the movements of the short-term or long-term interest rates? Have these three types of communication been improving the transparency of the Federal Reserve? Is there any remarkable effect to be mentioned

regarding the aim of the Federal Reserve sharing the expectations of market participants? Does central bank talk matter at all? Economic variables, particularly the Treasury forward rate and interest rates, are driven more by words than by deeds: 'In this regard, statements appear to be an important component of the policy implemented by the FOMC' (Kohn and Sack 2003, 11).

The testimonies of the chairman to Congress have a still greater effect on the economic variables in question, that is, 'Federal Reserve funds rate, Eurodollar future rates, the two-year Treasury yield, and Treasury forward rates' (ibid, 2003, 12). The authors argue that the FOMC statements often contain the same information, but its disclosure does not lead to such a significant effect on the near-term interest rates as does the chairman's testimony.

What is the difference between these two types of communication? Before addressing this question, let us first move on to the third type of communication. Compared to the FOMC statements and the testimony of the chairman, the third type of communication, the speeches of the chairman, evidently do not have a remarkable effect on the movements of economic variables at all. The reasons are presumably to be found in the broad range of topics regularly discussed by the chairman. The speeches of Greenspan dealt with many issues, including those which are not concerned in a narrow sense with monetary policy strategy.[7] Nevertheless, it is reasonable to suppose that the effects of these speeches are embedded in the Federal Reserve's function of providing a pattern of prospective roots for monetary policy strategy – a prospective view which is important to the expectations of market participants. Although the authors deny any systematic link between the speeches of Greenspan and the reactions of market variables – that is, changes in the decisions and reactions of market participants resulting from his speeches – they do not argue that the speeches are without any relevance. The empirical evidence shows they are less significant to the market variables than are the two other types of communication. Kohn and Sachs (2003, 11) stated:

> Judging from the effects of his testimonies, we believe that speeches that address the current or prospective economic environment are likely to generate a significant market response. Our approach probably includes enough instances in which he did not address those topics to obscure the effects of speeches that did.

Regarding these three types of communication, central bank communication does matter, but why? Kohn and Sachs emphasize the

important role of expectations for economic development. A central bank cannot be successful by trying to avoid having an influence or fooling market agents or market expectations. Without doubt, the market has an interest in listening to the views of the chairman. A lack of transparency would impede the effectiveness of monetary policy and restrict its ability to fight monetary shocks.

However, I briefly turn now to central banks as institutions just in order to add the considerations above. There is no space and time to get into the details of the literature and research on monetary institutions and path-dependency of institutions or organizational path dependence (see Sydow, Schreyögg and Koch 2009). Central banks do not communicate as individuals to the market regardless of whether the chairman speaks in a press conference; they communicate as institutions. The central bank's need to focus on special information and to investigate certain economic developments – that is, the monetary transmission process which differs greatly between countries, or prices of goods markets, currencies, the rate of economic growth, and so forth – and furthermore to create and communicate certain data according to an economic environment, describes clearly its role as a monetary institution. As monetary institutions, they have comparable monetary strategies in order to secure the effectiveness of monetary policy. Institutions – their rules, structures, services – are institutional facts. Institutional facts are not 'brute facts' (Anscombe 1958). As social phenomena they are not independent of the perception, acknowledgement, and utility of the people involved. In light of the social science paradigm, social phenomena or institutional facts are created facts; they are based on language activity (Brandom 2006). One certain feature of institutional facts – like a central bank or a university – is that 'they are placeholder for pattern of activity'. They earn their acceptability by their ongoing activity. A certain characteristic of institutional facts is that they are not worn out or exhausted by its continuity:

> At this point, I am just calling attention to a peculiar logical feature that distinguishes social concepts from such natural concepts as 'mountain' or 'molecule'. Something can be a mountain even if no one believes it is a mountain. ... But for social facts, the attitude that we take toward the phenomenon is partly constitutive of the phenomenon. (Searle 1995, 34)

'Why and how does the use of language create social facts or institutions?' The answer was given by Searle when he stated that performative

acts play a particular role in the creation of institutional facts because they refer a certain status to an utterance. For instance, if I, as a private individual, say, 'the interest rate will be unchanged', this statement creates a different (presumably no) response than would be the case if the chairman of the Federal Reserve had uttered that sentence. Saying something counts as if one is entering into a contract or commitment (for instance marriage or other agreement or undertaking) – but exactly what depends on the circumstances, social functions, and position or role. For instance, the sentence 'X counts as Y' uttered in a particular circumstance or environment would (or at least could) have a different result from that in another.

Institutional facts can be created by performative acts – or speech acts – when the status-function (Y) can be imposed by declaring it to be imposed – for instance where the term X is itself a speech act. Not all institutional facts are created by speech acts. However economic facts are not like objects – stones, cars, trees – instead, economic science uses language activity to create and shape economic environments. For instance, 'the word money functions as a placeholder for the linguistic articulation for all these practices' (Searle 1995, 52–53). We do not need money to define 'money' because we can refer to different institutional facts, like buying, selling, owing, and so forth. We do not need the word 'money' as long as it is embedded in practices. Similarly, we do not need the word 'language' to define language. Searle (1995, 60) stated:

> If institutional facts require language and language is itself an institution, then it seems language must require language, and we have either infinite regress or circularity.

But such a circularity or infinite regress will not be the case regarding those concepts which are embedded in social practice. Searle (1995, 52–53) concluded:

> We avoided the vicious circularity only by expanding the circle by including other institutional concepts. We are not trying to reduce the concept 'money' to noninstitutional concepts.

To sum up this point with Searle (1995, 57):

> Since the function is imposed on a phenomenon that does not perform that function solely in virtue of its physical construction, but

> in terms of the continued collective intentionality of the users, each use of the institution is a renewed expression of the commitment of the users to the institution. Individual dollar bills wear out. But the institution of paper currency is reinforced by its continual use.

Other findings in the literature also emphasize the structure and political circumstances as favourable or as impediments for a central bank's work. However, the empirical findings have documented that the effects are very different in different countries, and the horizon of interest rate movements in different money markets – regardless of a central bank's monetary policy – is based on an explicit inflation target or monetary target. A seminar organized by the IMF invited speakers from the Asian Region, India, and Latin America to discuss the importance of the central bank communication modes and methods (Enoch 2006, Lambert 2006, Reddy 2006).

The debates over the need for a disclosure policy outline the problems regarding the status and democratic surroundings of a central bank. For instance, the structure of the financial sector in emerging countries is often too sensitive to be discussed in the same way as in the established industrialized countries (Rozkrut, Rybinski, Sztaba and Szwaja 2007). The demand for transparency and communication needs to be treated in a different manner, as the documentation by the Bank of International Settlements clarifies (Simmons 2006). This is partly due to the existing exchange rate targets and partly due to the varied economic and political environment of the central bank in different countries (Burkhard and Fischer 2009; Chiu 2003; Fratzscher 2009).

At this point I would like to summarize this chapter with some further considerations: Concepts and meaning are not givens. The history of the meaning of concepts – like 'rules' in the history of central banking and monetary policy – is the history of the procedure of creating the sense of a 'rule'. The history of concepts inevitably implies the history of the construction of the meaning of concepts. Trying to explain any historical sense and meaning leads to the requirement of explaining the language-based construction of knowledge in and of a society.

No central bank can have knowledge about the decisions and reaction of market participants *ex ante*. Nevertheless it does not start at point zero. It anticipates the perception of market participants regarding their decision-making and actions in the past, and regarding current economic performance. For instance, the 'public's understanding of the monetary process' (Winkler 2000) is observable by the decisions and reactions of market agents. Greenspan made the point that the

price level and wage level indicates what people are doing. The task of the Federal Reserve Bank is to evaluate why people do something specific, that is, to figure out upon what kind of a state of confidence are their decisions and actions based. Therefore, a central bank has to achieve an understanding of the opinions and beliefs of market participants. Since there are no direct interactions between a central bank and market participants, it can only get to this level of knowledge by interpreting market reactions and by perceiving market decisions (order and re-order). From my perspective, the experiences of the Volcker and Greenspan eras have opened the path to a broader theoretical horizon in macroeconomics. The modern view on central banking has a pioneering role for further refinements in macroeconomics by intensifying the interdisciplinary approach. Noteboom (1999) provides convincing examples of how the interdisciplinary approach – including epistemology, philosophy of language, cognitive science and sociology – opens up the understanding on how and why organizations, that is, institutions, behave, learn, and act (Voigt 2009).

4
Economics and Language

This chapter discusses a relatively small range of contributions addressing the combined fields of economics, communications, and language.[1] Language is a constituent for scholarly work in economics. Language is used to build and develop certain research tools, methods, and instruments in different realms of economic science. Despite the focus of this book being on central banking, I would like to shed light on the question of how economists have been working on language. Economists are not used to systematically reflecting on their use of language. This chapter presents an overview of how economic sciences have dealt with communication, and it outlines an example of how central bank modelling has been influenced by the acknowledgement of the constitutive roles played by language and changing contexts, that is, by stepping out of the model view.

4.1 Economics, communications, and language

In social sciences the traditional view of a supposed distinct realm of 'pure data' and 'pure theory' is a thing of the past because the data production itself is acknowledged as theory-laden.[2] Furthermore, the constitutive role language plays in the development of theories and descriptive methods has been accepted. First at all, we should remember that the roots of economics are found in philosophy and, hence, moral science, as underscored, for instance, by Smith in the eighteenth century and Keynes in the twentieth century. Let us be specific with the question: How did economists of the eighteenth and nineteenth centuries discuss the role of language in economic theory? How, for instance, do Smith, Locke, Hume, and Cantillon reflect on language in its constituent role, or on language (Blaug 1980)? How did they use language in order to

build up economic theory and conduct economic research (Mirowski and Cook 1990)? What kinds of symbols, metaphors, or signs were developed, for instance by Marx, Mill, Ricardo, and Marshall (Hundt 1995)? Some authors have referred to Mill's pioneering work on inductive reasoning as a possible road for generating knowledge (Erreygers and Jacobs 2005; Blaug 1980). How did economists in the late nineteenth and early twentieth century – for instance Keynes, Menger, von Hayek, Wicksell, or von Mises – reflect on the use of language in economic theories and model building (Muchlinski 2011)? How did these economists view the function of language regarding the tools of economic theory and modelling (Bonadei 1994; Maennel 2002; Priddat 2008)?

Without going into detail, it is possible to argue here that discussions on the constitutive role of language for economic theories and, hence, the 'linguistic turn' in economic literature, were only temporary. The predominant concern regarding language in economics is the question of how language can be used to achieve greater efficiency or effect in communicative interactions by emphasizing language as a public good (Breton 1999), as many publications – particularly from the University of Toronto – have explored. The 'language analogy' as proposed by Winkler (2000) also refers to the efficiency of monetary policy by emphasizing common understanding as a procedure. As was already outlined, he dissociated himself from the assumption of 'common knowledge' in order to shed light on the non-linear process of communication by proposing the use of language analogy with monetary policy.

Beyond the examples sketched in the previous paragraph, postmodern discourse has worked on hermeneutic principles in economics and has tried to examine the role of interpretation in understanding economic theories. Benton (1990), for instance, proposed a hermeneutic approach to economic science and raised the question: 'If economics is not science, and if it is not merely mathematics, then what could it be?' These debates have focused on the role of economic metaphors, symbols, and model-building in order to establish a new perspective and to get into distance to the traditional view, for instance, to the Chicago School. Most contributions have emphasized the uneasiness with the dominant modernist viewpoint in economics, which was often discussed as if the modern approach to economics were without any alternatives (Amarillo 1990). Any contention to define a method of research as being without any alternative must be regarded sceptically. Yet, this has been the case in economics because the model view, deductive reasoning and, hence, a strict formal description, have been the key methods since the 1950s. This cognitive 'straitjacket' is not acceptable (Hillard 1995). This

dominating monomethod – which one might even say is akin to a monotheistic approach – seriously damages scientific work.

Some authors added further considerations to McCloskey's approach to rhetoric and on discourse strategies in economic sciences (Backhouse 1993; Bill 1993). McCloskey restored the significance of language in economics by investigating economics as rhetoric. Closkey (1983, 513) pointed out the credo of economics: 'I am scientist: give way.' Economists should, in her view, first of all reflect that they are engaged in rhetorical interactions and also acknowledge the impact of their rhetoric. Her work on discourse strategies in economic sciences started with thoughtful, provocative articles and ended suddenly at the beginning in the nineties. She expressed her position in this way (1983, 82–83):

> By 'rhetoric' is not meant a verbal shell game, as in 'empty rhetoric' or 'mere rhetoric' ... rhetoric is the art of probing what men believe they ought to believe, rather than proving what is true according to abstract methods; ... it is the art of discovering good reasons, finding what really warrants assent because any reasonable person ought to be persuaded; ... it is careful weighing of more-or-less good reasons to arrive at more-or-less probable or plausible conclusions – none too secure but better than would be arrived at by chance or unthinking impulse.[3]

Rhetoric is based on conversation, and it is this which characterizes economic interactions within social interactions in general. With a pioneering paper on rhetoric, McCloskey attacked the positive-economic methodology as proposed by Friedman and initiated further debates. Most branches of economic research adhere to the widely accepted scientific principles of positivism and behaviourism. The net effect of this view of the scientific method, captured in the idea of modernism, is the hypothetic-deductive method of conclusive arguments arising out of already fixed simple premises. This modernism is assumed to be beyond any kind of doubt or uncertainty (McCloskey 1983, 484).

To put it briefly, modernism is the orientation of the Chicago School. Economists avoid the reflection on its premises and opening up their discussion towards an interdisciplinary approach to economic questions. If economists based their models on the hypothesis of rational expectations and the common knowledge assumption, which they generally do, then uncertainty (and uncertainty about the future) is eliminated by these premises. On the one hand, most economists demand positive-economic methodology as suggested by Friedman, and on the other hand they refuse falsification.

The debate on rhetoric, economics, and methodology turned back to modernism as proposed by Friedman's principles based on Popper's claim of falsification (Henderson Dudley-Evans 1993, 132–152; Muchlinski 1996a, 1998a). The key goals of the accepted methodology of economists, since Friedman's article, have applied modernist principles to economic scholarship as follows:

a) the priority of forecasts,
b) the relevance of forecasts for modelling,
c) the implication that observations require the repetition of experiments and their objectivity,
d) adherence to the criterion of falsification of a theory,
e) adherence to methods of quantification and measurability in analogy with mathematical modelling of physics,
f) the creation and maintenance of scientific procedure by applying methodological rules, and
g) the view that a scientific explanation of an event should be subordinate to an extensive law of economics.

Friedman explicitly proposed that economic scholarship should not reflect so-called realistic assumptions but reliable forecasts which should be tested empirically. Therefore, the mainstream view on economics is that forecasts and empirical testing are the key tasks of economics. The demand for empirical testing created the problem that the results could not be interpreted accurately because of the missing link to economic reality. If the premises are not linked to the contemporary world, given Friedman's advice, how could the result of economic modelling be empirically tested?

Postmodernist economists also criticized modernism's maintaining of knowledge without any doubts, without metaphysics, moral sentiments, beliefs, and persuasions (Medema and Samuels 1996; Samuels 1990). Scientific research and results which are completely free from these concerns will, in the extreme, only provide meaningless standards which are manifested in non-personal solutions.

Another predominant work on methodology beyond Friedman's article is Blaug's (1980) *The Methodology of Economics: Or How Economists Explain*. This book also adheres to Popper's view on positivism by defending abstract and universal principles. McCloskey (1983, 491) objected:

> Words like these flow easily from a modernist's pen. But why would preaching unrelated to actual practice be worth considering at all?

> Why do economists have to defend in the abstract their principles of reasoning, and before what tribunal?

Blaug's demand to differentiate between 'wheat and chaff' in order to implement positivist standards in economic science is no longer convincing. Scientific progress is not achievable by neglecting alternatives or by adherence to rigidly fixed rules or universal principles which lack contexts or circumstances. Devotion to rigid rules of scientific process, modelled in analogy to mechanical procedures, is not a sufficient point of reference in economics as a social science. Economists who are devoted to modernism often start their argumentation with words like 'objective'. McCloskey asked: 'Should it all be "objective", "experimental", "positive", "observable"? Can it be (ibid)?' Of course it is not possible, otherwise the theoretical improvements made by different people and epistemic communities would have been much poorer than they are. As the history of science shows, inventiveness is not based on these principles.

The conclusion by McCloskey is that rhetoric is too narrow. By focusing only on model building, economic science itself has moved towards metaphysics. McCloskey summed up that these – and other – words and metaphors in economics are not merely ornamental but paradigmatic. For instance, the notion of 'elasticity' was first of at all a 'mind-stretching fancy', and the term 'equilibrium' was compared with an apple in a water basin. Many terms are brushed-up, like 'competition' or 'children as durable goods' (human capital), and so forth. They are used as metaphors. A metaphor creates a coincidence of thoughts and a transaction of contexts. For instance, the metaphor 'human capital' brings together two distinct realms by supposing the interdependency of 'human' and 'capital'. Also, the metaphor 'car' and 'central bank' links two separate domains, driving and monetary policy, into a cognitive and emotional relationship by use of language.

But economists do not expressly reflect on this, either. Metaphors, such as the 'invisible hand', evoke certain persuasions or convictions. Most economists, though, avoid elucidating the implications and consequences of such metaphors. Some economists find the metaphor 'invisible hand' impressive and convincing, and imply that nothing has to be explained beyond this and no further discussion seems necessary. The alternative to such modernist tendencies of the sciences is not silence. The alternative to silence is the continuity of reflecting the use of metaphorical language regarding its implication and consequences. McCloskey proposed considering the rhetoric of economics as a reflexive method. Economists do have a great knowledge about the world they have hidden behind an

artificiality of created words or concepts. The use of a reflexive rhetoric would be more effective in order to explain economic problems.

4.2 The constitutive role of language in economic models and description

Models of central bank reality and contexts are driven by the use of language. Economic problem solving cannot be separated from the use of language. Given the fact that a central bank can control only the short-term interest rate, which has long-term effects, and within different interactions in various financial markets, a central bank needs to reflect on its own contribution to the creation of the context which surrounds the decision-making process of both the financial markets and the central bank. The circumstance within which a central bank acts is neither given nor invariant. The meaning of words, sentences, and the understanding are not given. Language as an action of communication configures the context or situation in which any central bank acts. The constitutive role of language has to be recognized for economic models and economic description. One example is the debate on central bank accountability and reputation, which is also driven by changing views of how central banks should implement their mandate.

Brayton et al. (1997a, 1997b) constructed a pioneering econometric model of the Fed. The authors gave an instructive example of the long-lasting process of learning how to link the methods of economic modelling concerning the Federal Reserve Bank and its monetary policy in relation to the building of expectations. They propounded that the aims linking the development of these models to historical contexts and perceptual context in which they have been evolved should be articulated in order to understand its functioning.

They differentiated two generations of macro-models in the Federal Reserve based on the view that adaptive learning and asymmetry of information is relevant. They have created the first generation model based on the IS/LM/Phillips-Curve and the Federal Reserve policy model today (1997, 49).[4] The enlargement of the first generation model (FRB/US) by an international framework, that is, the FRB/Global – also implies the abandonment of restrictions of the IS/LM/Phillips-model. The FRB/Global framework integrated international finance and trade. Brayton (1997a, 47f.) et al. discussed the great efforts made to overcome the bilateral view and its formulation: the substitution of bilateral equation with multilateral equation for describing the economic interdependences of the U.S. economy with the rest of the world.

Brayton et al. outlined the real challenge for the continued process of the improvements of the existing model, namely the specification of functions which could be described by an open economy model of exchange rate determination. The radical revision on this part of the model development was implemented through the 1980s and the early 1990s. Whereas this example demonstrates that the process of the improvements of model building will never stop, other models in economics are seen as invariant. The new macro-models from the middle of the 1990s on have been incrementing both the adaptive expectation hypothesis (vector auto-regression: VAR) and the rational expectation hypothesis (RE). The VAR model describes how agents react against the historical background (backward-looking or adaptive expectation) of inflation, interest rates, output, and the long-run expectations of inflation and interest rates. This model acknowledges the limited information available to the agents. In contrast to this, the rational expectations hypothesis describes the model-consistent, or so-called rational expectations which are supposed to be identical with the model itself.

Using both hypotheses in the FRB/US and FRB/Global the results are significantly different and provide the flexibility of responses which are needed to work within a situational approach. In the paper, Brayton et al. (1997) compared at great length both premises encapsulated in both models regarding the inflation rate, output gap, the Federal Reserve funds rate, and the ten-year government bond rate. But this degree of flexibility should not be confused with 'constantly changing policy advice and interpretation', which is not possible. Brayton concluded all these innovations were linked to theoretical and empirical developments in central bank practice and, therefore, guided the way to the continuity of model improvement. In another paper, Brayton et al. (1997b, 227) pointed out:

> The approach to expectations taken in the FRB/US model is best understood in the context of a debate that has engaged macroeconomists for the past twenty-five years. ... However, they disagree about the basis on which individuals form expectations and thus about the way to model them.

One striking pattern of the model discussion was how to model individual expectations and how to link it to economic modelling and economic circumstances:

> The lack of adequate data has meant that builders of macroeconomic models have had to specify a priori how individuals form expectations.

> Most models developed in the 1960s and 1970s, including MPS, incorporated the simplifying assumption that people form expectations *adaptively*. Under this assumption, for example, the expectation for inflation in the next year is based on the recent inflation trend. Similarly, expected interest rates depend on past interest rates. (ibid)

The innovation of the phenomenon of 'overshooting' investigated by Dornbusch (1976) as well as radical changes of view on how economics should be explained, given by the *New Classical Macroeconomics*, as they also configure the process of macro models by the Federal Reserve. At this point, the 'Lucas-Critique' had become temporarily important (Blinder 1987; Muchlinski 1999a). To sum up:

> The rational expectation hypothesis implies: 'Rational or model-consistent expectations are identical to forecasts produced by the macroeconomic model in which the expectations are used. This assumption has been used in many macroeconomic models developed in the past fifteen years and is one option for the formation of expectations used in FRB/US'.[5]

Reference to the approaches and assumptions above has been brief for the sake of simplification; that is, the assumption presented here of adaptive or rational expectations is not the ultimate state of research in economic modelling. This approach to modelling does not provide the knowledge or understanding economists need to understand mutual and complex interactions among the central bank and the private agents of financial markets. Consequently, Brayton et al. (1997b, 229) stated:

> Thus, individuals form their expectations of the future using rules of thumb or easily computed formulas, such as adaptive expectations. At the other extreme is the view underlying the rational expectations approach. In this case, collective and analyzing information is assumed to have small costs and large benefits, and consequently individuals base expectations on sophisticated forecasting models that make use of all relevant data. Between these extremes is the view that forecasting has both significant advantages and significant costs. Such a circumstance should lead households and firms to choose forecasting models that closely resemble their economic environment but fall short of a complete model of the economy in every detail. In FRB/US, one of the options for expectations formation, referred to as VAR expectations, is motivated by this view.

As the assumption of VAR expectation shows: models which work on this assumption do not follow the assumption of perfect information but of forming expectations on the basis of selected information. These methods draw attention to central banks in historical time and space. Central banks do not interact in universal time and space, but in situational contexts and circumstances. As Brayton et al. (1997a, 230) wrote:

> [T]he VAR approach in the FRB/US model assumes that households and firms form expectations primarily on the basis of their knowledge of the historical interactions among three variables: the Federal Reserve funds rate, the cyclical state of the economy, and the rate of inflation.

Modelling assumptions which refer to historical and situational contexts imply the abandonment of the rigidly fixed premises of most models. Working with VAR expectation, for instance, allows simulating how quickly or slowly a change in monetary policy – say the tightening of the money supply in order to reduce inflation and inflationary expectations – will be perceived by the agents of the market. An immediate perception of a change in the monetary policy would be associated with an immediate perception of inflation expectations by those operating in the financial markets. Model consistency concerning the expectation-building process – for example, the anticipation of a future change in monetary policy – can be constructed alongside the incorporation of information the firms and consumers acknowledge in making a forecast. To model the VAR expectation includes 'advance recognition' by specifying the expectations regarding both long-term inflation and interest rate which 'respond before the event' (ibid).

As Brayton et al. described, the emergence of the economic sense regarding central bank strategy, decisions, and actions is based on history and the use of language. However, to read and understand a model on central banks one needs to be trained in mathematics. Yet, one also has to acknowledge that economic questions, phenomena and problems are due to everyday perceptions and everyday language. At this point it should be mentioned that economic problems are not rooted in the vagueness and the non-exactness of everyday language. The problems as described by modern central bank literature are expressed in everyday language since they arise out of mundane contexts.

What can be drawn from the example put forward by Brayton et al.? If central bank literature refers only to deductive reasoning, that is,

to the model views, it misses the point and it can not explain how central banking works. Central banking does not function as deductive reasoning but rather as a reflexive procedure of different methods and instruments, hence new literature on this issue enlightens the effect of communicative interactions. If central banking or economics concentrate only on deductive reasoning, this 'formal aestheticism' (Morishima 1991) will exclude important topics of research and will lead to an impoverishment of scientific skills. I would like to emphasize that economics as a social science needs to enlarge on traditional economic methods and develop additional methods and instruments beyond such monopolistic methods.

One can take the example of the gold standard, as discussed in textbooks, by its supposed 'rules of the game'. The central banks were accustomed to acting as if the conditions of such a gold standard applied (Tullio and Wolters 2003). According to historical investigation, the gold standard came into existence as an international agreement on the international rules of the financial system (Flanders 1990; Spahn 2001). This meant, though, only insofar as a few central banks, particularly the Bank of England and the Federal Reserve Bank, had started to coordinate their policy of interest rate settings. It was on this basis that such rules of the game could be developed and implemented (Mundell 2000). No rules in social sciences become accepted as hidden rules. The rules of the gold standard may be seen as an aid to for organizing and commencing a particular game, but the fact was that the rule came into reality as the real practice of central banks, that is, inasmuch as the central banks used it to start to coordinate their policies. The context of central banks in modern society, and its link to the constitutive role of language, can be explained by referring to the discussion of different monetary policy regimes (Issing 2005b; Fracasso et al. 2003; Friedman, B. 2004; Kuttner and Posen 1999).

4.3 Meaning, intention, and utterance

In order to outline the complexity of communicative interactions, I have introduced a conceptual framework focusing on distinct dimensions. I referred to Giddens on the interdependence of structures and actions; to Bourdieu on habitus and its social impregnation; to Habermas on understanding by discourse and by agreement; to Searle and aspects of the 'speech act theory', and to Davidson on understanding by communicative interacting and by interpretation. I focus here on the theoretical foundation provided by Grice. Grice's theory can be outlined

in three steps: (4.3.1) the speaker's intention and meaning, (4.3.2) the principles of cooperation or postulates of conversations, and (4.3.3) the theory of 'implicature'. Grice contributed to language philosophy through his theory of conversation comprised of these three steps.

In current economic literature, references to Grice's work are prominent in language philosophy literature and also in game theory. For instance, Ariel Rubinstein (2000) built his theory, 'Economics and Language', upon Grice's view. As Rubinstein's work has already been discussed in economic literature, Grice stated that his approach to communicative actions entails the common acceptance of methods of communication, that is, the principle of communicative cooperation and associated maxims, which he supplemented by a new term, 'implicature'. Grice's famous proposal concerning the realm of the theory of communicative interaction is his theory of implicature (Grice 1989). The concept of implicature is based on Grice's differentiation between the speaker's utterance and the speaker's meaning. The speaker's meaning is to be seen as the speaker's intention. As we will see later on, Grice's theory of communicative interactions remains focused on the speaker's intention (Grice 1957/1989). According to Grice's view there is no difference between meaning or intending something with an utterance (Grice 1969).

4.3.1 The speaker's intention

Grice interpreted meaning in the manner of the questions, 'What do you think or what do you believe?' or, 'What do you mean by this?', that is, 'What is your opinion?' Grice provided a theory of meaning in which the term 'meaning' is based on a speaker's intentions and on what she or he thinks. The interpretation of 'meaning' by Grice differs from its meaning in modern language science, in which the practice and use of the word or sentence has been emphasized. Moreover, it differs from linguistic science in regard to the extension of the meaning in the semantic field (Trabant 1986). The term 'meaning' in ordinary language often refers to imagination, ideas, or persuasions. However, it also refers to ancient philosophy and the view that meaning is embedded in the mental state, soul, or consciousness of a person. The word 'idea' goes back to Aristotle. In light of this philosophy, the term 'utterance or expression' was interpreted as the expression of a mental state or of the soul (Brentano 1956, 24). Therefore, the utterance or expression ('hermeneia') was understood as the expression of the soul. According to this Latin tradition, which can be categorized as *de interpretatione*, the function of language was seen as a vehicle of the mental state, thoughts,

or the soul and, hence, as neutral towards mental states, thoughts, and the soul (Trabant 1999). Therefore it was argued that intention as interpreted by a mental state or soul needs a medium of transmission to be articulated and in order to be communicated. The Aristotelian philosophy is seen as 'Aristotle hermeneia'. As I have already mentioned and will explain in Chapter 5 in detail, Analytical Philosophy states that language has a constitutive role – and, hence, is *not* neutral to thoughts.

Grice objected to the view that a 'standard of meaning' contributes to the meaning. The view of a standard of meaning harks back to causal theory, such as 'John is tall' is part of the meaning 'John is an athlete' (Grice 1989, 216). Causal theory maintains there is a standard meaning of signs independent of their use. Any causal theory, therefore, ignores 'the fact that the meaning (in general) of a sign needs to be explained in terms of what users of a sign do (or should) mean by it on particular occasions' (Grice 1957, 217). Grice refused the view of a 'standard meaning' of signs because the meaning of an utterance is not identical with the meaning of the signs being used. He objected to the view that language is based on the use of precisely defined signs. 'What (does) a particular speaker or writer mean by a sign on a particular occasion (which may well diverge from the standard meaning of the sign)' (Grice 1989, 216).

Grice linked the speaker's utterance with his meaning and intention. 'I use utterance as a neutral word to apply to any candidate for meaning$_{NN}$; it has a convenient act-object-ambiguity' (1989, 216). The speaker's utterance is the way the meaning has developed out of his intention. Only in certain respects is it possible to argue that Grice advocated speech act theory. The speech act theory (Austin and Searle) emphasized that talks, speeches, and sentences imply the upcoming actions by the listener as a so-called 'performative' form. Speech act means a way of acting. For instance, if person A says 'close the door', the listener, person B, will act to close the door (or maybe will not act). Or if person A says 'I promise to return the book I lent to you', person B (listener) anticipates the action. In respect of speech acts, it is not possible to apply criteria of truth or falsehood to them. Traditional language philosophy stated that a sentence is truth only if, and insofar as, it corresponds to reality.[6]

In Grice's view the speaker's utterance also indicates the speaker's intention, which has to be received by the hearer or the audience. Regarding the relation of speaker and hearer, Grice stated that such relations are highly dependent. However, the role of the speaker is to transmit his intention to the hearer in order to be perceived in the

intended manner. We should read the quotation as a whole, given by Grice (1989, 219):

> A must intend to induce by x a belief in an audience, and he must also intend his utterance to be recognized as so intended. But these intentions are not independent; the recognition is intended by A to play its part in inducing the belief, and if it does not do so something will have gone wrong with the fulfillment of A's intention. More over, A's intending that the recognition should play this part implies, I think, that he assumes that there is some chance that it will in fact play this part, that he does not regard it as a foregone conclusion that the belief will be induced in the audience whether or not the intention behind the utterance is recognized.

Grice (1989, 220), hence, defined the meaning, that is, the speaker's meaning, as an expression of his or her intention:

> 'A meant something by x' is (roughly) equivalent to 'A intended the utterance of x to produce some effect in an audience by means of the recognition of this intention'.

In ancient philosophy the recognition of the utterance of the speaker by the hearer is regarded as the transference of intention by neutral language. According to this view, language matters as a neutral transmission. It is a vehicle or veil of thoughts. In other words, the intention or the mental state has been sent from the speaker to the hearer through language. However, particular problems in Grice's thinking still remained. If, for instance, the effect the hearer had realized was caused by the speaker's utterance, what gives reasons to conclude from this that the hearer also received knowledge about the speaker's intention? Grice conceptualized this as follows: whereas the speaker acts, the hearer reacts simultaneously. This line of thinking brings us to another crucial element in Grice's view. Any speaker's utterance causes an 'act-object-ambiguity' according to its purpose (see above). This implies ambiguity regarding either the sound or the content of an utterance. One asks what should be recognized more, the sound *or* the content? Beyond that, one might ask why should such a distinction be made? The 'act-object-ambiguity' draws attention to the result of an action and to the utterance as an action itself (the expressed sentence).

Given this line of argumentation, Grice followed in the footsteps of Aristotle, who distinguished the realm of actions into three aspects: (a)

acting as an action, (b) acting as a potential of an action and (c) acting as a result of an action. Grice, then, moved a small step forward trying to refine the constituent role of language.

Grice remained defending these three distinct realms while neglecting the research by Humboldt, Wittgenstein, and modern language scientists. Both Humboldt and Wittgenstein argued that language and reality are inherently connected because of the constituent function language has. There exists no external rule which can be applied or can assign language to different realms of reality. Since Humboldt's research on language, scholars have objected to the view that language can 'apply to' reality.[7] The modern view of language and, hence, the so-called 'linguistic turn', emphasized that different uses of language constitute views or perceptions on reality differently.

As outlined, Grice's concepts of meaning were rooted in the speaker's intention. Nevertheless Grice left it open to debate if the intention as a reference should be interpreted in the sense of idea, imagination, or opinion. The common goal of the communicative action implies that the speaker has to mention reasons so as to assume that the hearer is able to appreciate what is said as a consequence of what the speaker had said. The speaker must have grounds to suppose that the hearer understands according to the action itself because the action is identified with the utterance. According to the above quotations, the goal of a communicative action is described by the effect of the action. Grice had replaced the term 'beliefs', which he had used before, with the term 'effect'. The term 'effect' allows more space and a broader framework in his approach to communicative interactions as being observable by effects. In saying that the goal of communicative action is its effects, one is inclined to associate this with something perceivable. To use the term 'effects' allows us to avoid association with inner, or mental, processes of the speaker. Furthermore, Grice assumed that the term 'effect' would permit the integration of the reactions of the listener into his model of communication.

If one asks about the reasons for a communicative action then we assume that the action is based upon specific grounds and upon rationality. If the question about the intention of an action is analogous to the question about grounds, then grounds have to be recognized as such. If we interpret Grice in the way proposed, for example, by Wright (1975), that the "utterer's" intention is neither identical with his plan nor with his imagination, idea, or persuasion, then intentions can be interpreted as a part of a communicative action. Nevertheless, this kind of interpretation would touch only slightly on the constituent function of language as introduced by modern language philosophy.

What might support Wright's interpretation is that Grice replaced his early term belief with the term effects in order to point to the results of a communicative action. Grice also combined this substitution with the presupposition that the effect of an utterer's intention, that is, the action, can be controlled by the hearer. But, as we will see later on, this supposed control is an illusion. Grice tried to incorporate the active role of the listener within the communication dynamic so as to limit the key role of the speaker's intention. Grice (1969, 92) tried to explain his efforts to integrate the listener into his model of communicative interaction with the following definition:

> '*U* meant something by uttering *x*' is true if, for some audience A, *U* uttered *x* intending: (1) A to produce a particular response r, (2) A to think (recognize) that *U* intends (1); (3) A to fulfill (1) on the basis of his fulfillment of (2).

What at first glance seems to be circular reasoning could be interpreted as deductive reasoning based on the underlying presupposition that the speaker wants to cause certain effects on the hearer. Communicative action will take place only if the hearer understands what *should be understood* according to the speaker's intention. Grice explained that his definition shows that the audience (A) understands the intention of the utterance (U) not as caused effect but rather by reasoning (ibid).

Grice demanded two kinds of intention: (a) the speaker's intention to evoke a certain effect by the hearer, and (b) the intention that the hearer is recognized (a). Moreover, Grice asserted a particular relation between both (a) and (b). The recognition of (a) through the hearer should lead to the intended effects, understanding by the hearer. Grice, then, claimed that he had integrated the recognition by the hearer.

If we relate the above consideration to a central bank – (a) its mandate of steering the inflations expectations of (b) the listener, the agents in the financial markets, by setting the nominal short-term rate in order to fit the goal of long lasting price stability, we might grasp the example immediately.

For instance, Goodfriend (2005), among other authors in modern central bank literature, relates the communication of a central bank to the mode of a transferred intention from the central bank to the audience, that is, the agents in the financial markets. Goodfriend emphasized that a central bank needs to anchor the inflation expectations of the financial markets in order to derive the benefit of enlarging the flexibility of interest rate policy. 'Recent theory and practice ... teaches

that a central bank enhances the performance of the market by creating an environment of dependable low inflation' (2005, 253). Even if it is undisputedly a central bank's genuine task to steer market expectations, this does not imply that steered market expectations are to be interpreted as a transformation of the intention of the central bank to the audience. However, serious doubts arise as to whether the aim of a central bank to steer market expectations can be explained by reference to Grice's model of conversation and communication. I consider these doubts in Chapter 5.

Before I turn to the second issue of Grice's view as mentioned in the beginning of this chapter, I would like to summarize the critiques made of his first issue. My criticism of Grice is as follows: this strong presupposition of Grice that the hearer knows the speaker's intention implies that the reaction of the hearer is symmetrical to the speaker's intention. Both speaker and hearer have reasons to communicate, that is, a common goal. According to the presumed symmetry, both agents create the understanding actively. Grice stated that this symmetry enlightens his theory of dialogue. The hearer recognized the intention of the speaker towards the creation of a certain effect.

Doubts arise as to the premise of whether it is possible that the speaker is able to intend what has been assumed in this model of communication. Grice's answer to this is that intentions are more like the aims of a reconstruction and are to be seen as the minimum condition of every communicative action. Communicative actions without intentions do not make any sense. The same is true for actions without rationality and grounds. I think the notion that communication without intention is meaningless misses the point because doubts are reasonable as to whether the listener's reconstruction of the intention of the speaker is identical with the intention itself, or is rather an interpretation of the presumed intention of the speaker. Grice stated that the reconstruction is based on inductive reasoning.

However, this inductive conclusion to meaning lacks clarity as to how language functions. The meaning of a sentence does not label an object or a thing; rather the meaning refers to the interactive communication in the context. The general meaning neither evolves by inductive reasoning, nor by the process of the indefinite analysis of the meaning into its simple components.[8] Every person operates with words and sentences uniquely in each different situation with respect to the given general meaning or acceptability. This is why Humboldt explained that the variety of world views and of understanding is constructed and combined through the variety of the use of language. Grice undertook

several attempts to move beyond the traditional theories of meaning which are focused on the property of a word or its truth. He stated that it is most important to address the speaker's utterance, that is, action, in order to grasp the meaning.

We have to ask how the hearer in Grice's world could know whether he understood the speaker's utterance? While Grice stated that the hearer identifies the speaker's intention, he left it open as to how this knowledge should be possible. Grice maintained that the action mirrors the speaker's intention – given the capability of the hearer to interpret. Following Grice's line of argumentation the term 'meaning' is a manifestation of the speaker's intention, which the hearer already knows. He supposed a symmetry of both the speaker and the hearer. No distinction is made between a speaker's and a hearer's intention. Nevertheless, the hearer should be the one who controls the effects of the communicative interactions given the speaker's intention. Insofar as the dominant role of the speaker's intention still remains in Grice's approach, his attempt to integrate the hearer into communicative action theory also fails. Grice stepped away from the traditional conduit metaphor. He also criticized the stimulus-response mechanism modelled as a linear sender-receiver relation. In his first step, Grice presupposed the given meaning of the speaker's intention as perceived through action by the hearer. In his second step, however, he neglected that the meaning is something which is developed within the communicative interaction itself.[9]

4.3.2 The principle of cooperation or postulates of conversations

I turn now to the second element of Grice's approach. He proposed a principle of cooperation and associated maxims and the term 'implicature' to improve his theory of communicative action. While economists refer to Grice's principle as a renowned theoretical approach to communication, they do not discuss the important implications and conclusions of his approach for economic discourse, and this will also be considered in the discussion. Grice attempted to precise communication as a regulated procedure. He argued that communication procedures are based on rational and economic principles. The use of language is as being linked to its economic usage and based upon the consideration of trying to say as much as possible by the use of little and plain words.[10]

The principle of cooperation implies: 'Make your conversational contribution such as is required, at the stage at which it occurs, by the accepted purpose or direction of the talk exchange in which you are engaged' (Grice 1989, 26). The principle of cooperation is conceptualized as a rational mode

of communication and is focused on the understanding. The inherent consideration of the first part of this principle has widely been accepted in the literature although the second part, that is, 'the accepted purpose or direction', is still controversial because it is not clear what 'the accepted purpose or direction of the talk exchange' means. I find it neither conclusive to argue that communication is a 'talk exchange' nor that the direction of the communication has to be given in advance. This reminds me of the 'conduit metaphor' suggesting communication is a linear directed path from the sender to the hearer. The maxim of rational communication should initiate communication by aiming rationally at a mutual goal, that is, aiming at the effect of a communication. Understanding should thus be seen as the result of an assumed rational mode of communication.

The cooperation principle, or principle of conversations, was specified by Grice (1989, 28) by way of associated maxims – four postulates of conversations – which he defined as analogous to those of Immanuel Kant: quantity (*be informative!*), quality (*do not fool the audience, provide truth!*), relation (*be relevant!*), and manner (*provide clarity!*).

What is meant by this? The maxim *quantity* deals with the maxim of information, *quality* of information with the supermaxim, *relation* with both agents, sender and receiver, in the communicative interaction and the aspect of *manner* as providing as much clarity and communicative performance as possible to the situation. Grice thus defined the principles of conversations by definitions (1989, 26–27):

(I) Quantity:
   1. Make your contribution as informative as is required (for the current purpose of the exchange).
   2. Do not make your contribution more informative than is required.

(II) Quality: Try to make your contribution one that is true.
   1. Do not say what you believe to be false.
   2. Do not say that for which you lack adequate evidence.

(III) Relation: Be relevant.

(IV) Manner: Be perspicuous.
   1. Avoid obscurity of expression.
   2. Avoid ambiguity.
   3. Be brief (avoid unnecessary prolixity)
   4. Be orderly.

The maxims and subordinated maxims listed in the quotation above are related to each other. For instance, the maxim of quality and its

subordinated maxims are not to be taken in isolation; rather, they play a role within these principles of conversations as a whole. The maxim 'be relevant' makes sense together with the maxim of both quantity and manner. To utter something which is relevant will establish a line towards the goal of communicative interaction.

The above principles are often cited in theories of communication and language philosophy (Kober 2002). They are accepted as guidelines for communication by which the authors begin their own considerations so as to move further towards particular theoretical approaches (Stekeler-Weithofer 1999; Scholz 2001).

Grice introduced this principle of cooperation or the postulates of conversations as a normative rule. What does it imply? We normally do not want to irritate or to fool other participants in dialogues. The principle of cooperation, therefore, frames most communications with a view to rationality. As a normative rule it should frame communicative interaction generally because people aim at certain effects of communication. People aim to follow these principles in order to achieve their aims.

As the quotation above reveals, the principle of cooperation is oriented to the speaker. The speaker utters a sentence within a certain situation, which also indicates that this sentence should be interpreted as a rational contribution aiming at a mutual accepted purpose of the communication. If understanding is seen as a presumed connection to rational communication, then the effect of understanding is guaranteed. The hearer, then, interprets the utterance of the speaker as a contribution aimed at that mutual purpose. The hearer should rationally avoid interpreting the speaker's utterance as an objection to this mutual goal which he or she shares with the speaker.

However, in my view, this should also point towards the context. The maxim 'avoid ambiguity' and 'avoid obscurity of expression' is addressed towards the idea of rationality of communicative action as outlined previously. It can be read as an appeal to the actors in their aiming at the common goal. But this maxim also can be seen as a demand for applying traditional scientific principles addressing an exact, measurable, and non-ambiguous process which has to present exact, non-ambiguous, and measurable results in order to fulfil the common sense view of science, as rooted in the principles of Descartes and Leibniz. Grice, however, neglected the possibility and necessity of error, of deception, and of the bounded possibility of exactness, of the non-ambiguousness of science and knowledge.

Of course we shall ask why the speaker should act in such a manner as proposed by the cooperative principles and associated conversational maxims put forward by Grice? His answer was,

> It is just a well-recognized empirical fact that people do behave in these ways; they learned to do so in childhood and have not lost the habit of doing so; and, indeed, it would involve a good deal of effort to make a radical departure from the habit. (Grice 1989, 29)

Here again, he presupposed the rational action as the basic pattern of any action. Acting reasonably is to be seen as a common goal because it makes no sense to refuse it. Therefore, Grice proposed supporting a kind of conversation that implies principles for both the sender and the receiver. Moreover, he assumed what has to be accepted by the speaker is also a 'must' for the hearer. There is no escaping this principle of cooperation and the associated maxims. Grice denied delivering a normative claim to communication (1989, 29). He appealed to a certain kind of relationship between the agents, which he compared with a car accident and the expectation that another person who perceives that accident is willing to help, to coordinate with the person who is a victim of the accident. Therefore, both are motivated to communicate or coordinate and, hence, this is characteristic for every communication. Grice concluded that any communication aims to 'distinguish cooperative transactions' (1989, 29). However, in comparison with Habermas's approach to understanding, Grice draws attention to communicative interaction as a certain type of rule-following communicative behaviour and not as the mode of developing a way of communication in order to reach a common goal.

As the quotation above indicates, Grice based his view on two key arguments: (a) on the inductive-probabilistic argument, and (b) on a particular consideration regarding human behaviour. The roots of the principle of coordination are to be found (a) in the methods of the empirical science and (b) in evolutionary pattern. Along this line of argument we also find these principles as parts of the scientific process combined with a particular view of human nature. To focus on this explanation one has to ask what role is left to circumstances, contexts and culture? Unfortunately Grice gave no answer.

Understanding requires us to recognize the context and to apply hermeneutic principles to the communicative interactions, such as the assumptions of coherence and rationality or truth. The assumption of rationality is – as explained above – a prerequisite of any communicative

action which aims towards an understanding. The assumption of truth refers to credibility of the communicative actions by the agents involved. Reference to a conventional meaning or towards external rules of language is not possible. The conventional meaning of a sentence only provides the fragment of a proposition. Let us take the example of understanding utterance at a press conference held by a central bank official. The maxim relevant for consideration is:

(II) Quality: Try to make your contribution one that is true.
    1. Do not say what you believe to be false.

A central bank press conference mostly entails two main parts: the speaking activity of a chairman or speaker of the central bank and a written document. Beyond this written document the usual case is that the chairman or speaker proceeds to answer the questions put by the interviewers. According to the reasons explained, in light of the modern view of central bank theory monetary policy works *through* markets.

Let us expound on the textual horizon of this maxim, (II) Quality. If, for instance, the sentence runs: 'No further interest rate change is to be expected', in its literal and lexical manner the sentence implies that there will be no increase. The reporter judges the implication of this sentence: Does this sentence imply that there will be no further increase of the interest rate this year although, considering economic indicators, it would be necessary? What does the literal meaning and the implication of the utterance initiate? The interviewers at the press conference, or the public reading the reports, might have doubts about the truth of this sentence because high domestic growth and prices present another scenario of the current performance of the economy.

The reporter believes that the information by the central bank is not true because it does not fit with the economic indicators. The statement of the central bank would appear to violate the principle of cooperation. The public might argue: Does the central bank base its judgment upon the actual empirical economic performance in a way different from the public? If so, on what grounds? Does the central bank have different data about the economy than the public does? The public, then, attempts to find out from this press conference the differences between the data or the foundation of judgments upon which the central bank bases its decisions and expectations compared with the data the public has. If the assumption of a different data base is not supported by

evidence, the reporters will not be convinced. Understanding will fail because the statement of the chairman violates the *maxim of quality: 'Do not say what you believe to be false'*. If the central bank has similar data, the statement by the chairman or spokesperson at the press conference does not make any sense.

Let us turn back to the sentence used as an example above, 'No further interest change will be expected'. According to a perceived economic situation – as we assumed in the example on the foregoing pages – this sentence is not convincing. This sentence will be judged as wrong or as the central bank's attempt to lie and violate the principles of cooperation. Literally, the chairman has said that the interest rate will not be changed, but this apparently makes no sense at all.

4.3.3 The theory of 'implicature'

According to the literature, Grice contributed to a theory of dialogue by emphasizing his newly created term *implicature*. This is a technical term which is related to both the speaker and the hearer. The concept of implicature outlined the idea that any utterance also neglects information and knowledge which have to be provided or supplied by the hearer (Grice 1989, 24). I would like to add that the implication or implicature also needs to be anchored in the respective context or circumstances. Grice stated that we understand a sentence beyond its literal meaning; we understand it by its implication, which he defined by the technical term implicature. By this additional term, implicature, he further advanced the 'indirect speech act theory' of Searle (1995) towards hermeneutic principle. For instance, if person A says to person B 'Could you pass me the bread and butter, please', it is expected that person B handle bread and butter. Person A does not expect the answer 'no' or 'yes'. If person B answered 'no' or 'yes' then we could judge that B has misunderstood the speech act or is not willing to cooperate with A. Person A's speech act is a request and not a question. Searle (1995) called this an 'indirect speech acts'.

The 'indirect speech act' entails an implicit sense regarding the situation in which the sentence is said. Therefore the 'indirect speech act' implies a pragmatic or implicit sense beyond the literal meaning of the sentence. The indirect speech act lets us understand both the content and the modus of the sentence. The indirect speech act complements the principles of interpretation which need to be bounded by contextual factors. As was already outlined in Chapter 2, the context itself has no boundary.

Let us be more precise: the implicature is the additional content ascribed to the speaker's utterance in order to secure the common goal of the communicative interaction and understanding. To judge

confidently the central bank's spoken language, the participants at the press conference assess the statements against their own economic knowledge, information, and the current economic background.

In this example, then, the statement of the central bank obviously violates *maxim (II) 'Quality: Try to make your contribution one that is true'.* If data pointing to a high growth rate, and rising prices and wages in the domestic economy exist, the sentence will not be acceptable as true. As we know, the *maxim of quality demands: 'Do not say what you believe to be false.'* However, the spokesperson's statement, 'No further interest rate change is to be expected', is misleading if the participants at the press conference believe the sentence is not true for reasons explained in the foregoing paragraph.

This example sheds light on the understanding of the sentence, which depends not on the lexical meaning of the words of which the sentence is composed but rather on the perceivable economic context which surrounds the press conference and the communicative interactions of the involved participants. Most of the words used in a spoken language – speeches, discussion, interviews – and also in written language – statements, comments, reports – are vague and ambiguous in a lexical sense: that is, their meaning is not fixed lexically. To understand, then, requires shedding light on the context or practice within which, or through which, the word or sentence has been used (Bach 1994). Without doubt, for economics as a social science it is of great interest to deal with these questions on how meaning evolves and how sentences are understood in different circumstances.

At this point, monetary policy or central banking leads directly to such questions of understanding. These questions of understanding and meaning inevitably enlarge the traditional view of economic science. Regardless of famous examples in the history of economic science, the understanding and the evolution of meaning in economics as a social science have not been a topic of economic theory until now. Since modern central bank theory and policy have moved towards an interactive approach of both the central bank and the agents of the financial markets, the understanding and the evolution of meaning in economics have assumed great importance. How can a central bank or the chairman of the central bank know if and how the public has understood the released information?

I now want to discuss another maxim regarding the principles of cooperation:

2. Avoid ambiguity.

Let us apply this maxim (IV) to another example: if the chairman of the central bank says in a press conference, 'The interest rate will rise up to 3.5 percent', the public will understand this sentence in its literal meaning as well as take the history and the current economic performance into account. The public recognizes that the interest rate was before at the level of 3.25 percent and it also knows that during the last 12 or 24 months the interest rate has risen step by step. In a literal meaning, the statement of the chairman implies an increase up to 3.5 percent. It does not imply further decisions at all. Regarding the modern view of central banks, the public assumes the chairman has stated the truth. Moreover, the public supposes that the information release was done for the sake of clarity and information and not to fool the public. The public understands the utterance within a context which goes beyond the released information. The public supposes that the chairman, like the public itself, knows that the future level can differ from the actual level of 3.5 percent. This presumption is inevitably connected with the enlargement of the expressed sentence by a greater content, that is, by implicature.

To put it more precisely, because Grice did not discuss it with clarity, the implication does not refer to the mental state or intention of the chairman but to the context in which the sentence had been used. As we have already outlined, Grice assumed the maxims on quantity, quality, relation, and manner, and its subordinated maxims guide the understanding, for example, *maxim (I) 'Quantity: Do not make your contribution more informative than is required'*. Grice took this to open to debate how the general cooperative principle could guide a person's action and expression in a concrete situation.

The term implicature rests itself on the cooperation principle. In making a distinction between the speaker's intention, the meaning and its implication on the one hand and the utterance to be perceived and interpret by a hearer on the other hand, Grice distinguished between what can be understood by conventional meaning and what cannot. He, then, assumed the speaker's utterances can be differentiated by (a) what the speaker says and what has been understood by the hearer, and (b) what is meant with the utterance, that is, what has been implicated. Grice differentiated the 'implicature' of an utterance into (b.1.) 'conventional implicature' and (b.2.) 'non-conventional' or 'conversational implicature' (1989, 24).

The conventional implicature (b.1.) entails the literal meaning of the utterance or the sentence. Its understanding is based on conventions, that is, given understandings or practices. The conversational

implicature (b.2.) encompasses the literal meaning of the sentence and those parts which are not literally uttered in the sentence but which are parts of the communicative interactions. For instance, if the speaker's utterance contradicts the principles of cooperation and associated maxims, the hearer, then, has to judge this contradiction through an interpretative approach. The hearer asks: 'How can his statement be reconciled with the supposition that he is observing the overall Cooperative Principle?' (Grice 1989, 30). The hearer works out, or infers, from the conversational principle how the speaker's expression should be understood. The hearer assesses whether or not the speaker has left the cooperative discourse, that is, has already avoided aiming at a common communicative goal.

Box 1 provides a short cut:

Box 1 Grice's theory of implicature

Presupposition (I): The understanding is a result of (a) inductive-probabilistic reasoning & (b) prudential reasoning

Presupposition (II): The speaker's perspective, i.e. utterance, matters.
The speaker's utterance is differentiated into:
a. What the speaker said, utters, i.e. what has been understood &
b. What has not been said, i.e. what has to be implicated:
('the implicature of an utterance')

Presupposition (III): The implicature of an utterance is distinguished into:
b.1. the conventional implicature, i.e. the utterance
b.2. the non-conventional utterance, i.e. the conversational implicature (which entails non-verbal utterances)
Short: b.1. & b.2. encompasses verbal & non-verbal considerations

Conclusion: Presupposition (I) to (III): Conversational implicature roots in efforts of the hearer to interpret the speaker's utterance as compatible with the principles cooperation – at first glance it has seems to be not the case.

The conversational implicature is the part ascribed to the speaker in order to secure the common goal of the communicative action. It should give support to the view that the speaker does not threaten or damage the principles of cooperation. This is why Grice argued that the competent speaker has the feasibility to let the hearer understand what should be understood, that is, the competent speaker exploits the conversational maxims. Grice stated succinctly that the speaker gives the hearer to understand what should be understood. However, the speaker's dominance still remains. The speaker guides the understanding of the hearer. Only in the case that there is no content able to be implied

at all will doubts arise as to whether the speaker is still acting cooperatively. According to Grice, adherence to the principles of cooperation, then, should guarantee understanding.

As already mentioned above, while the consideration that utterances mostly are subject to implication has been widely accepted in the literature, the further distinction made by Grice between 'conventional implicature' and 'conversational implicature' has not. Furthermore, Grice's assertion that any communicative situation moves beyond the 'exchange of knowledge and information' according to conventional and conversational implicature is hardly acceptable. He presupposed a mutual knowledge condition which is, of course, a rigid premise regarding the role of the speaker's implicature. I doubt that by stating the mutual knowledge condition it could be possible to assume that knowledge or information could be exchanged in a dialogue. I return to this point later on, outlining why knowledge or information has to be understood, and not be exchanged like a car or stone. A key assumption of this book is that *information* is considered as *a related object*, hence as *information processing* as outlined in Chapter 2.

One objection to Grice's emphasis on the speaker's framework shall be made now: The speaker's implicature is rooted in the speaker's framework, that is, the speaker's intention, and not deducible from the general cooperative principle. In this, by emphasizing the generality of the principle of cooperation. Grice neglected the social function of rules and conventions.

What relevance does such a general rule have in changing contexts? Since Grice introduced the principle of cooperation and conversational postulates as a normative rule, one might ask how its acceptance has been achieved? Only in the case where doubts have arisen about the validity of the general principle will the principle itself become a matter of debate because of the varieties of those differences which have emerged. He introduced the speaker's ability to exploit the conversational implicature, that is, the speaker's ability guides the understanding of the hearer. It is for this reason that Grice identifies the speaker as competent.

If we accept Grice's view we can conclude the speaker implies the principle of cooperation and its associated maxims by defining certain presumptions in order to achieve the communicative effect.

One remarkable point is that the theory of implicature introduced by Grice leads to a further important hermeneutic principle Grice himself did not work out. Given his emphasis on the speaker's competence to 'exploit' the conversational implicatures, this can be reread as the

speaker's ability to apply hermeneutic principles to the interactions with the hearer. Scholz (2001, 160) proposed expanding Grice's approach to communication and language towards a 'presumptive rule'. The history of language philosophy is acquainted with such presumptive rules as hermeneutic principles. Presumptive rules function as methods to structure arguments or judgments, to conceptualize a justification or objection, an interpretation or communicative interaction (Dennett 1978, 1987; Davidson 1984; Quine 1953, 1991, Trabant 2008).

A presumptive rule also implies certain considerations of rationality regarding the communicative interactions which Dennett (1978, 242, 247, 272), for instance, defined as 'assumption of rationality' and 'presumption of rationality'. He described it as a rational hermeneutic principle in order to underline the aspect of understanding as being inherent in all communicative interactions. It is noteworthy here that the rationality assumption is not linked to the economic principle configured as *homo economicus,* but rather devoted to a goal-oriented interaction of people (Muchlinski 2006; Simmons 2006; Sullivan, Snyder and Sullivan 2008). To act in a certain manner and to communicate in a particular way also implies the strategy of coming into contact with another person. In contrast to this view, the theoretical construction *homo economics* is a non-interactive, autistic individual who acts in order to achieve his or her own benefit. Humboldt defined aiming at the other person as reaching 'you' (meeting the other person), whereas Davidson described it as a 'principle of charity' and as aiming towards 'the second person'; Martin Buber (1977) defined it as 'partner of dialogue'. Dennett (1978, 9) wrote:

> We start by assuming rationality. We do not expect new acquaintances to react irrationally to particular topics or eventualities, but when they do we learn to adjust our strategies, just as, with a chess-playing computer, one sets out with a high regard for its rationality and adjusts one's estimate downward wherever performance reveals flaws. The presumption of rationality is so strongly entrenched in our inference habits that when our predictions probe false, we at first cast about for adjustment in the information-possession conditions ... or goal weightings, before questioning the rationality of the system as a whole.

A presumptive rule could be expressed as follows: The speaker wants to aim at a success of rational communication, that is, he avoids initiating distraction from the success of communication by providing

overloading or misleading information. A presumptive rule implies that sentences lead towards a communicative goal. A presumptive rule can be interpreted as a hermeneutic presumptive rule. Scholz (2001[2], 166f.) referred to Ullmann-Margalit (1983). She, and also Ullmann-Margalit and Margalit (1982), had worked on the idea of a presumptive rule as a guide of rational understanding and action more fundamentally. The presumptive rule is neither a rule to make a forecast on the communication action nor a commitment but rather is addressed to the hearer to guide his action, that is, the understanding.

According to central bank communication and language, such a presumptive rule is welcome because the central bank doesn't act for its own benefit. A presumptive rule is not to be interpreted as a commitment towards prospective decisions by the central bank. A presumptive rule steps beyond the ideal construction of principles of cooperation and associated maxims such as conversation principles. To guide expectations in the markets a central bank needs to guide the communicative interactions in order to secure the understanding of its decision-making procedures by the audience.

The presumptive rule is embedded in the history of, for example, a country, its experience, the central bank, and the economic situation. A presumptive rule supports the understanding of what has been said in direct speeches and in all modes of publications. The public presupposes the central bank to be aiming at a rational dialogue with the financial market. The public knows that the interest rate will fluctuate over time. The direct speech at a press conference provides only sentences with limited time horizons. But this is not a failure of language activity or a failure of the everyday language, but rather a key feature of the literal meaning of colloquial language in communicative interactions.

What are the presumptions according to the principles of cooperation, the associated maxims, and the economic context? The participants at the press conference expect the central bank to raise the interest rate immediately. They presume that the chairman uttered a true and relevant sentence, and that he was aiming seriously at the common goal of communicative interaction. It is important to judge beyond the literal meaning of the sentence in order to get an understanding of the sentence as embedded in practice. Without any coherent, relevant, or rational presumption about the circumstances, no understanding of press releases of the central bank, direct speeches, or statements are possible. The understanding refers to the standard of rational dialogue, hermeneutic principles, empirical assumptions about common responses by people regarding different information and circumstances.

Common responses or common reactions imply that people act rationally in order to achieve their goals, and they therefore avoid misleading information or language activities.

In contrast to the view outlined in the previous paragraph, the presumed reliance on a merely mechanical response or reactions or so-called reflexes will not lead to understanding. Only if the economic science still adheres to the naïve behavioural paradigm in economic theory, which has already been abandoned by other social sciences, is it possible to argue by way of such a mechanical response reaction analogy.

The term implicature is proposed as a cooperative principle which introduces the cooperative presumption, determinacy, and mutual knowledge conditions, but Grice left open how the implicature could achieve that rule as a cooperative principle. How should it be possible to achieve mutual knowledge and determinacy by a reference to the term implicature? The term implicature is not oriented towards a coordinative interaction since it only has a semantic role. Grice also stated that conversational implicatures can be worked out or inferred from conversational principles. The generative assumption, stating that the conversational implicatures are generated by and predictable from the satisfaction of those principles is not convincing, since Grice only proposed it as a premise. It is a failure to argue that conversational implicatures can be derived from, and explained by, conversational rules.

The theory of implicature provides a theory of rational dialogue or rational hermeneutics based on the hermeneutic presumptions Grice defined as conversational and conventional implicature. Grice's principle of cooperation and its associated maxims are subordinated parts of the overriding principle of rational dialogue. Davis objected to Grice's theory of implicature: 'In sum, Gricean theory fails because speaker implicature is a matter of intention, sentence implicature is a matter of convention, and neither is calculable from or generated by psychosocial principles. Conversational rules instead codify social goals motivating intentions and sustaining conventions' Davis (1988: 190).

Although I agree with the first part of that critique, the non-acceptability of the speaker's intention regarding communicative interaction, the criticism misses the point. Admittedly Grice did not succeed in stepping beyond the 'matter of intention'. The dominant figure in Grice's approach to communication and understanding still remains the speaker, which I do not find acceptable because it is based on the idea of the conduit metaphor and focused on information as linear transmission (see Chapter 2). However, if we appreciate the attempt to

integrate conventional and conversational implicature into the conversations principle as proposed by Grice – as, for instance, Scholz among other authors has suggested by reference to the function of a presumptive rule – then we could come to a further conclusion which, from my point of view, would be beyond the prepositions of logic ordered regularly in the diagrams of truth-possibilities and of truth-arguments.

I propose interpreting this conclusion as inductive reasoning, also implying the creation of meaning in the communicative interaction and, hence, in the context, which also includes to acknowledging uncertainty about the communicative interaction as a whole because of the use of everyday language. If, on the other hand, we assume that the implicature functions in a logical sense, we then have to presuppose that Grice had configured communicative interactions as a deductive system. My proposed interpretation, as outlined in the previous paragraph, contradicts two other ways of interpretation: The term implicature has been criticized in the literature by those who interpret implicature as deductive reasoning of a formal system by emphasizing that this contradicts the role of language and meaning as rooted in the context, circumstances, and trappings of a particular culture (Keller 1995). However, the term implicature has been accepted by those writers who support the view that communication is based on coded language and a certain types of behaviour.

Although Grice did not define the term implicature, it is possible to argue that it draws a kind of conclusion. Grice argued that since any utterance is incomplete regarding the speaker's intention as the whole, that is, the speaker's utterance provides only a part of the meaning. Therefore the incompleteness of the expression regarding its content leads to the implicature. The content of the communication which goes beyond the utterance itself has to be implied. We are now able to conclude that the theory of implicature restricts the supposed generality of the principles – a conclusion Grice did not make.

I now turn to draw some conclusions on Grice's view. He limited the proposed general rule-based approach to achieving a communicative success by way of his theory of implicature. However, he did not discuss the theory of implicature in its function as a restriction of that supposed generality. Grice discussed the principle of cooperation as a requisite to achieve the success of communication by stating that the speaker's capability of exploiting the mentioned principles and associated maxims will lead to success whereas the hearer will decipher the speaker's intention through the speaker's action. While Grice tried to implement a theory of dialogue, he failed to articulate how a dialogue

could be implemented. The speaker's intention determines the meaning and understanding. The speaker utters what he meant, and the hearer acknowledges what the speaker means by reacting in a certain way.

Although Grice referred to the speaker's intention, he did so not in the way that proponents of the theories of intentionality of meaning do. A particular feature of theories of intentionality is the idea that the intentionality of terms is related to a person. Dennett described it as an 'intentional stance' (1971). The relation to the person is linked with the intentional pattern of acting. The supposed ascribing of the intention to a person also implies certain assumed persuasions, wishes, expectations, and mental states of the person which are interpreted as particular reasons to act (see Brandom 1994). The difference between what the speaker 'means' with words or sentences and what he utters refers to theories of intentional systems (Kemmerling 1986). The demand for the speaker's framework is hardly acceptable for a theory of dialogue (Thomas 1995). It is hardly acceptable to identify the result of a communicative interaction as the speaker's intention transmitted to the hearer. In my view Grice's principles of cooperation and its associated maxims can be reread as principles of commitments.

To sum up this section: Searle defined 'conversational implicatures' as 'indirect speech acts' (Searle 1979, 30). Both Grice and Searle referred to the important aspect of why communication is understandable while the spoken sentence, the utterance, is incomplete. The differences between Grice and Searle emerged at this point. While Grice emphasized the importance of the speaker's intention, Searle focused on speech acts as a way of acting in communicative interactions. Grice's theory and Searle's 'speech act theory' can be reread as distinct theoretical approaches to a rational dialogue. Both imply a hermeneutic approach to communication, although they differ significantly regarding the role of speaker and hearer (Searle 1969). The use of language, that is, language activity or a language-game is at the centre of the question on how the meaning of a word evolves (see the next chapter).

One important consideration of this language approach is that every language-game is governed by the rules of life, that is, the use of language in the context and not by premises proposed by Grice. Therefore, rules are not external to the language-game. Such rules will derive their meaning within the language-game, that is, the communicative interaction and context.

One important result of the speech act approach to language, that is, to meaning and understanding, is that speech acts create institutional facts. Economic institutions – like other social institutions – are

designed, created, and configured by the language-based activities of society, which have to be acknowledged and accepted. Their existence depends on social acceptability and agreements. Economic institutions are created neither by natural procedures nor by ontological entities. Institutions have to be perceived for their existence, that is, they are dependent on social acceptability (Windeler 2001; Searle 1995). Institutional facts are defined neither by physical laws nor by physics.

According to modern language science and its founders, Humboldt, Wittgenstein, Austin, and Searle, we have to distinguish between ontological, or immanent, features and language constructed in the real world. I now turn to a different view proposed by Ariel Rubinstein.

4.4 Formal language versus everyday language

Rubinstein told us that the roots of his interest in language go back to his childhood, since he always wanted to understand the people's argument and talk, focusing on the link between formal language in model building, game theory, and everyday language. Rubinstein (2000, 3) wrote:

> I continued to explore formal models of game theory and economic theory, though not in the hope of predicting human behavior, not in anticipation of predicting the stock market, and without any illusion about the ability of capturing all of reality in one simple model. I am simply interested in the reasoning behind decision-making and in the arguments people bring in the debates. I am still puzzled, and even fascinated, by the magic of the links between the formal language of mathematical models and natural language. This brings me to the subject of this lecture – Economics and Language.

Rubinstein's book provides many examples of his interest in language as a focus of decision-making by economic agents, game theory, and the development of formal models in the game theory. He refers to current discussions of formal modelling and how to interpret this formalism in terms of daily language. He stated that formal models are not improved by a transformation into daily language or words of common use, because formal language is not expressly in everyday language. There exists a gap between both. Rubinstein referred to Grice's work as being about pragmatics, a branch of linguistic studies. Rubinstein wanted to construct rules for a cooperative communicative approach concentrated on the speaker's intention and his aim to influence the outcome of communication. In order to investigate the hierarchy between speaker and hearer in the light

of game theory, Rubinstein reformulated the central concepts and notions given by Grice. The term implicature, then, provided the key argument in Rubenstein's approach to the economics of language.

One main topic of economic investigation is social interaction in differently designed relations and economic systems. Rubinstein explained that all economic agents are acting on the basis of language capability, making decisions and forming judgments. This statement is beyond the trivial, since there is another player in economic theory, one who is accustomed to building mathematical models which are regularly interpreted by common language. This, importantly, 'derives from interpretation, which is expressed using daily language' (Rubinstein 2000, 5).

The focus of Rubinstein's interests is the development of formal model in game theory and its link to natural language. As he (2000, 5) puts it precisely:

> Much has been written on the rhetoric on economics in general; little however, has been written on the rhetoric of game theory. The starting point of the discussion is that an economic model is a combination of a formal model and its interpretation. ... I argue that the rhetoric of game theory is more 'useful' than it actually is, and that a better interpretation would make game theory less relevant than is usually claimed in the applied game theory literature.

By this reference to rhetoric, Rubinstein emphasized the distinction between formal models and language. Finally, for him language is part of formal modelling. He refers to Grice's work as an explicit contribution to game theory.

Two main questions are raised by Rubinstein to describe his approach to economics by language. Firstly: 'Why would economic theory be relevant to linguistic issues?' Secondly: 'Why would economic theory be a relevant subject of research from the point of view of language'? (Rubinstein 2000, 4). Rubinstein answers the first observation that economics deals with 'non-physical regularities in human interaction' which are based on 'natural language'. This notion was of great relevance for Grice and the understanding of the dialogue between speaker and hearer. Pragmatics has been influencing the theory of action, rules, and convention. Rubinstein (2000, 6) explained:

> Pragmatics searches for rules that explain the difference in meaning between a statement made in a conversation and the same statement when it is stated in isolation. Grice examined such rules in the

framework of a conversation in which the participants are assumed to be cooperative. Here, game-theoretical analysis will be used to explain a certain phenomenon found in debates.

In Chapter 3 of his book, Rubinstein outlines why the approach given by Grice is of relevance for this investigation of economic decision, debates, and structure within the framework of game theory analysis. To summarize his view: he supported the approach made by Grice. He interpreted the speaker's utterance as a signal which transfers information already given (Rubinstein 2000, 37). The way the hearer interprets the speaker's intention and how the speaker defines the assumptions addressed to the capability of the hearer are important factors for the understanding of an utterance. In game theory such matters as how an utterance would be interpreted commonly or be understood is to be viewed as an output of a game between speaker and hearer. Rubinstein stated that the only 'real phenomenon' of game theory is the term *debate*. A linguistic approach to game theory could provide more clarity on the linguistic meaning. For instance, the term 'debate' depicts a situation in which two persons do not agree and which provides a framework for them to explain themselves in order to possibly achieve an agreement.

Understanding refers to the complexity of the propositional attitudes of the speaker. Propositional attitudes express the speaker's intentions, opinions, expectations, experience, or thinking. It had been a long-lasting controversy in the literature as to whether it is possible to make a distinction between the meaning of a sentence or word and propositional attitudes.[11] For instance, in the 1950s Quine wrote a famous criticism of the traditional analytic/synthetic distinction, referring to the 'two dogmas' of empiricism. Later on, Quine overcame his previous view and regretted that in his early writings he had overlooked that it is not possible to set a border on meaning by semantic or linguistic rules, on the one hand, and by experience, on the other.[12] The results of an experiment have to be explained in sentences which are not created by the experiment itself. Moreover, there exist no particular experimental sentences or words which are developing with the experiment itself (Quine 1953, 1991). The experimental procedures and its results have to be expressed in public language.

Quine put forward a hypothesis of 'inextricability' by stating that it is not possible to differentiate between pure meaning independent of the praxis or the context in which the word is used and the propositional attitudes. 'Inextricability' emphasized the inherent connection among

meaning, context, and information. The implication of 'inextricability' can be understood if we consider how children learn the meaning of a word or a sentence. For instance, the word 'chair' is not learnt by looking into a catalog. The meaning of a chair is learnt by its use in practice. A child learns how to use the chair to sit or to stand on in order to enlarge its horizon. It learns how to put chairs around the table and how to move a chair in order to create another goal for its use in the context, or to remove the chair to change the game. It does not learn the meaning of a chair as a synonym for an object or piece of wood which possesses at least four legs. It is not possible to draw a rigidly fixed border between a so-called pure meaning and the knowledge of the use of language 'chair'. There exists no pure theory of the meaning of words or sentences beyond the practice of the language in use (see Chapter 5).

Quine later followed Wittgenstein's and Humboldt's research, accepting that there exists no boundary between the sentence which describes an experimental result and the sentence which refers to the theory. Nowadays, the dogmatic view of a dichotomy of experimental or empirical versus theoretical sentences is no longer relevant.

The consequence of the abandonment of this analytic/synthetic distinction was the acceptance of holistic and hermeneutic approaches to meaning. These approaches to meaning imply the acknowledgment that there is no boundary to be drawn between different kinds of sentences in describing data, observations, experiments, information, meaning, opinion, or utterances. For example, Davidson, who adhered to Quine's later view, argued that for the sake of a coherent interpretation of the speaker's utterance we have to recognize the conditions the person has taken into consideration to assess on the truth of a sentence. There are two factors to be mentioned: the beliefs or persuasions of that person who decides and the meaning of a speaker's utterance. Which persuasions, beliefs, and meaning (opinion) we are going to credit to a person depends on our *interpretation* of the speaker's utterance. Davidson applied the holistic view to his theory of 'radical interpretation'. Our interpretation of the speaker's utterance also depends on the meaning or opinion we have attributed to him or her. A particular characteristic of the holistic view of meaning is that all theories of meaning have been evolving against the background of scholarly experiences. Therefore, if this experience and the explanatory power of an analysis contradict the theory, one has to asses which elements of the theory must be revised or rejected.

4.5 The use of language as coordinative acting

> This is so much the conventional way of thinking about language that it is sometimes hard to imagine that it might not fit reality. (Lakoff and Johnson 1980, 459)

The discussion on central bank communication refers to 'convention' or the coordinative function – the coordination channel of communication (see Amato et al. 2003) – in order to try to explain why language matters in the economy. As was outlined in the previous section, Grice (1989) also stated that conventions imply 'what users of the sign do mean'. This brings us to Lewis's contribution, which at the initial stage of the debate provided a conceptual view on convention (Muchlinski 1998b). Lewis (1969, 2) objected to the view that convention and language are connected in a particular way:

> It is a platitude that language is ruled by convention. Words might be used to mean almost everything; and we who use them have made them mean what they do because somehow, gradually and informally, we have come to an understanding that this is what we shall use them to mean. ... To say only this is not to say much.

Lewis thus tried to explain how and why conventions evolve and what role is left to language. Lewis (1969, 2) also objected to the view that conventions are based on agreements:

> We have no concept of convention which permits language to be conventional (ibid). ...
>
> The conventions of language are a myth. The sober truth is that our use of language conforms to regularities – and that is all.

What are the roots of conventions? Lewis argued that conventions are modes of regularities of behaviour. Lewis referred to different means by which different people aim towards a common goal. Such efforts should be called communicative interactions. Given the assumption that the use of language conforms to regularity, Lewis assumed the 'use of language belongs to a class with a conspicuous common character: situations I shall call *coordination problems*' (Lewis 1969, 5). Lewis outlined that any social interaction implies a communicative action as a form of coordination, hence the use of language concerns coordinative actions.[13]

To be brief on this premise of Lewis, conventions arise out of the regularity of people's behaviour. The coordinative interactions are a kind of communicative action. They are the means of a coordination game in

terms of the game theory approach. Lewis, then, defined a coordinative action as based on common interests to serve common purposes. The assumed common interests lead to a further premise of the rationality of coordinative acting. For instance, agent (A), then, expects a common interest with agent (B) and, hence, is willing to coordinate and interact with (B). This assumed coincidence of will also implies the coincidence of the expectations of (A) and (B). This premise is required for realizing the common goal of communicative interactions, that is, in terms of Lewis's view, the coordination. Lewis (1969, 6–7) illustrated his approach to convention by the following examples, referring to Hume's *Treatise on Human Nature*:

> Suppose you and I are rowing in a boat together. If we row in rhythm, the boat goes smoothly forward; otherwise the boat goes slowly and erratically, we waste effort, and we risk hitting things. We are always choosing whether to row faster or slower; it matters little to either of us at what rate we row, provided we row in rhythm. So each is constantly adjusting his rate to match the rate he expects the other to maintain.

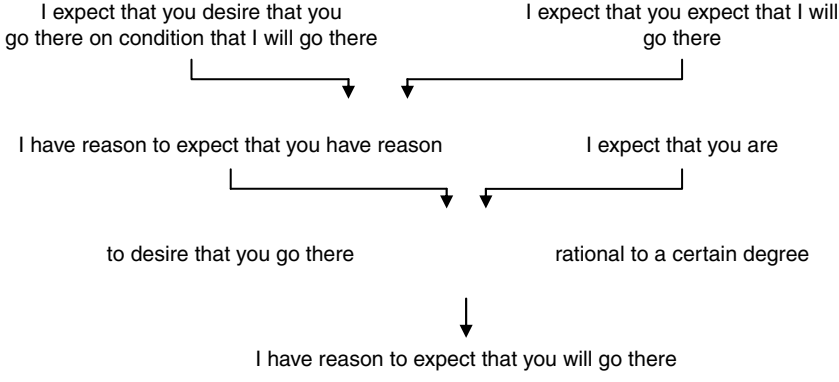
Lewis discussed examples with more than two people: for instance, campers in the wilderness or a car driver on the road. The involved agents will be only successful if they acknowledge their dependencies by working on a coincidence of common interests and also the coincidence of will, expectations, and goals. Since Lewis denied that conventions are based on an explicit agreement in advance, he went on to expound that any pattern of the coordinative interactions is based on the regularities themselves. These regularities of behaviour work like a natural force. It is the rule which guides the agents through the game in order to fulfil their common interests. Lewis, then, defined common interests of the agents and the emergence of a congruent goal, the coordination as an equilibrium referring to the principles of game theory (see Lewis 1969, 14). A common purpose requires coordinating the actions of agent (A) and agent (B) regarding their mutual expectations. A coordination problem, then, exists in a case of distinct alternatives of actions. Lewis defined a coordination problem as follows:

> Coordination problems ... are situations of interdependent decision by two or more agents in which coincidence of interest predominates and in which there are two or more proper coordination equilibria. (Lewis 1969, 24)

Decision-making is not required in cases of common interests. The presumption of common interests implies the double coincidence of wants. Lewis assumed that coordinative acting will be better the more it is based on mutual expectations of both agents (A) and (B) or among a group of agents respectively. This assumption serves the readiness of the agents to build up 'concordant mutual expectations' (Lewis 1969, 25). Lewis gave the following example: 'I may go to a certain place because I expect you to go there, while you go there because you expect me to' (ibid). What is needed, then, is an agent's confidence in the expectation-building process in which she or he is involved and the certainty that she or he expects the other agents to be involved, too. The involved agents are motivated by their common interests, expectations, and confidence, hence motivated by the behaviour of others. At this point the common knowledge assumption comes into consideration again. As is already outlined, the common knowledge assumption has a prominent place within economic theories. This presumed strong interrelation of the agent's expectations can be described as the expected expectations of all expectations.

> I said earlier that coordination might be rationally achieved with the aid of concordant mutual expectations about action. ... Coordination may be rationally achieved with the aid of a system of concordant mutual expectations, of first or higher orders, about the agents' action, preferences, and rationality. (Lewis 1969, 33)

This first order is illustrated in Figure 1:



A coordinated solution of an interactive process among different agents is provided by the recognition of mutual expectations. It is a replicate process of reasoning with one's own knowledge and beliefs based on different orders of assessment and reasoning. Lewis described this assessment as 'a process in which *one* person works out the consequences of his beliefs about the world' (Lewis 1969, 32).

To assess the expectations of others requires considering one's own expectation in relation to other agents' views. This is not an easy task, but can be accomplished by a mechanism. As Lewis (1969, 27) pointed out:

> If I know what your believe about the matter of fact that determine the likely effect of your alternative actions, and if I know your preferences among possible outcomes and I know that you possess a modicum of practical rationality, then I can replicate your practical reasoning to figure out what you will probably do, so that I can act appropriately.

This replication of a person's reasoning is based on the mutual interdependence of actions and the mutual expectations of the agents. Lewis, then, tried to strengthen his argument of a coordinating acting. How can agent (A) reach the point of a certain confidence in the behaviour of agent (B)? It is rational for agent (A) to get as much as information as possible about the prospective actions and the underlying expectations of agent (B). This information will serve as a guideline to orient his own actions and expectations of (B). Lewis focused on the interrelated procedure and mutual perception of expectations of (A) and (B), and also on implications the 'expected expectations' of the other agent regarding one's own expectation might have. This coordination approach can be described as a cognitive and acting procedure. Person (A) has to find out what person (B) expects him or her, that is, person (A) to do. Therefore person (A) needs to figure out the information in order to solve the coordination problem. Any reasoning by person (A) about the other person's (B) expectations or beliefs or actions will be replicated by person (B) and so on.

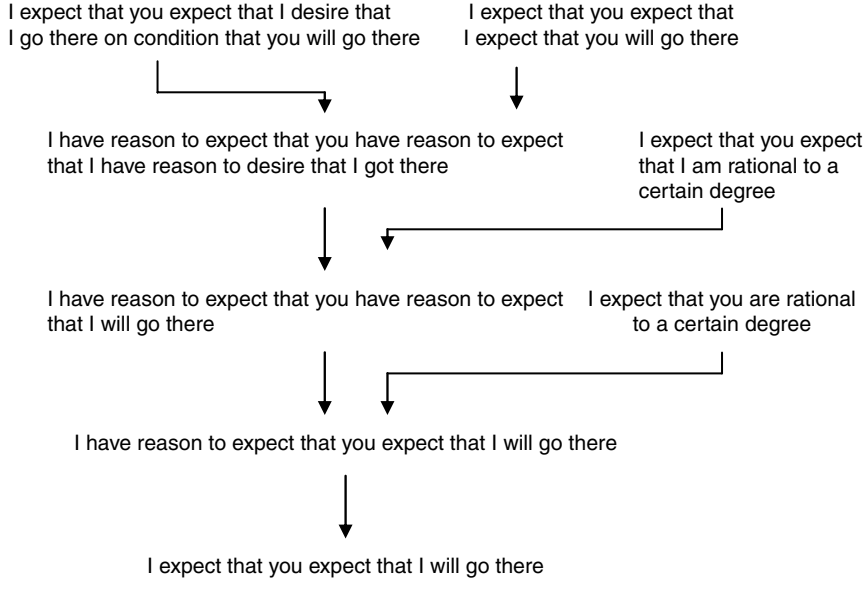
This procedure of mutual recognition cannot be modelled as a linear causality. The consequence of this is: person (A) might expect person (B) to try to replicate the attempt of (A) to replicate the attempt of (B) to replicate the reasoning of (A). Therefore the chain of reasoning or the mutual process of replicate reasoning will not end after person (A) expects person (B) to realize something. This process of reasoning about the reasoning and also about the ongoing replicate reasoning of others will continue before it has to be stopped by decision-making. Lewis (1969, 28) stated:

> Before things get out of hand, it will prove useful to introduce the concept of higher-order expectations, defined by recursion thus: A

first-order expectation about something is an ordinary expectation about it. An (n +1)th-order expectation about something (n>1) is an ordinary expectation about someone else's nth-order expectation about it.

Lewis described the mutual recognition of mutual expectations as a process of balancing different phases of judgment and reasoning according to the capacity to work out information and unambiguous perceptions. It is a procedure to discover the unambiguousness of a given situation. Furthermore, it is the evaluation of expected-expectations as a kind of rational reasoning. This premise of rational reasoning does not impose the commitment to act rationally, but rather it provides the possibility that agents will be able to understand. This process of replicate reasoning is not a back–and-forth linearity between two persons. Moreover, the process of reasoning is an outcome of 'a process in which one person works out the consequences of his beliefs about the world' (Lewis 1969, 32).

The high-order expectation or the replication of person (A) of the replication of person (B) is sketched in Figure 1 (ibid, 29–30): Person (A) expects person (B) to expect (A) to go to a certain place to meet one another. The expectations of (A) according to (B)'s expectations arise out of the procedure of the replicate reasoning of (A). With respect to Figure 1, Lewis stated this comparison is only perceivable as an



approximate one and, hence, as a consequence of acting. Therefore agent (A) will be able to build up a hierarchy of both his preferences and of (B)'s preferences, including the underlying rationality of both acting. The coordination problems can therefore be solved by the effort of concordant mutual expectations of actions. 'Coordination may be rationally achieved with the aid of a system of concordant mutual expectations, of first or higher orders, about the agent's actions, preferences and rationality' (ibid, 33).

What role is left for circumstances in Lewis's thinking? Circumstances serve as a framework to judge the expectations of other agents. Agent (A) assumes that (B) will act like he or she acts. However, circumstances indicate merely a certain pattern of regularity of behaviour. Lewis argued that the better the circumstances are perceived by the agents the more they will support the agent's procedure being justified in forming mutual expectations. The premise of perceiving another's expectations also implies the perception of one's own expectations. Lewis explained the process of judging one's own expectations and preferences, as well as grasping the expectations and preferences of other persons, as a concluding argument. The knowledge of conventions is linked to modes of actions. The coordinative process implies that conventions are to be perceived as a shared or 'common' world.

Lewis explained 'common knowledge' as a state of affairs. He defined common knowledge as the requirement, that is, as a constituent for any successful coordinative action (Lewis 1969, 61). To Lewis, the common knowledge assumption is constitutive for the evolution of conventions. Moreover, it provides a strong prerequisite needed in order to achieve the common interests of both agents (A) and (B) or group agents.

According to the common knowledge assumption and the definition of conventions as a regularity of behaviour, agents guide their present solution based on the knowledge of comparable problems of coordination and its successful solutions (see Geanokoplos 1992, 54). Interacting, coordinating, and aiming at a common goal are based on common knowledge and regularity of behaviour. This premise of conformity is literally renewed in any action and interaction iteratively. Lewis assumed that our knowledge of analogies motivates the regularity of our view of other agents, their expectations, preferences, and modes of acting. As assumed by Lewis (1969, 41), taking note of these regularities of behaviour supported a general premise:

> We come to expect conforming actions not only in past cases but in future ones as well. We acquire a general belief ... that members of a

certain population conform to a certain regularity in a certain kind of recurring coordination problem for the sake of coordination.

The explanation of the evolution of a convention now is clear: it is the recurrence of past events or the 'conspicuous analogy' which stabilize our expectations. Since all agents rely on this precedent of stabilized expectations in future situations, such a regularity of behaviour works as a stabilizing rule. 'Our defining conditions for the existence of a convention consist of regularity in behaviour, a system of mutual expectations, and a system of preferences' (Lewis 1969, 58).

How is it possible to perceive the expectations of other agents? In Lewis's view, the expectations, willingness, and preferences are perceived by acting. Common patterns of perception lead to a common procedure of building expectations, which conforms to a certain pattern of regularity of behaviour. Knowledge which enables agents to act is defined as knowledge of acting. Lewis stated that such capability should be seen as knowledge proper. His statement that 'knowledge (is) confined to particular instances' sheds light on an important implication of his approach to convention, because following a convention is only applicable to a particular situation and not to be understood as a general rule. The concept of convention encompasses the situational approach. The consequence is that 'any convention is arbitrary because there is an alternative regularity that could have been our convention instead' (Lewis 1969, 70).

Agents have to decide which convention should be chosen regarding the situation. Lewis (1969, 78) defined convention as follows:

Box 2

A regularity R in the behaviour of members of a population P when they are agents in a recurrent situation S is a *convention* if and only if it is true that, and it is common knowledge in P that, in almost any instance of S among members of P,

(1) almost everyone conforms to R;
(2) almost everyone expects almost everyone else to conform to R;
(3) almost everyone has approximately the same preferences regarding all possible combinations of actions;
(4) almost everyone prefers that any one more conform to R, on condition that almost everyone conform to R;
(5) almost everyone would prefer that any one more conform to R', on condition that almost everyone conform to R', where R' is some possible regularity in the behaviour of members of P in S, such that almost no one in almost any instance of S among members of P could conform both to R' and to R'.

What does a 'recurrence situation' mean? It is to be interpreted as a situation in analogy. The reference to the population (P) in the above definition makes clear that any possible ambiguities and discrepancies are not expected to be great ones. Lewis sketched a common background of society for the agents in interactions. It includes a kind of common pattern of perceptions and actions. The term convention gets its meaning by its uses in different contexts.

The pattern of perceptions and the modes of interaction are guided by the conventions of a certain population and context. This particular context and the involved population give place to the use of language in actions. As Lewis (1969, 177) explained:

> We are trying to find out what the members of a population P must do in order to make it the case that a certain possible language *L* is their actual language – that they use *L*, in the sense we are after. It is surely something they do in conformity to a convention: something everyone in *P* does because he expects his conversational partners in P to do it too, and because a common interest in communication leads him to want to do his part if they do theirs. This much we know, just because we know that it matters little (in the long run) which language we use, so long as we all use the same one.

Lewis linked contexts, people and language. Lewis's model provides an explanation of the evolution of convention and how it takes place within a group of agents. With respect to the function of the population, one can argue that Lewis gave place to the meaning according to different situations and actions.

Nevertheless, the functions of language are not explicitly expounded in his model. As the quotations at the beginning of this inform us, in Lewis's view language emerges to solve a problem of coordination. Lewis described language as a medium of transporting information or signals from the sender to the receiver. He presumed the identical sense or meaning of any sentence. To put it more precisely: the agents exchange a given meaning. This contradicts the supposition of arbitrary convention. Lewis explained the success of communicative interaction as the outcome of any speaker's utterance. In his model of communicative interactions, the language of conventions is interpreted as a regularity of behaviour in order to develop the speaker's utterances, which guide the reactions by the listener. Lewis, then, maintained the success of the sender-receiver relation regarding the intention of a successful cooperation.

Here we find the analogy to Grice's concept of meaning. Like Grice, Lewis developed his notion of convention on the basis of a model of acting. Thus the actions can be viewed as a mirror of both the intentions (Grice) and the expectations (Lewis). Lewis, then, elucidated that actions are often done with definite intentions. An agent's intention can be reconstructed by the action of this agent. This brings us to the key aspect of Lewis's model: conventions provide a reliable pattern of behaviour.

Any communicative acting resembles different expected patterns of behaviour of different agents that can be interpreted in a conventional way. Within such a situation the expectation of behaviour relies also on communicative, social, and grammatical modes. Therefore, it is not possible to argue that the implementation of a communicative action is identical with following a regularity of behaviour. The success of communicative actions depends not on an exchange of given meaning, but on the evolution of the meaning through communicative acting. While the communicative action is a certain feature of the complexity of language-games the communicative action itself cannot be interpreted as driven by regularity in behaviour – a convention – as defined by Lewis.

Lewis tried to expound on the evolution of a convention regarding the mutual recognition, interest, will, and expectations of the involved agents. Lewis failed to explain how the listener's understanding could be based on the conventional approach. In the end, the listener's understanding is determined by the speaker's intention. Lewis followed the traditional theory of communication and the 'conduit metaphor'. Lewis did not explain the functions of language. Both speaker and listener have to assess the signs, symbols and words because there is no objective meaning of signs, symbols and words. The language itself works as a mode of coordination. Lewis also stated that a population chose a language. This is not convincing, since language is not a commodity or thing which can be chosen to be consumed.[14] At this point I should ask: What role is left for language in Lewis's model? What does it mean for language to conform to regularities? Language is a verbal signal. Any coordinative acting is based on communication. Lewis stated: 'A population's common use of some one language ... is a convention' (1969, 49). It does not matter in which language person (A) and (B) communicate so long as both use the same language. Davidson (1998) objected to this hypothesis by stating that understanding does not root itself in a shared language.

Lewis stated that the wish to be understood leads directly to 'media of exchange'. He referred to economic discipline and explained that

the coin of a particular realm is such a medium of exchange. How had the acceptance of that coin as a medium of exchange been achieved? Lewis argued that the acceptance of a medium of exchange is rooted in our conventions. We would accept this medium as a mode of return or reciprocity. It is obvious that acceptance is not given by the object, the coin, but rather by a state of confidence. Lewis agreed that it is certainly not a convention to use a language. Using a language is a convention and, therefore, a regularity in behaviour. A convention does not guide the behaviour of the population in every detail, but rather a convention restricts behaviour. 'Here I will say only that it is a regularity restricting one's production of, and response to, verbal utterances and inscriptions' (Lewis 1969, 51). He stated, 'conventions are like fires: under favourable conditions, a sufficient concentration of heat spreads and perpetuates itself', that is, a convention is a regularity in behaviour (Lewis 1969, 88). If a population has the choice between two possible languages, it follows from this that 'it must be by convention that a population chooses to use one or the other', concluded Lewis (1969, 50). In my view, Lewis missed the point of the use of language. It is not possible to choose a language like an apple. His view that 'language conforms to regularity' denies the constitutive role of the use of language in practice. It is for this reason that Lewis's view is not an accurate approach to central bank communication.

5
Language, Expectations, and Circumstances

> Our talk gets its meaning from the rest of our proceeding.
> Wittgenstein 1979, § 229

In this chapter I would like to provide an introduction to language as opposed to a coded language. This chapter tries to show why understanding matters to central banking. According to modern central bank literature, the genuine task of a central bank is to steer market expectations. Since expectations and the expectation-building process are not to be regarded as mental states but rather as articulations (utterances) configured by language-based interactions in different circumstances, central bank talks matter. However, expectations are neither linearly determined causal responses to stimuli nor causal connections to disclosed information. Economics, as a social science and as institutionalized procedure, is not based on causality as is typical for mechanical stimulus-responses. This is also true regarding understanding.

As we have seen in the previous chapter, Grice presupposed that meaning is analogous to the intention of the speaker. Moreover, as a general rule he differentiated between the meaning of the speaker and listener. The 'standard meaning' is seen as abstracted from communication interaction, that is, it is not based on social interaction but rather incorporated in symbols, signs, and words. Although Grice tried to step out of the classical theory of meaning with the term 'act-object-ambiguity' – that is, meaning as incorporated in mental states, intention, or in an object itself – he remained focused on the speaker's intention because he emphasized intention as an analogy of speaking and acting. As Grice stated, the 'effect' of a communicative acting should be ruled out by the listener. The listener has to reconstruct the speaker's intention.

Lewis demanded a rule or convention, such as common knowledge, for communicative interactions. Lewis stated the common knowledge assumption is necessary as a rule both to coordinate and to create a convention. Language acquires its role through 'conforming regularities' of behaviour and, hence, understanding is seen as rule-following. The aspect of understanding has been neglected by both Grice and Lewis. From my point of view it is not beneficial to rely on rules or a coded language, since understanding is neither a result of a stimulus-response mechanism nor of deciphering. A coded language could probably work within a stimulus-response mechanism among agents and machines in order to set a machine in motion. However, such a stimulus-response mechanism is not a model to capture and understand the communicative interaction between a central bank and agents of the financial markets. The analogy of human behaviour to a machine misses the point of economic interactions in the financial markets, not only because of the different time horizons but also because of the interdependency of these actions according to monetary policy being worked out through markets.

The view to set agents in motion by a coded language, like a struck billiard ball, is misleading. To understand how monetary policy works through markets, one needs to acknowledge the processes perception and understanding of the central bank talk and communication within markets involving many different agents in different markets. Any attempt to guide market expectations by a coded language implies a risk of a significant disappointment of such agents if, for instance, the central bank has to change its policy in response to the changing circumstances, that is, changes in the context and environment. The more a central bank tries to avoid such misunderstandings through a commitment to communication via a coded language, the greater will be the risk of generating misunderstanding among market agents.

To acknowledge understanding as part of the communication strategy implies stepping beyond presumptions about the intention or mental state of the speaker. Understanding cannot be conceptualized as rule-following. Rules must be applied to something, such as 'the rules of car-driving'.

Understanding is not to be reduced to deductive or inductive reasoning – those procedures based on certain regular features. As a judgment at hand, it does not follow procedures of decoding or a cybernetic exchange of information. It is an attempt to come to terms with a problem or event.

Understanding – also degrees of understanding – are an epistemic consequence insofar as I am changing my knowledge about circumstances

immediately. I cannot interrupt the understanding. Understanding is not a mental status but rather an ability to participate in circumstances differently. However I could maintain not understanding anything. Understanding is hypothetical or inferential reasoning. Understanding is related to the complexity of sense or context, which includes knowledge of the world and acting, which means participation in a shared practice. This shared practice encompasses also the knowledge of others whom I perceive in communicative interactions. Keynes explained it as an 'average opinion' (see Section 2.3.2). Wittgenstein (1983, 334) described it as participating in a 'language game' by articulation: 'A game, a language, a rule is an institution.' A language-game is an appropriate concept to capture and describe the communicative interactions between a central bank and financial markets.

I am going to explain why, according to Analytical Philosophy and modern language science since Vico, Herman, Herder, Humboldt, Kant, and Wittgenstein,[1] the meaning of utterances or articulations are inherently embedded in the communicative interactions, hence in their context (Muchlinski 2006).[2] Their view does not support the approaches Grice and Lewis had proposed. The meaning of signs, symbols, and words is not rooted in itself. It is impregnated by its use in different circumstances. From the view point of Analytical Philosophy, the intention is not the sum of the mental state of an individual. It is to be seen as the realized action. Therefore action is perceivable as activity or communicative interaction respectively; there are no two things like (a) intention and (b) action.

As Humboldt (1836/1998) explained, on the basis of his comprehensive language studies on the differences in world languages, language is '*Thaetigkeit* [*energeia*]' activity (Trabant 1986). Language as activity implies that the meaning is embedded in different patterns of language in action. Language is not a label for mental states, intention, or thoughts because language is not neutral towards meaning. Humboldt et al. have revolutionized our view on language by emphasizing that language has a constitutive function in the creation of meaning and circumstances. In contrast, the traditional philosophy presupposed the (speechless) 'idea of mind' (Aristotle, Locke), and that mental states, intentions, or thoughts are created independently of language. According to this view language works as a symbol, sign, or word and has the function of post-labelling thoughts, intention, or mental states. Thinking comes first, speaking follows.

However, as the criticisms of Analytical Philosophy go, single words, symbols, or signs do not configure the meaning because it is the

surroundings of a communicative interaction and the structured relations of the words in use which create the meaning. It is contradictory to assign language a constituent function and simultaneously assign the description of the world to words or concepts as images. Wittgenstein developed Analytical Philosophy further, and this has been accepted in the modern view of language science (Günthner and Imo 2006; Fiehler et al. 2004). He related everyday language to 'forms of life': 'To imagine a language means to imagine a form of life' (Wittgenstein 1978, § 19).

> Meaning is not a process which accompanies a word. For no *process* could have the consequences of meaning. (Wittgenstein, *PI*, II xi, 218)

A word does not acquire its meaning as an isolated or illuminated point. As was said in the introduction, the use of a sign, symbol, or word gives life to it (Wittgenstein *PI* § 432). However, the current research on central bank talks and communication looks to the use of single words or code words in the speeches, minutes and publications of central banks in order to decipher the meaning of the information (Berger, de Haan, Sturm 2006).

Let us pause here to consider economic circumstances: how are they created? Let us consider for instance the financial crisis which started at the end of 2007; it can hardly be denied that many of the so-called financial 'products' in question – a variety of derivates which contained the promise of future earnings – a promise of payment, (see Akerlof and Shiller 2009) – were created by the use of language; they were not ontologically supplied as things. However, it was possible to create these financial products within certain economic environments through certain communicative interactions, based on certain expectations, beliefs, persuasions, or, as Wittgenstein would have described it, as 'language-games' among the agents in markets. Keynes also described language-games in economics:

> For it is, so to speak, a game of Snap of Old Maid, of Musical Chairs – a pastime in which he is victor who says 'Snap' neither too soon nor too late, who passed the Old Maid to his neighbour be fore the game is over, who secures a chair for himself when the music stops. The games can be played with zest and enjoyment, though all the player know that it is the Old Maid which is circulating, or that when the music stops so me of the players will find themselves unseated. (1936, C.W., VII, 156)

Communicative interactions create economic circumstances and, hence, 'economic facts and fictions'. Central banking as acting through markets needs to recognize the epistemic presupposition of a successful

communication. A central bank has also to acknowledge the constitutional conditions of the knowledge of participants in the markets or the knowledge of the society. This includes the history of the use of its key terms and concepts. A central bank's action in financial markets is embedded in its historical experience, as King (2004) explored in his studies of central banking, money, and inflation in Japan and Brazil.

5.1 Benefits and risks of a coded language

This section deals with certain characteristics of a coded language, its benefits and risks. I would like to give a short summation of some important questions and answers here: What is, after all, a coded language? Certain characteristics of coded language will be explained and the term itself defined in the following paragraphs. Where does the meaning of a coded language come from? It results from a defined rule. What is the implication of making reference to a coded language? The implication is the presumption that circumstances do not change and that the meaning is incorporated in symbols, signs, and illuminated words. Does a language code simply rule how to react to a stimulus? Yes.

Recalling the example of the car and car driver, it is possible to imagine setting certain limits in order to define the context of car-driving. It is also possible to define it by making a list containing all the elements contained in that context: roads, maps, cars, light, rules of traffic, wheels, steering wheels, spark plugs, fuel, and so forth. As this example indicates: A coded language is rooted in an exact definition and in a defined area or field. There is no vagueness or ambiguity in its meaning. A coded language can be explained by a list of all the distinguishing marks or features which provide an invariant context and situation. The meaning of a code is given ahead of its use. A coded language maintains a sense by itself regardless of any further interactions between the authors, agents, or institutions. A coded language is incorporated as a fixed rule or in a logical structure which is itself defined independent of changing environment and context. It is like the traffic light based on the simple rule. It does not create specific institutional facts or respond to their changes. A coded language is rooted in a certain system of definition. It makes sense to use a coded language in an invariant environment composed of and, indeed, designed using mechanical rules. A coded language – like the instructions on how to use a car or a machine – can in effect only be anchored in an invariant environment – for example, regardless of whether one drives on the left or the right. The context of an instruction on how to use a car is stable.

The car is defined by certain mechanical properties. Instruction on how to understand a coded language in order to get a driver's license demonstrates how the use and understanding of a coded language differs from everyday language. This generates a particular behavioural pattern which is necessary to avoid crashes of cars by establishing a strictly regular order applying to car drivers. A coded language is not embedded in a history, or at least not in one which reflects the dynamic, ever-changing and newly conditioned interactions. A coded language is not, in that sense, an echo of past events. Since a coded language is not rooted in interaction and practice, it is an artificial language. Words separated from a particular environment or set of environments lack any useful meaning. Here we can see the reason why a coded language is free of ambiguity and vagueness, which seems to be beneficial for economics and central banking because of their particular methods, which focus on quantifying, measuring, and forecasting.

Considering the essential characteristics of the modern view of central banks working *through* markets, how then could a coded language be a link between heterogeneous agents and the central bank? The problem of a central bank's talk based on a coded language is pointed out by Issing (2005a, 70):

> Code words can be readily identified and taken into account in market operations; they can reduce uncertainty in the run-up to meetings of the decision making body, and they can help to avoid errors in the short-term planning of operations and curb the volatility of interest rates. However, with the use of such code words, the central bank puts itself under pressure to honor a quasi-promise.

Karen Johnson, on the board of governors of the Federal Reserve System, argued that central banks need first of all to create a 'communication language. Currently, they tend to use very few words, often seen as coded language' (2001, 96). Johnson explained the problems which arise out of the use of a coded language:

> When these words seem to work with the target audience they are used over and again. But then, if the words differ only a little bit from one time to another, they may be mistakenly interpreted as a policy change. (2001, 96)

Indeed, the risks of a coded language are evident. Any conditional announcement regarding future decisions and actions implies both the

eventual necessity, and thus the risk, of a self-commitment with the consequence of greater inflexibility in action and reaction by the central bank. This reduced freedom to act and react also implies the risk of disappointing the market agents. Where a redirection of monetary policy is required, a central bank's announcement based on a coded language has, in any case, to be explained ex post facto in everyday language. A coded language which has to be explained subsequently in everyday language is not credible. People will not trust in it. Moreover, this reinterpretation diminishes the credibility of the central bank because its efforts to translate the coded language into everyday language will fail. In the light of modern central bank theory and according to the selective FOMC transcripts introduced in this book, we could argue that communication 'as the heart of both accountability and transparency' (Blinder and Goodhart et al. 2001) must be based on everyday language. A thorough and complete evaluation of the FOMC transcripts of the Volcker era will broaden support for this.

Any announcement or statement of the central bank can only be understood as an announcement regarding the mandate the central bank is aiming to carry out. A conditional announcement also points to particular eventualities governing a central bank's prospective actions not yet known. Since market actors tend to look for particular hints in order to make their own decisions, a coded language will in fact increase the problem of the central bank's inflexibility to alter its own decisions. An example is the abandonment of signal codes the European Central Bank declared in May 2007.

As I showed in Section 4.5, Lewis emphasized the characteristic of language as a rule with the statement *'language conforms to regularity'*. Admittedly, the creation of a rule of car-driving could be seen as an example of such regularity by language. The rule of car-driving will achieve its acceptability, not through the public's acceptance and acknowledgement, but simply by the mechanical procedure or by a specific DIN-norm. At this point any further analogy comes to an end. Car-driving – or using a machine – is not identical with creating a rule as a result of social interactions. We have to distinguish between rules which have been created socially that can be defined as institutional rules, on the one hand, and rules which conform to regularity, on the other hand. If we recall Lewis's view, he defines language-based acting as a rule and, hence, as convention. However, according to Habermas we need to differentiate between the social acceptability and validity of rules and rules based on mechanical analogy. Since language rules do not exist ontologically compared with something like a car, a

hermeneutic interpretation of language rules is needed (Scholz 2001). Acting as social acting in different circumstances is not directed in its meaning ahead of its use by focusing attention on existing rules listed in a catalogue. Social acting in different circumstances is not comparable with car-driving on different roads in different countries.

There is no doubt that a coded language can guide reactions in particular directions; for example, it can induce so-called iterative movements. A good example is the well-known metaphor of a 'run on the bank' (Bagehot 1873) which is, in effect, a self-fulfilling prophecy, and has caused many bank crises. There exists no doubt concerning the dangers of a situation in which coded language may guide mass behaviour, as the history of communication has shown (Lasswell 1935, 1948).

Whereas economic data always provide their own ambiguity, as chairmen Volcker and Greenspan emphasized, Chairman remark concerning the empirical findings seems to confirm the uncertainty. The chairman remained reticent when the data could not be read as a certain unambiguous description. The risk is evident that statements by the Federal Reserve Bank accompanying the interest rate move could lead to some unsettling signals in the long run. With uncertainty in the landscape, central banks – like other institutions – need to be anchored. The uncertainty would be intensified by the use of a coded language.

One particular benefit results from the assumption underlying a coded language: that the future of financial markets or the economy in general is capable of being conceived with greater clarity and less – or indeed no – uncertainty. The coded language appears to open an opportunity of interpretation by following a clear and unambiguous road map on the highway towards financial success. A coded language appears as a sure guide towards the best choice among financial or economic opportunities directly and, hence, supposes certainty in a world of uncertainty. This is illusory. From a car-driver's point of view, the end of his or her road indicates either the success of the way selected or at least its partial success. The expectations addressed towards the use of the coded language in central banking must, however, fail because the language activities of communication, meaning, and understanding are a complex task.

The presumption of a pregiven meaning of a word or sentence is, however, without doubt problematic, since the meaning is rooted neither in the intentions of the agents, nor in invariant situations. The classical view of communication neglects the functions of language, which is deemed to be neutral and, hence, a label, and communicative interaction as a principle for organizing and systematizing the ambiguity

which cannot be eliminated. The classical view of communication contradicts the modern view of language and cognitive sciences.

To achieve a meaning a word must be used several times in different contexts, practices, and circumstances. A coded language can not provide such a continuum of uses. If central banks try to act on the basis of a coded language they would adapt a given meaning of sentences independent of the context and the culture. This contradicts sharply the continuity of changing circumstances, contexts, and environments and therefore information as being subject to relationships. Moreover, it is meaningless regarding monetary policy strategy and the mandate of a central bank. In contrast to a coded language, language in use is neither a number nor a calculus which can be measured, weighed, and counted in order to give meaning to it. As Wittgenstein (1978 § 81) explained:

> We often compare the use of words with games and calculi which have fixed rules, but cannot say that someone who is using language must be playing such a game. – But if you say that our language only approximate to such calculi you are standing on the very brink of a misunderstanding. For then it may look as if what we were talking about were an ideal language. As if our logic is so to speak, a logic for a vacuum. – Whereas logic does not treat of language; and as if it took the logician to shew people at last what a proper sentence looked like.

An ideal language or language as symbolism is not appropriate for the need of understanding as Wittgenstein (1958, 25) explained:

> When we talk of language as a symbolism used in an exact calculus, that which is in our mind can be found in the sciences and in mathematics. Our ordinary use of language conforms to this standard of exactness only in rare cases.

If this premise of non-ambiguity and non-vagueness bears relevance it might seem to be the best method for a central bank to communicate with different agents in the heterogeneous financial markets. The non-ambiguousness and exactness of a coded language should lead to an understanding without being in any way misleading. It also defines the mechanism of understanding in order to avoid a discontinuity of understanding or a discontinuity generated by misleading elements. Therefore, in a coded language vagueness and ambiguity of meaning

are excluded by definition or by deductive reasoning. Furthermore, the assumption underlying a coded language implies the maintenance of a correspondence of objects with their names and properties as unique, clearly defined, exactly measurable and, hence, objective and true.

After this short review of the risks and benefits of coded language, I would like to raise the question of why precisely a coded language restricts a central bank's methods and possibilities of reacting immediately and flexibly. In my view a coded language increases the uncertainty surrounding monetary policy because a coded language does not improve understanding and does not suit a changing environment as mentioned before. One has to ask whether these methods are sufficient to guide market expectations or not. Should a central bank not aim at attempting to enlarge its set of methods? As already sketched, current empirical studies enlighten us to the importance of real-time data, that is, press conferences which mitigate uncertainty in the economy.

A coded language is a simplified form of communication; it works like a numeric sign or symbol. Any approach to the economy as a simplified model overlooks the importance of different interactions and the need of the central bank to influence the expectation-building of different agents in order to achieve its mandate of price stability. If a central bank adheres to the 'car analogy', it could attempt to apply Lewis's view that 'language conforms to regularity' to the steering of market expectations. If not, a central bank should be aiming at a common understanding.

The activity of speaking, decision-making and expectation-building processes is surrounded by uncertainty. Any of the simplified models involving an analogy to a mechanical arrangement emanates from the classical model of communication in which language and interactions by the receiving agents are eliminated. As explained, the classical model pictures communication as involving the causality between two mechanical impulses. The implementation for a coded language conforms to a behavioural regularity with such an analogical framework.

Contrary to its assumed beneficial effects, the use of a coded language will in fact create and exacerbate situations of being misled and misunderstood in financial markets. A coded language is by definition an exact and a non-vague language, whereas everyday language is not. Mundane language is characterized by non-exactness and vagueness but, it must be noted strenuously, not its meaninglessness. Vague terms and concepts are not bounded, whereas codes are. However, the boundaries of a coded language do not have any relevance to the shaping and development of monetary policy in practice (Sainsbury 1996).

Acting means that agents shape contexts and also create new contexts by their ways of acting (Kober 2002). There is no choice of whether to acknowledge the uncertainty of central banking or not. With uncertainty in the landscape, central banking needed to be anchored. It is important to emphasize that a central bank's pattern of acting structures the particular reality, that is, the environment and, hence, the relations of market interactions. Meaning and understanding cannot be anchored in an artificial system. The use of code words or signal words by a central bank does not itself provide a deeper understanding of how and when the central bank is going to take action. To understand the central bank's deeds and words as a coherent procedure requires one to perceive the central bank's talk or communicative action as embedded in the long-run framework of its mandate.

In contrast to a coded language, the use of everyday language – the language in practice – configures a certain context understood by participants of the financial market and the central bank. As a pattern of acting and a way of articulation it is impregnated by the changes of the context. Taking into account the communicative interaction between the central bank and the financial market, this ambient environment is part of the management of affairs in the contemporary world. It is configured by the articulated interactions. Therefore, it is appropriate to refer to a language-game to provide a picture of the totality of the embedded actions, rules, conventions, implications, interpretation, and persuasions of such communicative interactions.

5.2 Formal language as coded language

> Language did not emerge from some kind of reasoning. (Wittgenstein 1978 § 475)

This chapter gives some more evidence as to why the use of a coded language is not an appropriate way of achieving a central bank's mandate. A coded language implies the elimination of the arbitrariness of colloquial language. This would necessarily also imply depriving the language of its function. As was outlined, a word possesses multiple characters regarding different contexts and uses. Some of the risks of using a coded language were explained in the previous chapter. A coded language is rooted in a logical system or in an artificial system. If a language is grounded in axioms or logical principles the link to reality fails.

Scientific procedures are in general defined as objective and, hence, controllable by others. Logic, mathematics, and deductive reasoning are

accepted scientific methods. For instance, the language design of logic is reflective, analytic, and controllable. Mathematics leads to general models and formal language constructions. Logic and mathematics are driven by deductive reasoning and calculations. Deductive reasoning seems to fulfil the scientific criteria for truth and objectivity. Deductive reasoning should provide and guarantee a non-ambiguity, exactness, and precision of results, that is, the meaning. A coded language should also fulfil this demand to eliminate ambiguity, vagueness, and contextual sensitivity of the meaning of terms or concepts. However, the projection of mathematical and logical theories or axioms onto the world of experience is beyond the model world and is primarily a metaphoric approach to experience (Stekeler-Weithofer 1999, 516). The language of models and mathematics cannot be applied to experience directly but, rather, as related by analogies and projections. 'Exactness is a property of a model or formal theory and therefore limited in its proper application on real experience' (Stekeler-Weithofer 1999, 512).

> Just as poetry expressed in rhymes by no means leads to greater credibility of the poem and thus to increased ease of memorization, so do axioms and deductive premises define the sense of deductive sentences.[3]

A striking example of this failure to build up a system of a coded language in analogy to a machine was the attempt of the formal approach to language at the beginning of the twentieth century as introduced by Bertrand Russell and the early Ludwig Wittgenstein.[4]

I want to return briefly to this because it shed light on the limits on working out a theory of communication interaction based on a coded language (Muchlinski 2006). At that time a generation of scientists had attempted to build up a formal language approach to reality. The motivation was to conceptualize a complete system of formal language which should delete all ambiguity, inexactness, and vagueness from everyday language. Persuasions and convictions were to provide a scientific language for scientific processes which should fulfil all the supposed criteria of those processes. A scientific process was expected to be free of any ambiguity, inexactness, and vagueness. Scientific research should be expressed in a particular language which possesses all the criteria of non-ambiguity, exactness, and precision.

Russell explained his analytical tools in his publications on mathematics, logic, and philosophy. Shortly after these publications he opened up a discussion concerning the problems on how the meaning

of a formal language could be stated. He addressed certain problems concerning the formal language approach to science and to reality. He tried to build up a system of a formal language or coded language. He rejected his own earlier view, that is, his demand on the non-ambiguity, exactness, and non-vagueness of language. Russell (1986, 176) developed his critique of his early view on language and logic as a reflection to modern research in physics by stating that there are no simple entities such as atomic propositions in language.

Such neat assumptions of a formal language approach to reality and science were doomed to fail because the assumption of simplicity and exactness, and the atomised structure of the propositions and their meaning were themselves merely a construct by the protagonists of a formal language approach. In his lectures 'on logical atomism' in Cambridge in 1918, Russell started out by arguing that a formal language works only as a private language. Russell then abandoned the logical atomism in his approach to everyday language immediately after his lectures in 1918.[5] He went on to criticize the presumed isomorphism of a formal, that is, ideal, language, and its reality. Russell also criticized the view of a private language which neither leads to a meaning nor to an understanding because it is not shared or used by other people (Craig 1997 in Hale and Wright 1997).

Wittgenstein's *Tractatus* was influenced by Russell's thinking, and it addresses logic, logical syntax, and their relation to reality. The early Wittgenstein analyzed the relation of language and reality as an external relation. He stated that thoughts, mind, and reality were conducted by the system of logic and logical syntax alone. He defined the world as a composition structured by simple facts, that is, by logical syntax. Like Russell before 1918, the early Wittgenstein also tried to develop an ideal language and ideal language system. Such an ideal language, able to provide an analysis of the world, should be a picture of reality based on the same logical structure. The syntactical structure of the sentences should logically represent the facts as found. Objects and properties are independent of the use of language and therefore given ahead. The language only pictures the thoughts.

Wittgenstein proposed two main branches in his early work (Wittgenstein 1961): firstly, the 'doctrine of atomism' and, secondly, the 'picture theory of meaning'. Both doctrines imply the superiority of formal logic or logical syntax over everyday language. The early Wittgenstein argued, 'because language disguises thought', it is necessary to build up a logical system to organize and structure the signs and the symbols of meaning (1961, 4.002; 5.64). At the time that Wittgenstein

was concerned with his writings on *Tractatus*, he was attracted by the suggestion that logical syntax could work as a universal law and, hence, frame the language. His conclusion at that time was that propositions derive their meaning due to the logical syntax.

His 'picture theory of meaning' was based on the supposed simple entities. He conceptualized the 'picture theory of meaning' as a formal language approach to language and reality. Wittgenstein differentiated between the 'elementary proposition' and a proposition as the key elements of that picture theory. Any proposition contains simple elements, that is, it consists of 'elementary propositions'. An elementary proposition is defined as the simplest part of the proposition, in its atomic structure. The picture is determined by the logical structure of the world. To judge the truth or falsehood of a proposition or situation will depend on the correspondence of objects to reality according to a logical structure. Consequently, the structure of the reality is compared with propositions and, hence, driven by the logical syntax.

The picture theory of meaning as introduced in the *Tractatus* is based on the view of an isomorphism of the formal language approach and reality. This isomorphism was also propounded by Russell until 1918. Wittgenstein developed his picture theory as a picture theory of logical substitution. The elements of the picture are called facts because of their logical arrangement vis-à-vis other elements in this model. Facts, then, are defined logically. The structure is connected with the constituent elements logically. The picture theory of meaning should work as a measure for approaching reality and its meaning. All propositions or words are supposed to be arranged according to the logical syntax. The pictorial relation is rooted in that, too. Wittgenstein described the world or reality *as pictured through* the logical form or logical syntax.

The reader might ask, what can be said by a proposition defined as a pictorial relation? A proposition is a logical picture of a situation. Here again the dominance of the logical syntax became evident because any proposition configures its place in logical space. Also, a coded language is a picture. In contrast to the coded language, a word or sentence configures its place in the way of acting as a 'form of life'. At the end of the 1920s Wittgenstein changed his view radically – as Russell did – and stated that a private language does not imply that only one person uses this language alone but, rather, that such a person does not know if some other person means the same thing by using the same or other words. Whereas Wittgenstein in the *Tractatus* adhered to the view that meaning is rooted in the mental state, that is, the intention of a speaker, he abandoned this view in the late 1920s. The common saying that

thoughts, mental states, or intention are transmitted into a language is due to the traditional view of language as being a veil of thoughts or inner states (Trabant 1995). Articulation cannot to be separated from thoughts because the articulation is the thought itself.

Wittgenstein here made the turning point towards the meaning and understanding of sentences as rooted in their use and context. The use of language in practices does not imply the transformation of a private language into a public language, as Wittgenstein (1967b) said of this misleading view precisely: 'Here is a chair. Can you see it clearly? – Good – Now translate it into French!'

Like Russell, Wittgenstein had also undertaken fundamental theoretical upheavals at the end of the 1920s. He gave up the view that the structure of language mirrors the structure of logic. He developed his view on language as a process of language activity. Language is a pattern of acting and a way of proceeding. It is inherently connected with speaking or language in action. Language is rooted in the context and contingency, not in the causality of mechanical reactions or logical systems. A certain feature of language is that there are unlimited sentences to be created in various language-games. The network of sentences or concepts constitutes the system of the world as experienced. Although the network is changeable, nevertheless it includes entrenched sentences which are not in themselves suddenly changeable. Up to now I have referred to language approaches which describe language in its role as a means of acting. To be sure, there exist other views which are not discussed in detail here. However, to be brief about that – just to cast light on the key difference – the cognitive semantic approach defined language as an inner or mental system of categories not linked to the communicative interactions. The cognitive system itself is conceptualized as separated from human interactions because it is modelled as a mental isle which reacts to signals received. Every person is endowed with such a system. Language is seen as an amount of a parameter which can be measured and guided by a signal.[6]

The next section outlines the views of Wittgenstein. He pointed out that when we act we are acting *within a* game. There is no difference to be made between acting in a game and the use of language.

5.3 Meaning and understanding

> For such judgment, policymakers have needed to reach beyond models to broader, thought less mathematically precise, hypothesis about how the world works. (Greenspan 2004, 38)

This chapter outlines the concept of 'language-game', which seems to be appropriate to central banking communication. I will provide consideration as to why central banking should base communicative interaction on the everyday language rather than on a coded language to mitigate uncertainty in the markets. In contrast to a coded language, which has been introduced in the previous chapter as an artificial language, everyday language implies interactions in real-time reference and, hence, provides a degree of certainty to the evolvement of participation, understanding, and agreement.

The notion language-game is a concept coherently connected with working or employing language. It does not mean a 'language-play'. In using language, we do not reflect on it, we do not contemplate it, but we are simply involved as an agent in the language-game or communicative interacting. There are different language-games and a multiplicity of new types of language-games while others have become obsolete and forgotten. There exist resemblances between different language-games as interconnected nets. Not only *'times are changing' but also language-games are changing and bringing, therefore, a change in concepts and in the meaning of words.*

Wittgenstein emphasized in *Philosophical Investigation* that the language-game is the 'primary thing' which gives meaning to the sentence (1978 § 656). The 'primary thing' incorporates habits and contexts and is understandable as a pattern of language-based interaction. In (1978 § 23) Wittgenstein described the concept language-game as follows:

> Here the term language-game is meant to bring into prominence the fact that the *speaking* of language is part of an activity, or a form of life. Review the multiplicity of language-games in the following examples, and in others:
>
> Giving orders, and obeying them –
> Describing the appearance of an object, or giving its measurements –
> Constructing an object from a description (a drawing) –
> Reporting an event –
> Speculating about an event –
> Forming and testing a hypothesis –
> Presenting the results of an experiment in tables and diagrams –
> Making up a story; and reading it –
> Play-acting –
> Singing catches –

> Guessing riddles –
> Making a joke; telling it –
> Solving a problem in practical arithmetic –
> Translating from one language into another –
> Asking, thanking, cursing, greeting, praying.
> – It is interesting to compare the multiplicity of the tools in language and of the ways they are used, the multiplicity of kinds of word and sentence, with what logicians have said about the structure of language (Including the author of the *Tractatus Logico-Philosophicus*).

Wittgenstein's approach to the language-game was first discussed in lectures he gave in Cambridge, in the years 1930–32 and 1933–34, which were initially published in the 'Blue Book' and 'Brown Book', and finally published posthumously in 1953 as a single volume, titled *Philosophical Investigations*. Wittgenstein developed considerations opposed to his early view of the *Tractatus* he was once devoted to – as the last sentence in the above citation indicates.

Language-games as introduced in *PI* constitute themselves as rules and conventions, as pattern of acting in the times of their occurrence. Language-games do not follow external rules or conventions. A language-game is seen as a paradigm (*PI* § 51). 'When language-games change, then there is a change in concepts, and with the concepts the meaning of the words change' (*On Certainty*, § 65), hence the paradigm changes, too. Regarding the uncertainty surrounding the language-acting, we cannot predict how a language-game will change, but we know how it has been changed up to the present. The decision to participate and the decision building process are anchored in patterns of habits, in the inherent background of the communicative interaction, and not in artificiality. Agents learn by practicing and participating (Bernanke 2004; Ehrmann and Fratzscher 2009; Kohn 2009).

As patterns of acting, the language-games are not invariable throughout time. This is also true for the language-games of the Federal Reserve Bank (Bernanke 2009). A pattern of acting and a way of articulating, it is impregnated by the changes of the context and environment (Blinder 2006; Blinder and Krueger 2004). It is important to emphasize that a central bank's pattern of acting structures the particular reality, that is, the environment and, hence, the relations of market interactions. This is of remarkable evidence for its task in guiding market expectations. A central bank's way of acting creates the normative meaning of sentences. The 'language analogy' as proposed by Winkler to replace the mechanical analogy of central banking rests on the following

considerations: 'Language is an instrument. Its concepts are instruments' (Wittgenstein 1978 § 569). Wittgenstein agrees with Kant and Humboldt in emphasizing that only 'concepts lead us to make investigations' (ibid § 570). Concepts are embedded in the language-game as different studies on central banking in different countries have shown (see also Ehrmann and Sondermann 2009). The speaking activity of central banks and the interactions with the market create particular realities. It configures a normative context and environment. The meaning of language activity is the result of the continuity of procedures of the meaning. Market agents are not empty boxes in which the central bank is going to fill in the meaning by a certain policy of disclosure.

The new paradigm of central banks refers to modern language science indirectly. According to this interdisciplinary research, both 'matching deeds to words' (Blinder) and 'we do what we say and we say what we do' (Issing) implies no divergence between saying and doing, that is, *words* in t_1 are also *deeds* in t_1. Issing argues through this sentence that 'words' are also 'deeds' (Wittgenstein). Both sentences do not contain a commitment from t_1 towards t_{1+1}. The meaning of a sentence refers to the practice of the use of language (Wittgenstein 1978 § 43). The meaning of a sentence cannot be separated from its use in situations, context, or the way of acting, as Wittgenstein stated (1978 § 120):

> When we talk about language (words, sentences, etc.) I must speak the language of every-day. ... You say: the point isn't the word, but its meaning, and you think of the meaning as a thing of the same kind as the word, though also different from the word. Here the word, there the meaning. The money, and the cow that you can buy with it. (But contrast: money, and its use)

The meaning of a sentence cannot be conceived by a method of decomposition into its parts. As stated, concepts, sentences, and words are embedded in *changing contexts and environments*. These changes are linked to different 'forms of life' including institutions, like a monetary institution (central bank). According to the empirical finding that central banks act to reach their mandate and react to particular information in a similar way, Winkler has also outlined two consequences of the proposed 'language analogy':

1) A language in order to create 'an own specific language and corporate culture to serve their particular internal and external coordination

needs' is not desirable. It is important that sender and receiver share the 'same language' (Winkler 2000, 23–24).

2) Once a language has been trained there are benefits of language in terms of a public good insofar as words and sentences have been used in a consistent and coherent way according to changing circumstances. Winkler also stated that a central bank's information and messages needed to be anchored in a public space of judgment which also requires translating it into a language which is also known by the audience.

Winkler emphasized common understanding as elementary for the success of central banking in order to earn the coordinative benefits resulting from the efforts of aiming at a correspondence of internal and external communication:

> It is clear that there are considerable switching and learning costs involved in adapting a new language. This provides a strong case for continuity and careful, evolutionary step when modifications in the strategy become necessary unless a 'new language' is needed to signal a clear break with the past. (ibid)

Winkler referred to the habits and methods of institutions which tend to develop their own language as 'linguistic codes' (Kreps 1990). However, this language also has to be learned. I would like to add an additional consideration:

3) Given its task of steering market expectations in order to reach its mandate of price stability, a central bank has to reflect upon its own communicative interaction based on everyday language, hence as a 'language-game', in order to mitigate uncertainty in the markets and to stabilize expectation-building through a greater common understanding.

Admittedly, there are many words used daily in economic interactions and economic science which seem to possess a stable meaning, for example, economic growth, unemployment or unemployment rate, exchange rate, real interest rates, nominal and real wages, and deflator. As ongoing debates have shown, many other economic concepts, for example, price stability, sustainable growth, and exchange rate movements based on macroeconomic fundamentals, are periodically changeable and changing concepts.

As is documented by reference to selective FOMC transcripts of the Volcker era, the concepts of price stability and price movements and the concept of inflation was impregnated by two main paradigms: the monetarist view and the so-called Keynesian view. Greenspan similarly objected to implementing a numerically specified target for the Federal Reserve in order to define price stability. Blanchard, Dell' Aricca and Mauro (2010), International Monetary Fund (IMF), recently proposed to aim at an agreement between policy-makers and economists and, hence, central bankers, that price stability should be defined by 4 percent instead of the current accepted limit of 2 percent. 'Is it more difficult to anchor expectations at 4 percent than at 2 percent?' ('Should the Inflation Target be Raised?' ibid, 2010, 11). This proposal was immediately and negatively responded to by members of the European Central Bank, for instance Trichet and Bini Smaghi, among others.

> Identifying the flaws of existing policy is (relatively) easy. Defining a new macroeconomic policy framework is much harder. The bad news is that the crisis has made clear that macroeconomic policy must have many targets; the good news is that it has also reminded us that we have in fact many instruments, from 'exotic' monetary policy to fiscal instrument, to regulatory instruments. (Blanchard 2010, 10)

Many other concepts – for example, the Federal Reserve funds rate or discount rate of the Fed interest rates of money markets or bond markets, prices of option markets and prices of different good markets – work as scientific key terms. What they have in common is the fact that they do not refer to entities ontologically. Since experience can only be grasped and made through concepts, I propose that economics reflect this in its procedure of creating the meaning of concepts. Like other social sciences, economics is confronted with the relativity of the meaning of its concepts, or with the problems of context-sensitivity of the meaning and the need to focus on the understanding. Economic reality also emerges out of communicative interacting – as the current financial crisis has shown with clarity. The language-game represents the meaning of words and terms in relation to the conditions of life in society, lifestyle (Tugendhat; Wittgenstein), or lifeworld (Habermas).

Economic reality is partly constructed by particular concepts and terms (Knobloch 1999; Trabant 2009). However, the real economic facts and data deliver real economic real substances, for example, the balance of payment imbalances or international monetary relations,

currency union, and exchange rate targeting. Of course, a language-based constructed economic reality is not the whole story, if we look, for instance, at poverty, wealth, and external effects. The history of how the term 'external effects' has gained ground as a concept among economic scientists has shown, for instance, that conceptual changes and the procedures of creating new or distinct concepts and, hence, their acceptability in the community of science, occur throughout a long-lasting period of time.

Many of the above-mentioned concepts seem to work like codes because they seem to be exact, precise, and unambiguously defined words. Every agent in the market understands immediately what is meant by these concepts. Moreover, these concepts seem to possess an ontological reality because of their supposed incorporated reality and objectivity. They are understood as representatives of real economic entities which imbue information and strategies with clarity and confidence. These concepts also seem to function as an anchor for expectation-building. They are understood as real facts and as cognitive currency in the economic interactions, where they achieve their meaning in the contexts. To my view, economics as modern and self-reflecting science should not adhere to ancient principles or metaphors. Economics will not achieve acceptance and credibility by stating that economics is simply a mechanical exercise analogous to the pendulum proposed by Isaac Newton who – as Keynes (*Essays in Biography* 1942) investigated in his article 'Newton, the Man' – was himself a construct of his time:

> In the eighteenth century and since, Newton became to be thought of as the first and greatest of the modern age of scientists, a rationalist, one who taught us to think on the lines of cold and untinctured reason. I do not see him in this light. I do not think that any one who has pored over the contents of that box which he packed up when he finally left Cambridge in 1696 and which, though partly dispersed, have come down to us, can see him like that. Newton was not the first of the age of reason. He was the last of the magicians, the last of the Babylonians and Sumerians, the last great mind which looked out on the visible and intellectual world with the same eyes as those who began to build our intellectual inheritance rather less than 10.000 years ago. Isaac Newton, a posthumous child born with no father on Christmas Day, 1642, was the last wonder-child to whom the magi could do sincere and appropriate homage.

Indeed, the modern view of central banking has already started to reflect its own language-based interactions. However, economic science should more actively acknowledge the importance of language regarding the creation of economic 'facts and fictions'. One important step in this direction is to expand economic methods towards instruments that go beyond deductive reasoning. A variety of inductive methods is needed in order to obtain more clarity on language-based economics. The 'language analogy' (Winkler) should be applied to many more branches of economics. Language is a method to acknowledge, and the main instrument to create and shape the world. The language-based approach to economic issues implies that these procedures should also be part of economic science and not delegated or 'outsourced' to linguistic sciences. Economic reality is based on language construction and it is not possible to eliminate the vagueness and ambiguity of meaning by substituting it with logical constructions. The everyday language-based economy cannot be substituted by logic or deductive principles.

There exists no ideal language – not even logic or mathematics – with which to build up an economic science as an exact, non-ambiguous, and precise reality (see the argument by Russell, Ramsey, and the early Wittgenstein). An artificial language would fail since language evolves from its use in practice (Davidson 1994, 11):

> What is needed is a norm, something that provides a speaker with a way of telling (not necessarily always) that he has gone wrong, a norm the failure to satisfy which he or she will count as having gone wrong. ... Speaking in accord with socially accepted usage is such a norm, but one which, I have argued, is irrelevant to communication unless the audience of the speaker happens to speak as he does, in which case the norm is irrelevant not because it is a shared practice or convention, but because conforming to it results in understanding.

Why does such a norm matter? It provides a purpose for any speaker who wishes to be understood. Successful communication results in shared practices. The obligation, therefore, is to use words, that is, sentences, in such a way as to accomplish the purpose by being understood the way we expect. Therefore, a central bank will earn credibility by 'matching deeds to words', not by creating an artificial language that is not rooted in central bank practice itself.

> Meaning, in the special sense in which we are interested when we talk of what an utterance literally means, gets its life from those

> situations in which someone intends (or assumes or expects) that his words will be understood in a certain way, and they are. ... Thus, for me the concept of 'the meaning' of a word or sentence gives way to the concepts of how a speaker intends his words to be understood, and of how a hearer understands them. Where understanding matches intent we can, if we please, speak of 'the meaning'; but it is understanding that gives life to meaning, not the other way around. (Davidson 1994, 11)

As argued at the beginning of this chapter, a central bank's talk and language and, hence, its communication should rely on every day language. Wittgenstein gave reasons (1979 § 204) why coded language does not matter:

> Giving grounds, however justifying the evidence, comes to an end; – but the end is not certain propositions' striking us immediately as true, i.e. it is not the kind of *seeing* on our part; it is our *acting*, which lies at the bottom of language game.

Uncertainty would be enhanced by a coded language of central banking for reasons as outlined. However, in the connection of words and deeds, hence the *Thaetigkeit*, the communicative interacting as embedded in daily life and everyday language, provide certainty as a mode of agreement at hand (in the situation or language-game). Language-games constitute objects, truth, and convention insofar as agents do have confidence in the game. This is a prerequisite to participating in it. The pattern of language-based acting has been written by letters of life.

As Winkler proposed, the language analogy of the modern view of central banks should also pay attention to common understanding. What can be said about this understanding? Since the use of a concept is embedded in practice and interactions of agents and institutions, and in their expectations, goals, and the desire to be understood, the meaning and the understanding of a word or sentence depends on that contextual framework. Vagueness is characteristic of language, which is a social phenomenon. Trying to express a central bank's or central banker's statement in formal language would preclude common understanding.

Using a language is part of an activity or speech act which aims for common understanding. The meaning, implication, or interpretation still has to emerge from the interactive process involving all the

participants in the communication. The language of the actors is primarily addressed neither to names or signs, nor to things or objects. Rather, it leads to a coherence of meaning and understanding in the communicative interactions in that field, framework, or context.

Understanding is a result, and as such a capability to participate in market procedures. Since every participant plays a certain role by acting in different language-games, the use of everyday language is a way of acting. Understanding is not a mechanism which can be determined or defined by deductive reasoning or by purely mechanical elements. Understanding is not the deciphering of codes or input-output transformation. It is not deductive reasoning, like a coded language. If one says the code employed in a language corresponds to a particular sense or meaning, this does not in itself lead to a meaning and understanding but, rather, just to substitution.

Although meaning and understanding are not encapsulated in a concept, this does not imply that the text producer (for example, the central bank) offers an empty piece of paper which should be filled in by the audience's sense-giving in different contexts. We can argue that the central bank as a text producer tries to steer not only the expectations but also the attention of the audience. According to the history of language science, the subjective approach to language and understanding, wherein the listener discovers the meaning of the sent message, substituted the 'conduit metaphor' (see Chapter 1). However, a subjective approach has not been judged as an acceptable alternative. Understanding is rooted neither in mental states nor in the subjective construct of the meaning.

So where to go? If we remember that language is an activity, hence a language-game, we are able to argue that language – which is not private property – works as a public good and as an inter-subjective instrument. Understanding, which is based on the language as used in a dynamic way, echoes past events. It is the speaker, his experience of communication, his uses of the language, and the reaction from a multiplicity of listeners which echoes the understanding.

Understanding a text is interpretation, or text-based language activity. The text neither 'speaks' on its own nor is it an empty piece of paper. A text does not have a static meaning except where we attach such a static meaning to the text, such as is the case regarding instructions on how to use a machine. To understand (a text) is judging inferentially. To understand leads to further language-based activity. To understand implies participating in language-based interaction and, hence, to advance a step further. Inference from a language event or language-based event is

always embedded in knowledge and experience. Therefore, understanding is part of a language-based activity and, hence, reflexive. According to Analytical Philosophy and the modern view of language science, understanding is agreement in practice:

> [R]egularity, on agreement in action. ... We say that, in order to communicate, people must agree with one another about the meaning of the words. But the criterion for this agreement is not just agreement with reference to definitions, e.g. ostensive definitions – but also an agreement in judgments. It is essential for communication that we agree in a large number of judgments. (Wittgenstein 1983, 342–43)

As explained in current debates in central banking and also the proposal by the IMF according to a new inflation targets, different cultures generate different ways of understanding and conceptualizing transparency and communication. Empirical findings on central bank transparency and information policy strategy document that the language a central bank has chosen to express or explain its monetary strategy may differ considerably across countries and central banks. Regardless of how the mandate of a central bank is precisely established in different countries, the imperative in implementing a successful monetary policy of achieving price stability has been accepted as an 'iron law' of central banking in the economy.

6
Conclusion

Following recent scientific research, I have attempted to achieve four considerations concerning the implications and consequences of the new paradigm of central banking. I have drawn a clear distinction between a central bank's communicative interaction, hence the meaning of communication which is the key issue, and the implementation of a particular monetary policy, which is secondary.

First, I have shown that the term 'monetary mystique' (Brunner) differs from the general idea of 'mystique'. With respect to the iron law of communication theory – *'it is not possible to avoid communication'* – already accepted in social sciences and humanities, I have argued that meaning and understanding *do not arise beyond interaction* with agents of the financial markets and the central bank. Meaning and understanding are embedded in the context and environment. Therefore 'monetary mystique' described the lack of understanding and meaning. Something seems to have a 'mystique' when we do not have a full understanding of it.

I have then explained why the concepts 'matching deeds to words' (Blinder) and 'we do what we say' and 'say what we do' (Issing) are not encapsulated in a logical semantic or in deductive reasoning, but in a way of communicating action. The use of everyday language has its reference in concepts which refer to the means of acting and not to a coded language. Transparency and accountability refer to the central bank's *practice*, not to abstract premises. Achieving transparency and credibility can only be defined as a degree of transparency, or degree of credibility, because both concepts refer to the means of acting.

Secondly, I have tried to elaborate further reasons supporting why the 'language analogy' (Winkler) should replace the 'car analogy' in central bank literature. I have emphasized several aspects which describe the

changing environment of the central bank. As meaning and understanding cannot be separated from context, a coded language or formal language approach to central banking would in fact increase the uncertainty which surrounds the central bank's action. Transparency and accountability are the result of verbal and non-verbal interactions and of reciprocal relationships between a central bank and the market regarding changes in market variables and the perceived reaction by the central bank and the markets.

Thirdly, I have argued in favour of an interdisciplinary approach to central bank communication, following the proposal by Akerlof (2007). Such an interdisciplinary concept of communicative interaction is linked to the modern concepts of meaning and understanding in modern cognitive sciences and language sciences. Due to the 'language analogy' a central bank signals its verbal and non-verbal participation within a social context and reflects the reciprocal relationship with the market, which has to be perceived, interpreted, and understood.

Finally, I have proposed a conceptual framework of communicative interaction based on three dimensions, in which information is conceptualized *as a related object*. This raises the question of how the released information will be perceived and acknowledged. I have introduced an interdisciplinary perspective on how the acknowledgment, meaning, and understanding can emerge. To understand language and communicative interactions does not require reliance on a universal theory of understanding or a coded language. Any debate about a formal language approach to economics should be addressed to at least two main concerns (Morishima 1991): (a) the ontological aspect and (b) the epistemological aspect of economic reasoning. The ontological aspect concerns the focus of mathematical propositions. Do mathematical propositions say something about the mathematic system itself or about the empirical world? This question brings us to (b): The epistemological aspect deals with the question of whether we acquire and enlarge mathematical knowledge, or knowledge related to the empirical world, by the use of mathematics. Modern science abandoned the justification of causal principles by introducing conceptual investigations. The conceptual investigation was refined by Humboldt and Wittgenstein by explicating the context-sensitivity of concepts and, hence, the importance of context and circumstances regarding conceptual investigations.

Notes

Dramatis Personae

1. Blinder, Alan (1998) *Central Banking in Theory and Practice*. Cambridge, MA: 64.
2. Issing, Otmar (1999) 'The Eurosystem: Transparent and Accountable or "Willem in Euroland"'. In: *Journal of Common Market Studies*, Vol. 37, No. 3: 503-19: 508.
3. Wittgenstein, Ludwig (1978) *Philosophical Investigation*. Basil Blackwell, Oxford: § 546.

Introduction

1. I gave an appraisal of this issue: Muchlinski (2005, pp. 130–47).

1 The Way Out of 'Monetary Mystique'

1. http://www.federalreserve.gov/monetarypolicy/files/FOMC19800109meeting.pdf date of access 12.12.2009, p. 14.
2. Bailey and Schonhardt-Bailey (2005) evaluated the FOMC Transcripts of the year 1979 in order to provide textual evidence for a change of the attitudes of FOMC members towards anti-inflationary decision-making.
3. Aspects concerning foreign market and the exchange rates of the U.S. dollar were on the agenda of the meetings in the years 1979 to 1983.
4. The new wording was published in the 'Bluebook' 02/1979, pp. 19–21.
5. Chuck Partee at the conference call June 23, 1980 (ibid, p. 2): 'My only question is whether we ought to move further. I would agree with the Chairman, though, that we would want to be gradualist about this and that we have a meeting coming up not too long from now, so $400 to $500 million is acceptable to me'.
6. Furthermore 'secrecy' is, it is argued, also required in the case of a central bank's intervention in a foreign market (Chiu 2003; Fratzscher 2004, 2006). Fratzscher (2008, 149) offered new empirical findings on how exchange rates incorporate new information regarding three main channels. (1) The portfolio balance channel refers to foreign exchange interventions by central banks. (2) The signalling channel documents that long-term interest rates, stock prices, and exchange rates are significantly driven by expectations and, hence, communication and oral-intervention. The coordination channel draws attention to the 'double edged' (Amato, Shin, and Hyun 2003) of language as a function to convey information and provide an anchor for expectations-building. I turn to the so called 'double edged' function of language in chapters 5 and 6.
7. See Keynes (1936) *General Theory of Employment, Interest and Money* (1936), chapter 5.
8. Ehrmann and Sondermann (2009) provided a new empirical study according to the hypothesis that public signals minimize the volatility insofar as agents' beliefs are based on private information. The disclosure of the main

publication of the BoE (inflation report macroeconomic information) seem to be judged as 'stale over time' and hence private information has become more relevant for market driven variables (2009, 21).

9. See also chapter 2.3.2: Habermas' approach to communication and validity claims as composed of three types of validity: 'truth', 'rightness', and 'sincerity'.
10. Winkler does not adopt a 'socio-linguistic approach' as Geraats (2002) stated. For a 'socio-linguistic approach' read Coulmas (2005). Geraats revised her interpretation: see Geraats (2006).

2 A Conceptual Framework for Central Bank Communication

1. A comprehensive introduction on model of communication is provided by Strohner (2001), Rickheit, and Strohner (2008).
2. Due to this antique view the aspect of semantic was seen as unimportant, see Shannon, and Weaver (1963/1949), see also Reddy (1979) in: Ortony (ed.) (1979, 284–324).
3. In another paper, Lakoff and Johnson (1980a) contributed to the debate 'the essence of metaphor is understanding and experiencing one kind of thing in terms of another'.
4. Heuristic methods were also introduced by Kahneman and Tversky (1996), and in Tversky and Kahneman (1981) to emphasize a nonlinear and recursive process of information processing. Following the death of Tversky, Kahneman has recently enlarged the scope of the research (Kahneman and Tversky 2002); see also Brandstätter, E., Gigerenzer, G., and Hertwig, R. (2006), Gigerenzer and Brighton (2009), Gigerenzer, Hertwig and Pachur (2011).
5. Giddens, A. (1989) For further investigation on Giddens and the structuration theory as 'an attempt to work out an overall ontology of social life, offering concepts that will grasp both the rich texture of human action and the divers properties of social institutions', see Windeler (2001, 146).
6. The concept of 'indeterminacy' goes back to Quine (1959).
7. The 'Speech act theory' was founded by Austin (1962) and Searle (1969). Searle and Austin developed further the theory of speech act by integrating the language view provided by Ludwig Wittgenstein.
8. The problems of the 'speech act theory' should not be evaluated here because much work has already been done on this. See for instance, Fermandois (2000), who investigated the roots, implications, and consequences of the speech act theory in detail.
9. Early theories emphasize that communication is rooted in the sender's receptive efforts to construct an understanding (Altmann and Koch 1998). For instance, the founder of the 'radial constructivist approach', Maturana, failed to explain understanding as cognitive processing of information. He maintained the mechanical point of view of transmitting information. Also, Luhmann, who was influenced by that early constructivist approach, failed in this regard. He defined social agents, people, and institutions as 'referential systems'. Focusing on system as an autonomous entity, he eliminated the distinction between social actions, communication, knowledge,

and judgment. Any system in itself is defined as autonomous and referentially oriented as 'autopoesis' (Luhmann 1984).

10. The modified theories of information transmission today go beyond the formula Lasswell introduced in the 1940s.
11. Wittgenstein debated with Waisman, a member of the Vienna Circle, about this issue: see Wittgenstein (1967a). Wittgenstein proposed not to reconstruct intention as a mental state since the understanding of symbols, words or sentences occurs by the articulation in practice, that is, the use of language (Muchlinski 2006). Language is not neutral towards thoughts.
12. Stekeler-Weithofer (1999) proposed six criteria for communication: clarity, truth, explicitness, relevance, realism, and charity.
13. See also Künne (1990, 212–36).
14. Heath (2001, 23) proposed reading Habermas in the light of game theory approach. Heath differentiated between 'strategic action' and 'communicative action'. Whereas strategic actions refer to game theory – for instance, common knowledge, rational action alternatives and an acquainted probability distribution – communicative actions refer to a public realm created by language activity in order to solve coordinative problems.
15. Stekeler-Weithofer (2004, 180) concluded Davidson failed to develop his theory towards a theory of communication.
16. See chapter 2.3. On further introduction to miscommunication, see: Parret (1994), Taylor (1992).

3 Central Banking and Communication As a Function of Circumstance

1. Cukierman (2002, 15–35) gives an introduction to three main types of central bank transmission models, which are based on three different types of expectations hypotheses – the expectations-augmented Phillips curve (model 1), the fully backward-looking pricing model (2) and (3) a New Keynesian Transmission Mechanism with Forward-Looking Pricing model. The core premise of model, for example, is that changes in the expectations of future variables, prices or interest rates fundamentally affect current pricing behaviour. Cukierman also stated that two elements of the central bank's context and environment remain opaque: the Federal Reserve Bank's model and objectives. This is also the case of other central banks in industrialized countries because central banks are not willing to disclose 'their' model to the public.
2. Further analyses and contributions to this issue are also to be found in the conference 'Getting the Markets In Synch with Monetary Policy', Proceedings of the Twenty-Sixth Annual Economic Policy Conference of the Federal Reserve Bank of St. Louis, in *Federal Reserve Bank of St. Louis, Review*, July/August 2002, Vol. 84, No 4.
3. The Taylor Rule has been extensively discussed in Orphanides and Williamson (2005) among many other contributions.
4. Bernanke (2004a) referred to the biographer of Montagu Norman, a former governor of the Bank of England.

5. To give a complete list of the contributions here would take up a great deal of space; see, for example, Blinder (2009), Ehrmann and Sondermann (2009).
6. Among the literature on this topic, see, Ehrmann and Fratzscher (2009, 2007a, 2007b, 2005a, 2005b, 2003), Fracasso et al. (2003), Heinemann and Ulrich (2005), Schmidt and Ullrich (2006), Berger, de Haan, and Sturm (2006).
7. The *International Herald Tribun*e reported: 'the Growing Greenspan Role Worries Some' (Friday, October 2001). 'Greenspan has been everywhere in guiding economic policy in the wake of the terrorist attacks – slashing interest rates, helping to get Wall Street running again, shaping the tax cuts being developed by the Congress and evaluating which airlines should receive government loan guarantees.' Politics became wary of the greater influence of the monetary policy in their own terrain, whereas some economists feared that the Federal Reserve would be too involved in politics and hence lose its independence.

4 Economics and Language

1. I should repeat here that I do not turn to contributions of the game theory and experimental research on game theory and public good experiments. See: Brosig, Jeannette/Weimann, Joachim/Ockenfels, Axel (2003).
2. I do not prefer the traditional view of economics as proposed by Friedman (1953), who followed Popper (1934). For an overview and criticism of this traditional view, see Dunn and Maddala (1996), Kuhn (1962), and Mirowski (1988).
3. For an approach on modern institutions, see McCloskey (1994).
4. FRB means the Federal Reserve Board: the FRB/US model focused on the U.S. Economy and the FRB/Global on the United States and the Rest of the World Economy (R.O.W.).
5. 'VAR expectations are identical to the forecasts of a small vector autoregression (VAR) model that includes equations for a few key economic measures. This is another option for expectations formed used in FRB/US', Brayton et al. (1997a: 228).
6. Russell (1905, 1914) provided different examples in order to discuss the problem with truth condition; see also Künne (1990, 1993); see also Dascal (1994, 323–34).
7. For conceptual investigation on the historical lines of modern view of language, see Trabant (2003).
8. 'It is, a priori, clear that in analysing we must arrive at simple components – is this, e.g. involved in the concept of analysis –, or is analysis ad infinitum possible? – Or is there in the end even a third possibility? ... And it keeps on forcing itself upon us that there is some simple indivisible, an element of being, in brief a thing', Wittgenstein (1979) *Notebooks 1914–1916*.
9. The controversy in the literature about that issue should not be repeated here. See Scholz (2001), Stekeler-Weithofer (1999), Lakoff (1977, 79–106).
10. This view has been enlarged to a research area, for instance see Beton.
11. Scholz (2001^2: 111, 196, 204ff.), ibid.

12. Wilhelm Quine (1908–2000), an American logician and philosopher, who taught at Harvard. He was influenced by Bertrand Russell (1872–1970) a British logician and philosopher.
13. Lewis referred to Schelling (1960).
14. Research on that field of cognitive sciences, economics, and rationality is provided by Gigerenzer (2004a).

5 Language, Expectations, and Circumstances

1. See Trabant (1998, 1999, 2003, 2009).
2. The term Analytical Philosophy encompasses both the roots of Analytical Philosophy (see Dummett 1993; Nagel 1974) and the current state of Analytical Philosophy which could be categorized by different branches, for instance, the rejection of metaphysics (Frege, Moore, Ramsey, Russell, and the early Wittgenstein), the Vienna Circle and Positivism (Carnap, Hahn, Neurath) and the Language Philosophy or 'linguistic turn' (Austin, Brandom, Ryle, Searle, Tugendhat, the late Wittgenstein).
3. 'So wenig wie eine poetische Form, etwa Rhythmus und Reim, die Glaubwürdigkeit der mit ihrer Hilfe erlernbaren Merksätze erhöht, so wenig definieren Axiome und Deduktionsregeln die Wahrheit der deduzierbaren Sätze' (Stekeler-Weithofer 1999, 512).
4. The 'early Wittgenstein' concerns the *Tractatus Logico-Philosophicus* – quoted as *Tractatus* – he published in 1918. Shortly after publication he had started to criticize his *Tractatus*. Also Russell, Ramsey, and Keynes addressed their criticisms to that view on language (see Muchlinski 2011).
5. In contrast to Russell and Wittgenstein, Carnap (1928) tried to improve his view that language and reality are driven by logical syntax.
6. Criticisms addressed to this view are given by Trabant (1998).

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TREASURE ISLANDS Uncovering the Damage of Offshore Banking and Tax Havens

NICHOLAS SHAXSON

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PROLOGUE
An Offshore Awakening

ONE NIGHT IN SEPTEMBER 1997 I RETURNED home to my flat in North London to find that a man with a French accent had left a message on my answering machine. Mr. Autogue, as he called himself, had heard from an editor at the Financial Times (whom I was writing for) that I was to visit the oil-rich country of Gabon on Africa's western coastline, and he said he wanted to help me during my visit. He left a number in Paris. Curious as hell, I rang back the next morning.

This was supposed to be a routine journalist's trip to a small African country: I wasn't expecting to find too much to write about in this sparsely populated former French colony, but the fact that English-speaking journalists almost never ventured there meant I would have the place all to myself. When I arrived, I discovered to my surprise and alarm that Mr. Autogue had flown out to the capital of Libreville with an assistant on first-class Air France tickets and they had booked themselves into the city's most expensive hotel for a week—and their sole project, he cheerfully admitted, was to help me.

I had spent years watching, living in, and writing about the curve of oil-soaked African Atlantic coastline that ranges from Nigeria, in North Africa, through Gabon and down to Angola, farther south. Today this region supplies almost a sixth of U.S. oil imports[1] and about the same share of China's; and beneath a veneer of great wealth in each place lies terrible poverty, inequality, and conflict.

Journalists are supposed to start on the trail of a great story somewhere dramatic and dangerous. I found my story here unexpectedly, in a series of polite if unsettling meetings in Libreville. Lunch with the finance minister? No problem: Monsieur Autogue arranged it with a phone call. I drank a cocktail in a hotel lobby with the powerful half-Chinese foreign minister Jean Ping, who later became president of the U.N. General Assembly; the estimable Mr. Ping gave me as much of his time as I needed for my interview and asked graciously about my family. Later, the oil minister clasped me by the shoulder and jokingly offered me an oil field—then withdrew his hand, saying, "No: these things are only for les grands—the people who matter."

Never more than five hundred yards from foul African poverty on the streets of Libreville, I spent a week wandering about in a bubble. Mr. Autogue's attempts to keep my diary full made me determined to find out what it was that he might be wanting to hide. My new best friend had opened for me a zone of air-conditioned splendor: I was ushered to the front of queues to meet with powerful people, who were always delighted to see me. This parallel, charmed world, underpinned by the unspoken threat of force against anyone inside or outside the bubble who would disrupt it, is easy to miss in the affluent and easy West. In Africa the jolt was enough to begin to shake me from my sleep.

I had stumbled into what later became more widely known through a scandal in Paris as the so-called Elf affair.

The scandal began in 1994 when U.S.-based Fairchild Corp. opened a commercial dispute with a French industrialist, triggering a stock exchange inquiry. Unlike in more adversarial Anglo-Saxon legal systems, where the prosecution jousts with the defense to produce a resolution, the investigating magistrate in France is more like an impartial detective inserted between the two sides. He or she is supposed to investigate the matter until the end, when the truth is uncovered. In this case Eva Joly, the Norwegian-born investigating magistrate, found that every time she investigated something new leads would emerge. Her probes just kept going deeper. She began receiving death threats: A miniature coffin was sent to her in the post, and on a raid of one business she found a Smith & Wesson revolver, fully loaded and pointed at the entrance. But she persisted: Other magistrates became involved, and as the extraordinary revelations began to accumulate, they began to discern the outlines of a gigantic system of corruption that connected the French state-owned oil company Elf Aquitaine with the French political, commercial, and intelligence establishments, via Gabon's deeply corrupt ruler Omar Bongo.

Bongo's story is a miniature tale of what happened when France formally relinquished its colonies. As countries in Africa and elsewhere gained independence, the old beneficiaries of the French empire set up new ways to stay in control behind the scenes. Gabon became independent in 1960, just as it was starting to emerge as a promising new African oil frontier, and France paid it particular attention. France needed to install the right president: an authentic African leader who would be charismatic, strong, cunning, and, when it mattered, utterly pro-French. In Omar Bongo they found the perfect candidate: He was from a tiny minority ethnic group and had no natural domestic support base, so

he would have to rely on France to protect him. In 1967, aged just 32, Bongo became the world's youngest president, and for good measure France placed several hundred paratroopers in a barracks in Libreville, connected to one of his palaces by underground tunnels. This intimidating deterrent against coup plots proved so effective that by the time Bongo died in 2009, he was the world's longest-serving leader.

In exchange for France's backing Bongo gave two things. First, he gave French companies almost exclusive access to his country's minerals, on highly preferential terms that were deeply unfair to the people of Gabon. The country became known as French companies' chasse gardée—their private hunting ground. But the second thing Bongo provided was more interesting. He allowed his country, through its oil industry, to become the African linchpin of the gigantic, secret Elf system—a vast, spooky web of global corruption secretly connecting the oil industries of former French African colonies with mainstream politics in metropolitan France, via Switzerland, Luxembourg, and other tax havens. Parts of Gabon's oil industry, Joly discovered as she dug deeper and deeper in Paris, had been serving as a giant slush fund: a pot of secret money outside the reach of French judicial authorities in which hundreds of millions of dollars were made available for the use of French elites. An African oil cargo would be sold, and the proceeds would split up into a range of bewildering accounts in tax havens, where they could be used to supply bribes and baubles for whatever the unaccountable elites who controlled the system deemed fit.

Out of this pot, money flowed secretly to finance French political parties, the intelligence services, and other well-connected parts of French high society. Elf's secret money greased the wheels of French political and commercial diplomacy around the globe: France's biggest corporations were allowed to use this West African oil pot as a source of easy bribe money to support their bids for giant contracts ranging from Venezuela to Germany to Jersey to Taiwan—and the out-of-sight Gabon connection meant that the money trails did not lead to them. (One man told me how he once carried a suitcase of cash provided by Omar Bongo to pay off a top rebel separatist in the Angolan oil enclave of Cabinda, where Elf had a lucrative contract.)

President Bongo, for his part, was one of the smartest political operators of his generation and tapped into French Freemasonry networks and African secret societies to become one of the most important power brokers in France itself. He was the key to French leaders' ability to bind les grands—opinion-formers and politicians from

across Africa and beyond—into France's postcolonial foreign policy. This immensely powerful, corrupt subterranean system helped France punch above its weight in global economic and political affairs and remain significantly in control after independence, behind the scenes. A local

journalist summed the relationship up for me most effectively. “The French went out of the front door,” he said, “and came back in through a side window.”

The system emerged gradually, but by the 1970s it was already serving as a major secret financing mechanism for the main French right-wing party, the Rally for the Republic (RPR).[2] When a Socialist, François Mitterrand, became French president in 1981, he sought to break into this right-wing Franco-African offshore cash machine and installed his man Loïk le Floch-Prigent at the head of Elf to do the job. But the latter was wise enough not to cut out his rivals in the RPR. “Le Floch knew that if he cut the financing networks to the RPR and the secret services, it would be war,” explained the French authors Valerie Lecasble and Airy Routier in an authoritative book on the affair.[3] “It was explained that, instead, the leaders of the RPR—Jacques Chirac and Charles Pasqua—did not mind the Socialists taking part of the cake, if it were enlarged.” So the Elf system grew. It became more baroque, complex, and layered, and it began to branch out into international corruption so grand that Mitterrand’s man le Floch-Prigent was moved to describe France’s intelligence services, which dipped freely into the slush, as “a great brothel, where nobody knows any more who is doing what.”[4]

The system was a kind of open secret: A few well-connected French insiders knew all about it, and a fair number of educated outsiders in France knew something important was afoot but didn’t know the details and largely ignored it. Yet almost nobody could see the whole thing in overview. Everything was connected through tax havens. The paper trails, as the magistrates were discovering during my Libreville trip, were typically sliced among Gabon, Switzerland, Liechtenstein, Jersey, and beyond. Joly admitted that even though she probed deeply she only ever saw fragments of the whole picture. “Endless leads were lost in the shifting sands of the tax havens. The personal accounts of monarchs, elected presidents-for-life, and dictators were being protected from the curiosity of the magistrates.”[5]

My trip to Gabon in late 1997 came at an exquisitely sensitive time. On November 7 of that year, less than a week after I left Libreville, Christine Deviers-Joncour, a former lingerie model, was sent to jail in the southern suburbs of Paris, still protecting the secrets of her lover Roland Dumas, the French foreign minister. She was jailed for suspected fraud after magistrates found that Elf had paid her over $6 million to help “persuade”

Dumas, a haughty prince of the Paris political clans, to do certain things—notably to reverse his public opposition to the sale of Thomson missile boats to Taiwan. On an Elf credit card she had bought him gifts, including a pair of hand-made ankle boots from a Paris shop so exclusive that its owner offered to wash customers' shoes once a year in champagne. Nobody thanked her for her discretion, and five and a half months in jail gave her time to reflect on her treatment. "A flower, a single flower, even sent to me anonymously [in jail] would have been enough," she later explained.[6] "I would have known it came from Roland." The following year she cast aside the code of silence and published a book, The Whore of the Republic, which became a best seller in France.

So when I visited Gabon at that especially tricky moment, the Elf networks must have wondered why this English journalist was nosing around in Libreville. Was I really a journalist? No wonder Mr. Autogue took such an interest in me. Recently, I tried to find him, to ask him about our week together. His old phone numbers no longer work, several Africa experts in Paris hadn't heard of him, Internet searches turned up no trace of him or the company he claimed to represent, and the only person with that name in the French phone book has, a surprised-sounding wife in a rural Dordogne village informed me, never been to Gabon.

The Elf system, when I visited, was dying. The magistrates' investigations were in full swing, and they finally secured 31 convictions in November 2004 after eight years' work. Elf Aquitaine has since been privatized and is now part of the Total group, which has an utterly different character from the old Elf. Still, Elf was not the only creature in the corrupt Franco-African system—myriad smaller pots of offshore money existed too. And though Elf is long gone, it seems that the system is not really dead. When President Nicolas Sarkozy of France came to power in 2007 the first person he called was not the president of Germany or the United States or the European Commission but Omar Bongo. The French troops remain in place in Gabon today, connected by underground tunnels to the presidential palace. In January 2008 the French aid minister, Jean-Marie Bockel, complained that a "rupture" with a corrupt past that French leaders had promised "is taking its time to arrive." He was summarily sacked.[7] If the Elf system is dead, then French elites seem to have replaced it with something else.

Gabon is on no list of tax havens anywhere. But the Elf system that it hosted was part of, and a metaphor for, the offshore world. To understand this, it is necessary to explain some fundamental truths about what a tax haven or offshore jurisdiction is.

Tax havens provide escape routes from rules and laws elsewhere. These two words, "escape" and "elsewhere," will crop up repeatedly in this book. The zero tax rates offered in the Cayman Islands, for example, are not designed for Caymanians but are set up to attract the business of North and South Americans, Europeans, Asians, Middle Easterners, and Africans alike.

In truth, the term tax haven is a bit of a misnomer because these places offer an escape not just from taxes but from many other rules and regulations too. If a person or entity wants to do something but is forbidden by law from doing it at home, it escapes to somewhere else to do it. (To be more precise, it isn't usually the entity but its money that escapes.) The common feature of tax havens is that they offer secrecy. Once the escape has been effected, the escapee is very hard to find. The users of tax havens might be escaping any number of different laws or regulations: taxes, criminal laws, insider trading rules, inheritance rules, environmental laws, or financial regulation. If there is a law to stop or regulate it, there will probably be places that offer escape routes from that law. A simple example of an offshore escape is when a U.S. citizen, say, parks $10 million of drug money in a bank account in Panama. It will be exceedingly difficult for the U.S. authorities to find that money, let alone tax it.

The Elf system allowed bribes to be paid and other nefarious acts to be committed elsewhere—without the paper trails touching French soil. Offshore. The system did not exactly exist anywhere: It flourished in the gaps between jurisdictions. Elsewhere became nowhere.

The Elf affair illustrates another fundamental offshore truth. The escape routes from the rules and laws of society are provided almost exclusively for the benefit of wealthy and powerful insiders—leaving the rest of us to pick up the bill. The Elf system, a gargantuan octopus of corruption, affected ordinary people in both Africa and France in the most profound, if mostly invisible, ways. Ordinary African citizens saw their nations' oil money being siphoned off to the rich world through unfair oil contracts and general corruption, while French protection made Gabon's leaders invulnerable and hence unaccountable to their citizens—at the same time that the Elf system made France's elites unaccountable to that nation's citizens too.

These very same principles apply to the offshore system more generally. Because of tax havens, we have ended up with one set of rules for the rich and powerful and another set of rules and laws for the rest of us—and this applies to citizens of rich and poor countries alike. Just like the Elf system, offshore is a project of elites against their, and our, societies. It is not so much

about crime or taxes, important though they are. This is a story about how political power is distributed in the world today.

It is essential to understand from the outset that the offshore system is ultimately not about celebrity tax exiles and mobsters—though they are regular users of the system. It is about banks and financial services industries. This book will show that the offshore system is the secret underpinning for the political and financial power of Wall Street today. It is the fortified refuge of Big Finance.

The offshore system is also about a more generalized subversion of democracy by our increasingly unaccountable elites. "Taxes are for the little people," the New York millionaire Leona Helmsley once famously said. She was right, though in the end she wasn't big enough to escape prison herself. The media baron Rupert Murdoch is different. His News Corporation, which owns Fox News, MySpace, and any number of other media outlets around the globe, is a master of offshore gymnastics, using all legal means available. When The Economist magazine investigated in 1999, it reckoned that News Corporation paid a tax rate of just 6 percent—compared with 31 percent for its competitor Disney.[8] Neil Chenoweth, an Australian reporter, probed News Corporation's accounts and found that its profits, declared in Australian dollars, were A$364,364,000 in 1987, A$464,464,000 in 1988, A$496,496,000 in 1989, and A$282,282,000 in 1990. [9] The obvious pattern in these numbers cannot be a coincidence. As John Lanchester wrote in the London Reviewof Books: "That little grace note in the sums is accountant-speak for 'Fuck you.' Faced with this level of financial wizardry, all the ordinary taxpayer can do is cry 'Bravo l'artiste!'"

Much of what happens offshore is technically legal. A lot of it is plainly illegal and often criminal. And there is a vast gray area in between. All of it is profoundly dangerous, corrosive to democracy, and morally indefensible. Eva Joly explains what the Elf affair taught her about the distribution of power in the world. "I realized I was no longer confronted with a marginal thing but with a system," she said. "I do not see this as a terrible, multifaceted criminality which is besieging our [onshore] fortresses. I see a respectable, established system of power that has accepted grand corruption as a natural part of its daily business."[10]

From this strange Franco-African tale emerges one more important point, which will be a recurring theme of this book. In decades and centuries past, colonial systems helped rich countries preserve and boost their elites' wealth and privileges at home. When the European powers left their colonies after the Second World War, they replaced

formal controls over their ex- colonies with different arrangements to retain a measure of control behind the scenes. The Elf system was the main way that France achieved this. Britain did it with the modern offshore system, its financial replacement for empire. Citizens of the United States are paying the price.

> "It has taken me a long time to understand," explains Joly, "that the expansion in the use of these jurisdictions [tax havens] has a link to decolonization. It is a modern form of colonialism."[11]

Long before my first visit to Libreville I had noticed how money was pouring out of Africa, often into tax havens, but the secrecy surrounding this financial trade made it impossible to trace the connections. Financial institutions, and occasionally their accountants and lawyers, would surface in particular stories, then slip back into an offshore murk of commercial confidentiality and professional discretion. Every time a scandal broke, these intermediaries' crucial roles escaped serious scrutiny. Africa's problems, the story went, had something to do with its nations' rulers, or its cultures and societies, or the oil companies. It was their fault.

The providers of offshore secrecy were clearly a central part of all these dramas—but the racket was very hard to penetrate, and nobody seemed very interested in trying. It was only in 2005 that the threads properly started to come together for me. I was sitting with David Spencer, a New York attorney previously with Citicorp, talking about transparency in the public finances of West African oil-producing nations. Spencer was getting agitated about matters that were not at all on my agenda: accounting rules, U.S. tax exemptions on interest income, and transfer pricing. I was wondering when he was going to start talking about West African corruption when I finally began to make a serious connection. The United States, by offering tax incentives and secrecy to lure money from overseas, had been turning itself into a tax haven.

Tides of financial capital flow around the world in response to small changes in these kinds of tax and secrecy incentives. The U.S. government needs foreign funds to flow in, and it attracts them by offering tax-free treatment and secrecy. This is offshore business, Spencer explained, and it had become central to the U.S. government's global strategies for financing its deficits. Not only did almost nobody

understand this, he continued, but almost nobody wanted to know. Once, when he gave a speech at a major United Nations event outlining some of these basic principles, a top U.S. negotiator collared him afterward and told him that his shedding light on this subject made him "a traitor to your country." The negotiator was wrong: Spencer was being disloyal only to offshore interests on Wall Street.

In the Harvard Club with Spencer I began to see how the terrible human cost of poverty and inequality in Africa, Latin America, and other parts of the world connected with the apparently impersonal world of accounting and financial regulations and tax law. Africa's supposedly natural or inevitable disasters all had one thing in common: the movement of money out of poor countries and into parts of Europe and the United States, assisted and encouraged by the tax havens and a pinstripe army of respectable bankers, lawyers, and accountants. Nobody wanted to look beyond poor countries at the system that made this movement possible. The U.S. government and many others have allowed tax havens to proliferate because the elites who use them are the world's most powerful lobbyists.

Martin Woods, a Wachovia bank employee who became a whistle-blower after seeing billions of suspect dollars flowing from currency houses in Mexico in the midst of a drug war, illustrates the problem clearly. "If you don't see the correlation between the money laundering by banks and the twenty-two thousand people killed in Mexico," he said, "you're missing the point."[12] The world has, it seems, been determined to miss the point.

The offshore system hadn't been just an exotic sideshow in the stories I was covering, as I had thought. Offshore was the story. It binds together Libreville, Paris, and Jersey; Luanda, Geneva, and Moscow; Moscow, Cyprus, and London; Wall Street, Mexico City, and the Cayman Islands; Washington, the Bahamas, and Riyadh. Offshore connects the criminal underworld with financial elites and binds them together with multinational corporations and the diplomatic and intelligence establishments. Offshore drives conflict, shapes our perceptions, creates financial instability, and delivers staggering rewards to les grands, the people who matter. Offshore is how the world of power now works. This is what I want to show you. The offshore system is the greatest fault line in our globalized world.

An impression has been created in sections of the world's media, since a series of stirring denunciations of tax havens by world leaders in 2008 and 2009, that the offshore system has been dismantled or at least

suitably tamed. As we shall see, exactly the opposite has happened. The offshore system is in robust health—and growing fast. The crackdown has turned out to

be a whitewash.

WELCOME TO NOWHERE
An Introduction to Offshore

THE OFFSHORE WORLD IS ALL AROUND US. Over half of world trade passes, at least on paper, through tax havens. [1] Over half of all bank assets, and a third of foreign direct investment by multinational corporations, are routed offshore.[2] Some 85 percent of international banking and bond issuance takes place in the so-called Euromarkets, a stateless offshore zone that we shall soon explore.[3] Nearly every multinational corporation uses tax havens, and their largest users—by far—are on Wall Street.[4]

Tax havens don't just offer an escape from tax. They also provide wealthy and powerful elites with secrecy and all manner of ways to shrug off the laws and duties that come along with living in and obtaining benefits from society—taxes, prudent financial regulation, criminal laws, inheritance rules, and many others. Offering these escape routes is the tax havens' core line of business. It is what they do.

Before getting into the real story of offshore, this chapter will lay some basic groundwork for understanding tax havens, offering a few essential principles, some brief history, and a short overview of where the tax havens are located.

Nobody agrees exactly what a tax haven is, but I will offer a loose description here: It is a place that seeks to attract money by offering politically stable facilities to help people or entities get around the rules, laws, and regulations of jurisdictions elsewhere.[5] This definition is quite broad, compared to some others, and I have chosen it for two main reasons. First, I aim to challenge a common idea that it is perfectly OK for one jurisdiction to exercise its sovereign right to get rich by undermining the sovereign laws and rules of other places. Second, I am

offering a lens through which to view the history of the modern world. This definition will help me show how the offshore system is not just a colorful appendage at the fringes of the global economy but rather lies at its very center.

I should also make a short point here about some confusion in the language. When I say “offshore,” I obviously am not referring to offshore oil drilling. I am also not talking about “offshoring,” which is what happens when a company moves a manufacturing plant or, say, a call center from the United States to India or China, perhaps to save on labor costs. When I say “offshore,” I am talking about the artificial movement or use of money across borders, and about the jurisdictions, commonly known as tax havens, that host and facilitate this activity. Once the money has escaped offshore, it is reclassified in an accountant’s ledger and it assumes a different identity—and that means, very often, that the forces of law and order will never find it.

A number of features help us spot tax havens. Here are some important ones.

First, as my colleagues have found through painstaking research, all tax havens offer secrecy, in various forms. The term secrecy jurisdiction emerged in the United States in the late 1990s, and in this book I will use it interchangeably with tax haven. I will call the whole global structure of these places, and the private infrastructure that services them, the offshore system.

Another common marker for tax havens is very low or zero taxes, of course. People and corporations use them to escape tax, legally or illegally. Secrecy jurisdictions also have very large financial services industries in comparison to the size of the local economy. These places also routinely “ring-fence” their own economies from the facilities they offer to protect themselves from their own offshore tricks. So they might, for example, offer a zero tax rate to nonresidents who park their money there but tax local residents fully. This ring-fencing is a tacit admission that what they do is harmful.

Various other telltale signs exist. Tax havens usually deny what they are and strenuously assert that they are clean. Search for “We are not a tax haven” on the Internet or “We are a transparent, well regulated, and cooperative jurisdiction,” and see what comes up. Each has its own way of addressing the critics: In the Cayman Islands, for example, accusations of lax regulation after scandals are routinely dismissed as media stereotypes that do not correspond to objective reality.[6]

But there is one feature of a secrecy jurisdiction that stands out above

all: that local politics is captured by financial interests from elsewhere (sometimes these financial interests are criminal interests). This is why I include "politically stable" in my definition: Meaningful opposition to the offshore business model will have been neutered in a serious tax haven, so that such irritants as local politics cannot interrupt the business of making money. And here lies one of the great offshore paradoxes: These zones of ultra-freedom for financial interests are so often repressive places, viciously intolerant of criticism. The offshore world is steeped in a pervasive inverted morality: Turning a blind eye to crime and corruption has become good business practice: a way of attracting money; while alerting forces of law and order to wrong-doing has become the punishable offense. Here in the tax havens, rugged individualism has morphed into a disregard, even a contempt, for democracy and for societies at large.

One of the first things to understand about offshore business is that it is, at heart, about artificially manipulating paper trails of money across borders. To get an idea of how artificial it can be, consider the banana.

A bunch of bananas typically takes two routes into your home: a real route and an artificial offshore paper trail. On the first route a Honduran worker, say, is employed by Big Banana, a U.S. multinational I've just invented, to pick the bananas, which are then packaged and shipped to Britain, sold to a supermarket, and sold on to a customer.

The second route—the accountants' paper trail—is different. When a banana is picked in Honduras and shipped to Britain and sold, where are the final profits generated? In Honduras? In the British supermarket? In the multinational's U.S. head office? And how do you work this out? How much do the corporation's management expertise, or the brand name, or the insurance, or the accounting business, contribute to profits and costs? Which country ought to tax each component of the final

profit? Nobody can say for sure, so the accountants can, up to a point, decide for themselves.

Here, in simple form, is what they might do. They advise Big Banana to run its purchasing network from, say, the Cayman Islands, and put a financial services subsidiary in Luxembourg. The Big Banana brand might be parked in Ireland; its shipping subsidiary in the Isle of Man; it might locate certain parts of its "management expertise" in Jersey, and its insurance arm in Bermuda. All are tax havens.

Next, each part of this multinational charges the other parts for the services they provide. So Big Banana's Luxembourg finance subsidiary might lend money to Big Banana Honduras, then charge that Latin American subsidiary $10 million per year in interest payments for that loan. The Honduran subsidiary will deduct this $10 million from its local profits, cutting or wiping out its local profits (and consequently its tax bill) there. The Luxembourg finance subsidiary, however, will record this $10 million as income—but because Luxembourg is a tax haven, it pays no taxes on this. With a wave of an accountant's wand, a hefty tax bill has disappeared. Who is to say that the $10 million charged by Big Banana Luxembourg is the real going rate—or just an accountant's invention? Quite often it is hard to tell, although sometimes these prices are adjusted so aggressively that they lose all sense of reality: A kilo of toilet paper from China has been sold for $4,121.81, a liter of apple juice has been sold out of Israel at $2,052, and a ballpoint pen has been recorded leaving Trinidad valued at $8,500.

Though most examples are far less blatant than this, the cumulative total of these shenanigans is vast. About two-thirds of global cross-border world trade happens inside multinational corporations. And it is poor countries in particular, with their underpaid tax officials, that always lose out to multinationals' aggressive, highly paid accountants.

What Big Banana has done here is transfer pricing (or mispricing), a common offshore trick that U.S. Senator Carl Levin calls "the corporate equivalent of the secret offshore accounts of individual tax dodgers." The general idea is that by adjusting its internal prices a multinational can shift profits offshore, where they pay little or no tax, and shift the costs onshore, where they are deducted against tax. In the banana example, tax revenue has been drained out of a poor country and into a tax haven and funneled through to the wealthy owners of a multinational corporation. In October 2010 a Bloomberg reporter explained how Google Inc. cut its taxes by $3.1 billion in the previous three years through transfer pricing games known by names such as the "Double Irish" and

"Dutch Sandwich," ending up with an overseas tax rate of 2.4 percent.[7] The problem is getting worse. Microsoft's tax bill has been falling sharply, for similar reasons. Cisco is at it.[8] They are all at it. Transfer pricing alone cost the United States an estimated $60 billion a year[9]—and that is just one form of the offshore tax game.

Worldly readers may still shrug and tell themselves that this is just part of the ugly flipside of living in a rich nation. If they do, in their reluctantly cynical way, they are suckers—for they are victims, too. The tax bill is cut not only in Honduras but in Britain and America too. The annual report of a real banana company listed in New York notes: "The company currently does not generate U.S. federal taxable income. The company's taxable earnings are substantially from foreign operations being taxed in jurisdictions at a net effective rate lower than the U.S. statutory rate."[10] (Rough translation: We don't currently pay U.S. taxes because we use tax havens.)

This may be quite legal—but when it happens, small businesses and ordinary folk must step in to pay the taxes that multinationals have escaped. "Small businesses are the lifeblood of local economies," said Frank Knapp, member of a new group formed in 2010 called Business and Investors Against Tax Haven Abuse. "We pay our fair share of taxes, shop locally, support our schools, and actually generate most of the new jobs. So why do we have to subsidize multinationals that use offshore tax havens to avoid paying taxes?"

Multinationals, it has to be said, find it hard to cut their taxes to zero because governments take countermeasures. But it is a battle the governments are losing. The U.S. Government Accountability Office reported in 2008 that two-thirds of American and foreign companies doing business in the United States avoided income tax obligations to the federal government in the years 1998–2005, despite corporate sales totaling $2.5 trillion.[11] Not only this, but the corporate transfer pricing abuses that I have just described are just one of several forms of tax abuse. Subsequent studies suggest the problem is getting worse.[12]

Transfer mispricing is one of the most important reasons that multinationals are multinationals and why they usually grow faster than smaller competitors. Anyone worried about the power of global multinationals should pay attention to tax havens.

It is not just your bananas, of course. Much of the food you eat will most likely have taken a similarly twisted route into your home. The

water in your tap may have traveled on a similarly ghostly paper pathway en route to your bathtub. Your television, its component parts, and many of the programs it shows also likely took offshore routes into your living room. The offshore world envelops us.

All these offshore games make markets profoundly inefficient. Wealth has been transferred from poor taxpayers to rich shareholders—but nobody has produced a better or cheaper banana here. These are untargeted government subsidies for multinationals, courtesy of the tax havens, and they don't make multinationals more productive. When corporate managers focus on tax dodging they take their eyes off what they do best—making better goods and delivering them more cheaply to market. Add to that the time and billions wasted paying expensive accountants and lawyers to conjure up these schemes. And then there is the secrecy. A fundamental building block of modern economic theory is transparency: Markets work best when two sides to a contract have access to equal information. Treasure Islands explores a system that works directly and aggressively against transparency. Offshore secrecy shifts control over information and the power that flows from it toward the insiders, helping them take the cream and use the system to shift the costs and risks onto the rest of society.

David Ricardo's theory of comparative advantage elegantly describes principles that lead different jurisdictions to specialize in certain things: fine wines from France, cheap manufactures from China, and computers from the United States. But when we find that the British Virgin Islands, with fewer than twenty-five thousand inhabitants, hosts over eight hundred thousand companies, or that more than 40 percent of foreign direct investment into India comes from Mauritius, Ricardo's theory loses its traction. Companies and capital migrate not to where they are most productive but to where they can get the best tax break. There is nothing "efficient" about any of this.

The world contains about 60 secrecy jurisdictions, or tax havens, which can be divided roughly into four groups: a set of continental European havens, a British zone of influence centered on the City of London and loosely shaped around parts of Britain's former empire, a zone of influence focused on the United States, and a fourth category holding unclassified oddities like Somalia and Uruguay.

The European havens got going properly from the First World War, as

governments raised taxes to pay for their war costs. Switzerland's famous secrecy law, making violation of banking secrecy a criminal offense for the first time, was enacted in

1934 in response to a French tax evasion scandal, though Geneva bankers had sheltered the secret money of European elites since at least the eighteenth century.[13] Picturesque, little-known Luxembourg, specializing since 1929 in certain kinds of offshore corporations,[14] is among the world's biggest tax havens today: Well over $2.5 trillion is parked offshore in Luxembourg.[15] In March 2010 South Korean intelligence officials indicated that North Korea's "Dear Leader" Kim Jong-Il had stashed some $4 billion in Europe—profit from the sale of nuclear technology and drugs, insurance fraud, counterfeiting, and projects using forced labor; Luxembourg, they said, is a favored destination for the money.[16]

The Netherlands is another major European tax haven. In 2006, while the Irish musician Bono browbeat Western taxpayers to boost aid to Africa, his band, U2, shifted its financial empire to the Netherlands to cut its own tax bills. Austria and Belgium are also important European havens of banking secrecy, though Belgium softened its laws in 2009. A couple of other small European micro-state havens are worth noting, including Monaco and Andorra, with occasional cameo roles from odd places like the Portuguese Islands of Madeira, which was central to a major Nigerian bribery scandal involving the U.S. oil service company Halliburton[17] that resulted in the second largest fine ever paid in a prosecution under the Foreign Corrupt Practices Act.

The second offshore group, accounting for about half the world's secrecy jurisdictions, is the biggest. This is a layered hub-and- spoke array of tax havens, centered on the City of London, which mostly emerged from the ashes of the British empire.[18] As I will show, it is no coincidence that the City of London, once the capital of the greatest empire the world has known, is the center of the most important part of the global offshore system.

The City's offshore network has three main layers. Its inner ring consists of Britain's three Crown Dependencies: the nearby islands of Jersey, Guernsey, and the Isle of Man. The authoritative U.S. publication Tax Analysts estimated conservatively in
2007 that just these three havens hosted about $1 trillion of potentially tax- evading assets.[19] At a reasonable annual rate of return of 7 percent and a top income tax rate of 40 percent, the tax evaded on those could

be almost $30 billion per year—and income tax evasion is just one of several forms of offshore tax and financial losses. Other losses, which I will explain below, are far bigger.

The next, intermediate ring involves Britain's 14 overseas territories, the last surviving outposts of Britain's formal empire. With just a quarter of a million inhabitants between them, they include some of the world's top secrecy jurisdictions: the Cayman Islands, Bermuda, the British Virgin Islands, Turks and Caicos, and Gibraltar. [20] Like the Crown Dependencies, these places are partly independent from Britain—though Britain controls events behind the scenes. In the Caymans, for instance, Her Majesty the British Queen appoints His Excellency the Governor, the most powerful person on the island. He (never a she, so far) presides over a cabinet of local Caymanians who are elected locally but who have almost no power over the stuff that matters—the money. The governor handles defense, internal security, and foreign relations; he appoints the police commissioner, the complaints commissioner, the auditor general, the attorney general, the judiciary, and other top officials. The final appeal court is the Privy Council in London. MI6, Britain's Secret Intelligence Service, is highly active here[21] (as are the CIA and several other intelligence services).

The Cayman Islands is the world's fifth largest financial center, hosting eighty thousand registered companies, over three- quarters of the world's hedge funds, and $1.9 trillion on deposit—four times as much as in all the banks in New York City. And it has, at the time of writing, one cinema.

To indicate how murky things are here, the Cayman Islands reported in 2008 that institutions based there had $2.2 trillion in borrowings but had only lent out a third of that amount—even though these figures should match each other, more or less. The UK and Caymans authorities have not explained this $1.5 trillion discrepancy.[22]

The third, outer ring is a more diverse array of havens like Hong Kong and the Bahamas, which are outside Britain's direct control but nevertheless have strong historical links to the empire and deep current links to the City of London. One authoritative account estimates that this three-layered British grouping accounts for well over a third of all international bank assets worldwide. Adding the City of London itself brings the total up to nearly a half.[23]

This network of offshore satellites does several things for the City of London. First, it gives it a global reach: These havens scattered around the world attract and catch mobile international capital flowing to and

from nearby jurisdictions, just as a spider's web catches passing insects. Money attracted to these jurisdictions, and much of the business of managing that money, is funneled through to London. A lot of U.S. business is attracted to the Cayman Islands, and this gives the City of London the chance to get a slice of the action. Second, the spiderweb[24] lets the City get involved in business that might be forbidden in Britain, giving the financiers in London sufficient distance from wrongdoing to allow plausible deniability. By the time the money gets to London, often via several intermediary jurisdictions, it has been washed clean. The old City of London adage "Jersey or Jail" means that if you want to do a certain type of business but don't want to get caught, you just step out into the Jersey part of the spiderweb and do it there. Sometimes, business too dirty for the Crown Dependencies is farmed out further into the spiderweb. John Christensen, formerly a Jersey financial sector professional, remembers the Overseas Territory of Gibraltar being one particular favorite. "We in Jersey regarded Gibraltar as totally subprime," he said. "This was where you put the real monkey business." Later, a Caymanian character who introduced himself to me only as "The Devil" will help illustrate just how dirty this business can be.

Britain's understated, ambiguous, but ultimately controlling role in these nodes of the spiderweb is the bedrock that reassures flighty global capital and underpins their offshore sectors. The gesture toward local representation keeps Caymanians happy and gives Britain the chance to say "it is not our business to interfere" when something unpleasant breaks the surface, or when other countries complain of abuses being perpetrated out of there. Periodically, the charade of the overseas territories is exposed: In August 2009 Britain imposed direct rule in the Turks and Caicos Islands after corruption there spun too far out of control.[25] Britain plays down these episodes, as far as is possible, to distract attention away from its real control.

The outer reaches of the British spiderweb consist of a more complex and varied set of places that are independent from Britain, but with a history of involvement with the British empire or zones of close influence, and with enduring and powerful links with the City of London. The biggest are Hong Kong, Singapore, the Bahamas, Dubai, and Ireland,[26] though many others exist, like Vanuatu in the South Pacific, whose small offshore center was created by the British government in 1971, nine years before independence. New ones continue to emerge: In February 2006, for example, Ghana said it would set up offshore

legislation with help from Britain's Barclays Bank. The thought of a new African secrecy jurisdiction in the midst of a swath of

legendarily corrupt African oil-producing nations—and just as Ghana takes its own first steps as a big oil producer—is almost too horrible to contemplate. Botswana, right next to South Africa, is setting up its offshore center too.

One might ask why the United States has more or less tolerated the presence of British-run places parked off its eastern and southern coastline, eroding its tax base and undermining its laws and financial regulations. The answer isn't straightforward. U.S. officials have periodically tried to crack down on offshore tax abuse, at least since 1961, when President Kennedy asked Congress for legislation to drive these tax havens "out of existence,"[27] but have been thwarted each time by powerful interests on Wall Street. A U.S. Government Accountability Office (GAO) report from December 2008 provides a clue as to their power, showing that Citigroup had 427 tax haven subsidiaries, of which 290 were in the British spiderweb. The next biggest user was Morgan Stanley with 273 offshore subsidiaries (of which 220 were in the British zone), then News Corporation with 152, of which 140 were in the British zone.[28]

In these numbers lies another important point to understand from the outset. People have traditionally seen tax havens as marginal players used by mafiosi, drug smugglers, spies, petty criminals, and celebrity tax-dodgers. Plenty of these can be found offshore, it is true.[29] But I need to stress again: The big users of the secrecy jurisdictions are the banks and other financial institutions.

I am struck by similarities between Britain's postcolonial offshore network and what I encountered in oil-rich Gabon, the epicenter of France's own very strange, quasi-offshore postcolonial system. Gabon fits no conventional definition of a tax haven, but it is, like the havens in the British spiderweb, a relic (or even a rebirth) of a colonial empire that is being used by elites to do things—often unpleasant ones—that would not be allowed at home. The Elf system, with its subterranean bargains with African rulers and French politicians, was a way for France to retain a great degree of control over its former colonies after independence. Britain's spiderweb is different—most of its former colonies in Africa, India, and elsewhere really are independent. But what Britain has done instead is to retain a large degree of control of the vast flows of wealth in and out of these places, under the table. Illicit capital flight from Africa, for example, flows mostly into the modern British spiderweb, to be managed in London. In both the French and the British systems, powerful interest groups in the old colonial powers have built

secret financial relationships with the local elites, creating global alliances with each other against the ordinary citizens of these poor countries—and against their own citizens too.

The United States anchors the third big offshore pole. Before the great global offshore explosion began in the 1960s and the 1970s, the U.S. government was generally hostile to offshore business, and its leaders fought against the British spiderweb and the European havens. But as the 1970s wore on financial interests became increasingly influential in U.S. policymaking, and the country, facing large Vietnam War–era deficits and increasingly adopting an "if you can't beat 'em, join 'em" attitude toward tax havens, began consciously adopting its own offshore characteristics—particularly special tax incentives and secrecy structures available to foreigners—in efforts to attract financial capital into the United States to fill the deficits.

So there are two things going on here: Tax revenues and other money are being drained out of the United States into tax havens elsewhere, and a flow of foreign (often dirty) money is moving in the other direction back into the country. The United States is estimated to be losing $100 billion annually from offshore tax abuses—a gigantic transfer of wealth from ordinary taxpayers to rich people.[30] And that is not to mention the role the offshore system plays as a giant hothouse for international crime and fraud or its role in undermining financial regulation, which I shall get to.

But the money flowing into tax haven USA does not make up for the money and tax revenues being drained out. The inflows have made matters worse still for ordinary U.S. taxpayers, let alone for foreigners being stiffed by their own wealthy and unaccountable elites. As the following chapters will show, the inflows delivered massive rewards to a small financial elite, while helping Wall Street to gain its too-big-to-fail stranglehold on the U.S. economy and the politicians in Washington. "Tax havens are engaged in economic warfare against the United States, and honest, hardworking Americans," says Senator Carl Levin. He is quite right—but we should add that the United States in its role as a tax haven is conducting economic warfare against honest, hardworking people at home and around the world.

Like the British offshore system, the U.S.-based offshore system operates on three tiers.

At the federal level, on the top tier, the United States dangles a range of special tax exemptions, secrecy provisions, and laws designed to attract foreigners' money into the United States in true offshore style. U.S. banks may, for instance, legally accept proceeds from a range of crimes, such as handling stolen property—as long as the crimes are committed overseas. Special arrangements are made with banks to make sure they do not reveal the identities of foreigners parking their money in the United States.

The second offshore tier involves individual U.S. states. A range of different things are happening, in a number of states. Florida, for example, is where Latin American elites do their banking, and the United States generally does not share banking information with those countries, so a lot of this is tax-evading and other criminal money, protected by U.S. secrecy. Florida's banks also have a long history of harboring Mob and drug money, often in complex partnerships with the nearby British Caribbean havens. On a different tack, smaller U.S. states like Wyoming, Delaware, and Nevada have become specialists in offering low-cost and very strong forms of almost unregulated corporate secrecy, which has attracted illicit money, and even terrorist money, from around the globe.

The third U.S. offshore rung is an overseas satellite network, far smaller than the British zone. One is the U.S. Virgin Islands, a U.S. "Insular Area" and a minor haven used by Bank of America, Boeing, FedEx, and Wachovia, among others. [31] A more interesting haven in the U.S. zone is the Marshall Islands, a former Japanese colony under U.S. control since 1947, now under a Compact of Free Association with the United States. It is primarily the host for a "flag of convenience" service that, The Economist magazine recently noted, is "much prized among shipowners for its light regulatory touch." The Marshall Islands registry was set up in 1986 with USAID help by Fred M. Zeder II, a golfing buddy of George H. W. Bush who later ran the United States Overseas Private Investment Corp. (OPIC), and its flag of convenience service is run by a private U.S. corporation out of offices in Reston, Virginia, near Washington Dulles Airport. The Marshall Islands provides the anything-goes, unregulated flag for, among many others, the Deepwater Horizon, the BP-operated oil rig that caused environmental chaos off the U.S. Gulf Coast in 2010.[32]

A small, opaque tax haven also grew alongside the Marshall Islands shipping registry, which the GAO reckoned was being used by ConocoPhilips, Morgan Stanley, and News Corp. When Khadija

Sharife, a South African journalist, posed as a shipping client pretending to be worried about disclosure, she was told that forming a Marshall Islands company could be done

in a day for an initial filing fee of $650 plus annual fees of $450, and

> If the authorities . . . come to our Registry and Jurisdiction and ask to disclose more information, regarding shareholders, directors of the company etc.… we are not privy to that information anyway, since all the business organization and conduct of the entity is performed by the entity's lawyers and directors directly. Unless the name of directors and shareholders are filed in the Marshall Islands and become a public record (which is NOT mandatory), we are not in a position to disclose that information.[33]

In Africa, Liberia was set up in 1948 as a "flag of convenience" by Edward Stettinius Jr., a former U.S. secretary of state, and its maritime code was "read, amended, and approved by officials of Standard Oil," according to the historian Rodney Carlisle. Its sovereign shipping registry is now run by another private U.S. corporation out of Vienna, Virginia, about five miles from the Marshall Islands registry.[34] Sovereignty is, literally, available for sale or rent in such places.

The biggest tax haven in the U.S. zone of influence is Panama. It began registering foreign ships from 1919 to help Standard Oil escape U.S. taxes and regulations, and offshore finance followed: Wall Street interests helped Panama introduce lax company incorporation laws in 1927, which let anyone open tax-free, anonymous, unregulated Panama corporations with few questions asked. "The country is filled with dishonest lawyers, dishonest bankers, dishonest company formation agents and dishonest companies," one U.S. Customs official noted. "The Free Trade Zone is the black hole through which Panama has become one of the filthiest money laundering sinks in the world."[35]

This strange and little-known U.S.-centered pattern, echoing the neocolonial role of the secrecy jurisdictions in the British zone, provides a pointer to the fact that the secrecy jurisdictions have for years quietly been at the heart of neoconservative schemes to project U.S. power around the globe. And almost nobody has noticed.

It should be clear by now that the offshore world is not a bunch of independent states exercising their sovereign rights to set their laws and tax systems as they see fit. It is a set of networks of influence

controlled by the world's major powers, notably Britain, the United States, and some jurisdictions in Europe. Each network is deeply interconnected with, and warmly welcomes offshore business from, the others. Wealthy U.S. individuals and corporations use the British spiderweb extensively: Enron, for example, had 881 offshore subsidiaries before it went bust, of which 692 were in the Cayman Islands, 119 in the Turks and Caicos, 43 in Mauritius, and 8 in Bermuda, all in the British spiderweb. The United States returns the favor to wealthy British interests investing tax-free, in secrecy, via Wall Street.

Not only that, but the world's most important tax havens in their own right are not exotic palm-fringed islands but some of the world's most powerful countries themselves. Marshall Langer, a prominent supporter of secrecy jurisdictions, neatly describes the misperceptions that have grown up about tax havens. "It does not surprise anyone when I tell them that the most important tax haven in the world is an island," he said. "They are surprised, however, when I tell them that the name of the island is Manhattan. Moreover, the second most important tax haven in the world is located on an island. It is a city called London in the United Kingdom."[36]

Jason Sharman, an Australian academic, checked how easy it was to set up secrecy structures, using the Internet and those seedy offshore advertisements that infest the back pages of business publications and airline magazines. In his report published in 2009 he records making forty-five bids for secret front companies. Money laundering controls seem to be in operation patchily, but of those 45 bids, 17 companies agreed to set them up without even checking his identity. Only four of these were in the "classic" havens like Cayman or Jersey, while the other 13 were in countries from the wealthy Organisation for Economic Cooperation and Development (OECD), including seven in Britain and four in the United States.

What Sharman was encountering, The Economist magazine noted, was not traditional Swiss banking secrecy, where discreet men in plush offices promised to take their clients' names to the grave. "This is a more insidious form of secrecy, in which authorities and bankers do not bother to ask for names…. For shady clients, this is a far better proposition: what their bankers do not know, they can never be forced to reveal. And their method is disarmingly simple. Instead of opening bank accounts in their own names, fraudsters and money launderers form anonymous companies, with which they can then open bank

accounts and move assets."[37] The United States, Sharman noted, was offering nonresident foreigners all the elements of a tax haven, notably no taxes and secrecy. As he put it, "The United States, Great Britain and other OECD states have chosen not to comply with the international standards which they have been largely responsible for putting in place."

Rich OECD nations have worked hard to persuade their publics that there has been a major crackdown on the secrecy jurisdictions. "The old model of relying on secrecy is gone," said Jeffrey Owens, head of tax at the OECD. "This is a new world, with better transparency and better cooperation."[38] Many people believed him. French president Sarkozy went further. "Tax havens and bank secrecy," he said, "are finished."[39] Yet big OECD member states are the guardians and promoters of the offshore system. It continues to process vast tides of illicit money—yet an OECD blacklist of tax havens is effectively a whitewash, as I will explain later.[40] And to the very, very limited extent that rich countries have tried to address the problem, low- income countries are being left on the sidelines as usual.

When the fox announces that it has done an excellent job of beefing up the security of the henhouse, we should be very cautious indeed.

The offshore world is an endlessly shifting ecosystem, and each jurisdiction offers one or more offshore specialties. Each attracts particular kinds of financial capital, and each develops a particular infrastructure of skilled lawyers, accountants, bankers, and corporate officers to cater to their specific needs.

Yet few people are even aware that such businesses exist. You may well have heard of the Big Four accounting firms KPMG, Deloitte, Ernst & Young, and PricewaterhouseCoopers. But have you heard of the Offshore Magic Circle? Its members are made up of highly profitable multijurisdictional law firms mostly originating in Britain or its Overseas Territories and Crown Dependencies: a smartly dressed regiment of accountants, lawyers, and bankers forming a private global infrastructure that, in league with captured legislatures in the secrecy jurisdictions, makes the whole system work.

Offshore services range from the legal to the illegal, with a huge gray area in between. In terms of tax, the illegal stuff is called tax evasion, while tax avoidance is technically legal, though, by definition, it also involves getting around the intent of elected legislatures. To distinguish

between evasion and avoidance is a slippery business, and it often takes vast, lengthy court cases to find out which side of the law a multinational corporation's tax shelter lies on. Former British chancellor Dennis Healey gave a

neat definition of where the dividing line lies. “The difference between tax avoidance and tax evasion,” he said, “is the thickness of a prison wall.”[41] Even when offshore is not technically illegal, it is often a problem. Secrecy jurisdictions routinely convert what
is technically legal, but abusive, into what is seen as legitimate. Of course what is legal is not necessarily what is right: think slavery, or apartheid.

Illegal offshore services and structures include tax-evading private banking or asset management, sham trusts, corporate secrecy, illegal reinvoicing, regulatory evasion, fraud concealment, and many, many other nefarious possibilities. These are often hidden behind soothing bromides like “tax optimization” or “asset protection” or “efficient corporate structure.”

On the tax side, one important matter concerns something known as double taxation. Say a U.S. multinational invests in a manufacturing plant in Brazil and earns income there. If both countries taxed the same income, without giving credits for the other country’s taxes, the multinational would get taxed twice. Tax havens do help companies eliminate this double taxation— though you don’t need tax havens for this: It can be ironed out with appropriate treaties and tax credits between countries. But when tax havens eliminate double taxation, something else happens too: double nontaxation. In other words, not only does the corporation avoid being taxed twice on the same income. It also avoids being taxed at all. I will explore this strange and complex area in a little more detail later.

Each jurisdiction tolerates different levels of dirt. Terrorists or Colombian drug smugglers would probably use Panama, not Jersey— though Jersey’s trust company sector in particular, handling several hundreds of billions of dollars’ worth of assets, continue to make the island a sink for nefarious activity and illicit, tax-evading loot, notwithstanding Jersey’s routine claims to be a “transparent, well-regulated and cooperative jurisdiction.” Bermuda is a magnet for offshore insurance and reinsurance, frequently for the purpose of avoiding tax; the Caymans are favored locations for hedge funds, frequently for the purposes of escaping tax, legally or illegally, but more often to get around certain kinds of financial regulation. In securitization, the practice of packaging up mortgage loans and other assets to sell on to investors—a major contributor to the latest financial crisis—Wall Street has long favored locating its Special Purpose Vehicles (SPVs) in the Caymans and Delaware; in Europe the preferred locations for SPVs

are Jersey, Ireland, Luxembourg, and the City of London. All are, as this book will show, major secrecy jurisdictions.

Tax havens often target specific other large economies, usually nearby. Switzerland's wealth managers focus quite heavily on getting business from tax-evading rich Germans, French, and Italians—corresponding to Switzerland's immediate neighbors and to Switzerland's three main language groups—though they are open to all comers from around the world. Monaco caters especially to French elites, while some wealthy French and Spaniards use Andorra, sandwiched in the eastern Pyrenees between the two larger countries. Rich Australians often use Pacific havens like Vanuatu; a lot of illicit North African money finds itself routed through Malta, another former British outpost in the Mediterranean Sea. U.S. and Latin American corporations and wealthy individuals use Panama and the Caribbean havens for a lot of their business, while wealthy Chinese tend to use Hong Kong, Singapore, and Macau.

Some jurisdictions specialize as conduit havens: way stations offering services that transform the identity or character of assets in specific ways, en route to somewhere else. The Netherlands is a big conduit haven: About €4.5 trillion (US $6.6 trillion) flowed through Dutch Special Financial Institutions in 2008—equivalent to over nine times the Dutch GDP. [42] Mauritius, off the African coast in the Indian Ocean, is a new and fast-growing conduit haven that is the source of over 40 percent of foreign investment into India. It also specializes in channeling Chinese investments into Africa's mineral sectors. Money does not always flow through obvious geographical routes, however: Russian dirty money has favored Cyprus, Gibraltar, and Nauru, all with strong historical British links, as stepping-stones where it can be legitimized before entering the mainstream global financial system in London and elsewhere. A large amount of foreign investment into China goes via the British Virgin Islands.

Offshore financial structures typically involve a trick sometimes known as laddering—a practice also expressed by the French word saucissonage, meaning to slice something into pieces like a sausage. When you slice a structure among several jurisdictions, each provides a new legal or accounting "wrapper" around the assets that can deepen the secrecy and the complexity protecting the assets. A Mexican drug dealer may have $20 million, say, in a Panama bank account. The account is not in his name but is instead under a trust set up in the Bahamas. The trustees may live in Guernsey, and the trust beneficiary

could be a Wyoming corporation. Even if you can find the names of that company's directors, and even get photocopies of their passports—that gets you no closer: These directors will be professional nominees who direct hundreds of similar companies. They are linked to the next rung of the ladder through a company lawyer, who is prevented by attorney-client privilege from giving out any details. Even if you break through that barrier you may find that the corporation is held by a Turks and Caicos trust with a flee clause: The moment an inquiry is detected, the structure flits to another secrecy jurisdiction. Even if a jurisdiction cooperates with inquiries, it can drag its feet for months or years. "Even when they cooperate to eliminate the fraud," Robert Morgenthau, until recently the Manhattan district attorney, said of the Caymans, "it takes so long that when the door is finally closed, the horse has been stolen and the barn has burned down."[43] At the time of writing, Hong Kong is preparing legislation to allow incorporation and registration of new companies within minutes.

In 2010 Luxembourg's authorities pleaded this laddering as an excuse for potentially harboring North Korean money. "The problem is that they do not have 'North Korea' written all over them," a spokesman said. "They try to hide and they try to erase as many links as possible."[44] That is, after all, the point. Magistrates in France only ever saw a limited part of the Elf system because of this saucissonage. "The magistrates are like sheriffs in the spaghetti westerns who watch the bandits celebrate on the other side of the Rio Grande," wrote the magistrate Eva Joly, furious about how tax havens stonewalled her probes into the Elf system. "They taunt us—and there is nothing we can do."

Even if you can see parts of the structure, the laddering stops you from seeing it all—and if you can't see the whole, you cannot understand it. The activity doesn't happen in any jurisdiction—it happens between jurisdictions. "Elsewhere" becomes "nowhere": a world without rules.

I already mentioned some ballpark numbers suggesting how big the offshore system has become: half of all banking assets, a third of foreign investment, and more. But there have been very few attempts to quantify the damage that this system causes. This is partly because it is so hard to measure, let alone detect, secret, illicit things. But it is also because nobody wants to know.

Recently, however, a few organizations have sought to assess the problem's scale. In 2005 the Tax Justice Network estimated that wealthy individuals hold perhaps $11.5 trillion worth of wealth offshore. That is about a quarter of all global

wealth and equivalent to the entire GDP of the United States. That much money in hundred-dollar bills, placed end to end, would stretch twenty-three times to the moon and back. The estimated $250 billion in taxes lost each year on the income that money earns is two to three times the size of the entire global aid budget to tackle poverty in developing countries.

But that sum just represents the taxes lost on money wealthy individuals hold offshore. A much bigger transfer of wealth is occurring through illicit financial flows across borders from developing countries into secrecy jurisdictions and rich countries. The most comprehensive study of this comes from Raymond Baker's Global Financial Integrity (GFI) Program at the Center for International Policy in Washington. Developing countries, GFI estimated in January 2011, lost a staggering $1.2 trillion in illicit financial flows in 2008—losses that had been growing at 18 percent per year since 2000.[45] Compare this to the $100 billion in total annual foreign aid, and it is easy to see why Baker concluded that "for every dollar that we have been generously handing out across the top of the table, we in the West have been taking back some $10 of illicit money under the table. There is no way to make this formula work for anyone, poor or rich." Remember that the next time some bright economist wonders why aid to Africa is not working. We are clearly talking about one of the great stories of our age.

In a separate study subsequently endorsed by the World Bank,[46] Baker estimated that only about a third of total illicit cross- border flows represent criminal money—from drug smuggling, counterfeit goods, racketeering, and so on. Corrupt money— local bribes remitted abroad or bribes paid abroad—added up to just 3 percent of the total. The third component, making up two-thirds, is cross-border commercial transactions, about half from transfer pricing through corporations. His research underlines the point that illicit offshore flows of money are far less about the drug smugglers, mafiosi, celebrity tax exiles, and fraudsters of the popular imagination and mostly about corporate activity.

And out of this emerges another profoundly important point. The drug smugglers, terrorists, and other criminals use exactly the same offshore mechanisms and subterfuges—shell banks, trusts, dummy corporations, and so on—that corporations use. "Laundered proceeds of drug trafficking, racketeering, corruption, and terrorism tag along with other forms of dirty money to which the United States and Europe lend a welcoming hand," said Baker. "These are two rails on the same tracks through the international financial system." We will never beat the

terrorists or the heroin traffickers unless we confront the whole system—and that means tackling the tax evasion and avoidance and financial regulation and the whole paraphernalia of offshore. It is hardly surprising, in this light, that Baker estimates that the U.S. success rate in catching criminal money was 0.1 percent— meaning a 99.9 percent failure rate.

And that is only the illegal stuff. The legal offshore tax avoidance by individuals and corporations, which further gouges honest hardworking folks, adds hundreds of billions of dollars to these figures.

Almost no official estimates of the damage exist. The Brussels-based nongovernmental organization Eurodad has issued a limited-edition book called Global Development Finance: Illicit Flows Report 2009, which seeks to lay out, over a hundred pages, all of the comprehensive official estimates of global illicit international financial flows.[47] Every page is blank.

Eurodad's gimmick underscores a vital point: There has been an astonishing blindness on the part of the world's most powerful institutions to this system that has effected the greatest transfer of wealth from poor to rich in the history of the planet. As the sociologist Pierre Bordieu once remarked, "The most successful ideological effects are those which have no need for words, and ask no more than complicitous silence."

Language itself encourages the blindness. In September 2009, the G20 group of countries pledged in a communiqué to "clamp down on illicit outflows." Now consider the word outflows. Like the term capital flight, it points the finger at the victim countries like Congo or Nigeria or Mexico—which, this language subtly insists, must be the focus of the cleanup. But each flight of capital out of a poor country must have a corresponding inflow somewhere else. Imagine how different that pledge would be if the G20 had promised to tackle "illicit inflows."

Bad tax systems are pushing some nations toward becoming failed states. "Countries that will not tax their elites but expect us to come in and help them serve their people are just not going to get the kind of help from us that they have been getting," Hillary Clinton said in September 2010, to widespread and bipartisan applause. "Pakistan cannot have a tax rate of 9 percent of GDP when land owners and all of the other elites do not pay anything or pay so little it's laughable, and then when there's a problem everybody expects the United States and others to come in and help."[48] Leave aside for a moment the hypocrisy involved when the United States preaches to developing

countries about abusive tax systems while welcoming tides of their illicit money and wrapping it in secrecy. Clinton's basic point is still valid. Wealthy Pakistanis are as enthusiastic about tax havens as elites in any other poor country, and their ability to escape from any responsibility to their societies while leaving everyone else to pick up the tab is one of the great factors corrupting the state and undermining its citizens' confidence in their rulers. This is a security issue as much as anything else.

Even this is not all. The global offshore system was one of the central factors that helped generate the latest financial and economic crisis since 2007. Offshore did not exactly cause the financial crisis: It created the enabling environment for the conditions underlying the crisis to develop. "Trying to understand the role that offshore secrecy and regulatory havens have in the crisis," Jack Blum explains, "is like the problem a doctor has treating a metabolic disease with multiple symptoms. You can treat several symptoms and still not cure the disease. Diabetes, for instance, causes high cholesterol, high blood pressure, and all sorts of other problems. There are plenty of discrete aspects of the meltdown to talk about and many possible treatments for symptoms, but offshore is at the heart of this metabolic disorder. Its roots reach back decades, in bankers' attempts to escape regulation and taxation and make banking a highly profitable growth business that mimics the industrial economy."[49]

I will explore this in more detail later—but here is a very short summary of some basic reasons why offshore is implicit in the latest economic crisis.

President Roosevelt's New Deal in the 1930s inflicted a lasting defeat on financial capital, blaming it for the horrors of the Great Depression and tying it down with constraints that would ensure that the financial services sector would contribute to economic development, not undermine it. The New Deal was a great success, but it began to unravel properly just before the
1960s, when Wall Street found its offshore escape route from taxes and domestic regulations: first in London (the subject of chapter 4) then further afield in the British spiderweb and beyond. The offshore system provided Wall Street with a "get out of regulation free" card that enabled it to rebuild its powers overseas and then, as the United States turned itself in stages into a tax haven in its own right, at home. The end result was that the biggest banks were able to grow large enough to attain "too big to fail" status—which helped them in turn to become increasingly

influential in the bastions of political power in Washington, eventually getting a grip on both main political parties, Democrat and Republican—a grip that is so strong that it amounts to political capture.

Part of this process has involved a constant race to the bottom between jurisdictions. When a tax haven degrades its taxes

or financial regulations or deepens its secrecy facilities to attract hot money from elsewhere, other havens degrade theirs too, to stay in the race. Meanwhile, financiers threaten politicians in the United States and other large economies with the offshore club—"don't tax or regulate us too heavily or we'll leave," they cry—and the onshore politicians quail and relax their own laws and regulations. As this has happened, onshore has increasingly taken on the characteristics of offshore. In the large economies, tax burdens are being shifted away from mobile capital and corporations onto the shoulders of ordinary folks. U.S. corporations paid about two-fifths of all U.S. income taxes in the 1950s; that share has fallen to a fifth.[50] The top 0.1 percent of U.S. taxpayers saw their effective tax rate fall from 60 percent in 1960 to 33 percent in 2007, while their share of the income pie soared.[51] Had the top thousandth paid the 1960 rate, the federal government would have received over $281 billion more in 2007.[52] When the billionaire Warren Buffett surveyed members of his office he found that he was paying the lowest tax rate among his office staff, including his receptionist. Overall, taxes have not generally declined. What has happened is that the rich have been paying less, and everyone else has been forced to take up the slack. The secrecy jurisdictions, in partnership with changing ideologies, are the biggest culprits.

The next factor behind the latest economic crisis is the huge illicit cross-border flows of money that have on a net basis flowed very significantly into deficit countries like the United States and Britain, adding very substantially to the more visible macroeconomic imbalances that fostered the crisis. Meanwhile, zero-tax offshore incentives helped encourage companies to borrow far too much, injecting more risk and leverage into the financial system. In addition, financial and other firms have been festooning their financial affairs around the world's tax havens for reasons of tax, regulation, or secrecy—and the resulting complexity, mixed with offshore secrecy, made their financial affairs impenetrable to regulators and investors alike, eventually feeding the mutual mistrust between market players that helped trigger the crisis.

And now, to cap it all, the system is providing our richest citizens and corporations with escape routes from tax and regulation, meaning that it is ordinary people who will have to pay the costs to clean up this giant mess. The harm that stems from all this is incalculable.

Yet this is not a book about the financial crisis. It is about something older and deeper.

Deregulation, freer flows of capital, and lower taxes since the 1970s—most people think that these globalizing changes have resulted primarily from grand ideological shifts and deliberate policy choices ushered in by such leaders as Margaret Thatcher and Ronald Reagan. Ideology and leaders matter, but few have noticed this other thing: the role of the secrecy jurisdictions in all of this—the silent warriors of globalization that have been acting as berserkers in the global economy, forcing other nations to engage in the competitive race to the bottom, and in the process cutting swaths through the tax systems and regulations of nation states, rich and poor, whether they like it or not. The secrecy jurisdictions have been the heart of the globalization project from the beginning.

Finally, a word about culture and attitudes. In January 2008 the accountancy giant KPMG ranked Cyprus at the very top of a league table of European jurisdictions, according to the "attractiveness" of their corporate tax regimes.[53] Yet Cyprus, a "way station for international scoundrels," as one offshore promoter admits, is among the world's murkiest tax havens: possibly the biggest conduit for criminal money out of the former Soviet Union and the Middle East into the international financial system. If Cyprus is ranked as the "best" in an international league table on tax, something is clearly wrong with the world. When transparency rankings list Switzerland and Singapore, two great sinks for illicit loot, as among the world's "cleanest" jurisdictions, then we seem to have lost our way.

Tax is the missing element in the corporate social responsibility debate. Modern company directors face a dilemma. To whom are they answerable—to shareholders only or to a wider set of stakeholders? There are no useful guidelines.[54]

Irresponsible players treat tax as a cost to be minimized, to boost short-term shareholder value alone. Ethical directors recognize that tax is not a cost of production but a distribution out of profits to stakeholders, ranking on the profit and loss account alongside dividends. It is a distribution to society, and it pays for the things like roads and education that help the corporations make their profits.

The corporate world has lost its way, and nowhere is this more true than with the Big Four accountancy firms. Paul Hogan, the star of the

film Crocodile Dundee, put his finger on something important in 2010 when talking about an investigation by Australian tax authorities into his offshore tax affairs. “I haven’t done my own tax for thirty years,” he said. “They talk about me going to jail. Erm, excuse me: There’s about four law firms and about five accounting firms—some of the biggest ones in the world—that’d have to go to jail before you get to me.”[55] On this point, Hogan is right—or at least he should be. These firms, responding to their clients’ wishes to escape taxes and other duties that come with living in democratic nations, have grown to become steeped in an inverted morality that holds tax, democracy, and society to be bad and tax havens, tax dodging, and secrecy to be good. Serial tax avoiders are made knights of the realm in Britain and promoted to the top of high society in the United States; journalists seeking guidance in this complex terrain routinely turn to these very same offshore cheerleaders, the accountancy firms, for their opinions. Bit by bit, offshore’s inverted morality becomes accepted into our societies.

The fight against the offshore system will differ from other campaigns to fix the global economy. Like the fight against corruption, this struggle does not fit neatly into the old political categories of left and right. It does not involve rejecting cross- border trade or seeking solace in purely local solutions. This fight needs an international perspective, where countries try not to engage in economic warfare against each other. And it will provide a rubric for taxpaying citizens in both rich countries and poor to fight for a common cause. Wherever you live, whoever you are, or what you think, this affects you.

Millions of people around the world have for years had a queasy feeling that something is rotten in the global economy, though many have struggled to work out what the problem is. This book will point to the original source of where it all went wrong.

TECHNICALLY ABROAD
The Vestey Brothers, the American Beef Trust, and the Rise of Multinational Corporations

ONE WINTER IN 1934 THE ARGENTINE COAST GUARD detained a British-owned ship, the Norman Star, as it was about to sail for London. The raid had been triggered by an anonymous tip-off during an investigation into a cartel of foreign meat packers who were suspected of manipulating prices and shipping profits illegally overseas.

Ordinary Argentinians, amid the Great Depression, were furious about just about everything at that time. Their economy was still mostly in the hands of a few hundred landowning families, and British and American meatpacking houses, which engaged their employees under humiliating conditions, had organized a cartel so effective that while the prices they paid locals for their beef had plummeted, the investors' profits actually rose. The beef export industry was a major plank in the growth of the political power of the Argentine elites; in his book The Rise and Fall of the House of Vestey, the biographer Philip Knightley argues that the meat packers' cartel had such a crippling effect on the Argentine labor movement and early economic development that "it led almost directly to the formation of militant labour organisations that pushed Peron into power, the subsequent dictatorship of the generals, the terrorism, the Falklands War and the country's economic disasters."[1]

How much profit were these foreigners really making? Nobody could be sure, but London's influence on the Argentine economy was immense. "Without saying so in as many words, which would be tactless, Argentina must be regarded as an essential part of the British Empire," the British ambassador had noted in 1929. But he was not complacent, for he was aware how fast large U.S. companies were penetrating these areas of British influence. "The United States under Hoover means to dominate this continent by hook or by crook," the ambassador had recently noted. "It is British interests that chiefly stand in the way. These are to be bought out or kicked out."[2] The big historical competitors of the British meat packers, though now inside the Argentine

cartel, were the Swift and Armour groups from Chicago that until recently had formed the core of the American Beef Trust, an organization founded by the robber baron Philip D. Armour. The trust had sewn up food distribution inside the United States so effectively that a book about it published in New York in 1905, entitled The Greatest Trust in the World, described it as "a greater power than in the history of men has been exercised by king, emperor or irresponsible oligarchy . . . here is something compared with which the Standard Oil Company is puerile."[3] Although by the time of the coast guard raid their cartel tactics had been tamed in the United States, the trust was still happily playing the cartel game in Argentina, in partnership with the British.

Argentinians, of course, hated having their economy carved up in informal economic empires run by foreigners. "Argentina cannot be described as an English dominion," said Lisandro de la Torre, the fire-breathing Argentinian senator who led the investigation into the foreign meat packers, "because England never imposed such humiliating conditions on its colonies."[4]

So he was especially pleased with what the coast guard found in the ship's holds, buried beneath a reeking load of guano fertilizer: over 20 crates labeled "corned beef" and bearing the seal of Argentina's Ministry of Agriculture. When his men opened them, they found not corned beef but documents. De la Torre had exposed to public view for the first time the secret financial details of William and Edmund Vestey, founders of the world's biggest meat retailers, Britain's richest family, and among the biggest individual tax avoiders in history. Their story, and their wrangles and deals with their American competitors, provides a remarkable wind down into the emergence of multinational corporations in the early years of the last century and the emergence of a global industry of international tax avoidance alongside them.

William and Edmund Vestey had started out in 1897 shipping meat trimmings from Chicago to their native Liverpool, where they had built cold storage facilities, giving them an edge over their competitors. They branched out into poultry farming in Russia and China in the first decade of the twentieth century, from where they began processing and shipping vast quantities of super-cheap eggs to Europe. They set up more cold stores and retail outlets in Britain, and then in France, Russia, the United States, and South Africa, then moved into shipping in 1911, before expanding out to ranches and meatpacking in Argentina from 1913. At the outbreak of the First World War, they bought up more

farmland and plants in Venezuela, Australia, and Brazil,[5] by which time they were involved in the entire supply change of the beef trade, from cattle to restaurant hamburger. They were pioneers of the truly integrated multinational corporation.

The Vestey brothers dressed in dark, sober suits and hats, and perhaps the biggest visible extravagance for each of them was a watch and chain. They had no outside interests beyond business: They did not smoke, drink, or play cards, and despite their fabulous wealth they lived in modest houses and ate cheap meals. Once, while on honeymoon in Ceylon, William heard of a fire at a company packing plant in Brazil and packed his new wife off to sort out the mess there. William returned to London on the next steamer.[6] Frugal and puritan, the brothers refused to trade alcohol and would even inspect their employees' fingers for tobacco stains.

They lived by the maxim that it is not what you can earn that makes you rich but what you can keep. They lived on the interest on the interest on their income. Peers of the Realm, Masters of the Foxhounds, personal friends of the Prince of Wales, and that sort of thing, the extended Vestey family still enjoys so much inherited money today that some have only discovered they are heirs when presented, on their eighteenth birthday, with checks for startling amounts. One distant heir, suddenly presented with a quarter of a million pounds in the 1990s, said, "I can't handle it" and turned it down.

The brothers lived by two business rules above all: first, never reveal what you are up to; and second, never let other people do something for you if you can do it yourself. They were, at heart, monopolists. They gave their different companies different names to disguise their ownership and bought up rivals, and if one resisted they would use their extraordinary market power— derived from their owning the whole supply chain from the grass, via the cows, to the slaughtering houses, the freezers, the ships, and then distribution and retail outlets—to drive them out of business. "If you mention his name near a meat market, people look over their shoulders," wrote one critic. A weaker competitor said bitterly: "We're not doing business with them. They're in everybody's business and they want everybody's business."

As their business grew increasingly multinational, it became ever harder for anyone to even guess what they were up to. "The juggling acts El Inglés [the Vestey company] performed with the packing houses were enough to give the best aviator a dizzy spell," an Argentinian businessman wrote. "It is not surprising that the company tax inspector had a difficult job to unravel it all when El Inglés, in the end, was left with just one packing house."[7] In partnership with the Americans, the brothers showed the same controlling behavior at the retail ends too.

So when Senator de la Torre's investigation stumbled across the documents on the Norman Star he had achieved quite a coup. Top members of the Argentinian government were colluding in, and even profiting from, their subterfuges, he alleged, and dirty political brawls broke out. Insults and counter-insults ricocheted around the Argentine political landscape, culminating in an assassination attempt on de la Torre in which an aide died after taking a bullet intended for the senator.[8]

The Vesteys' basic formula for gaining market power—squeeze them at the producer end, squeeze them at the consumer end, and push all the profits into the middle—was a philosophy that they also deployed, with astonishing success, in the area of tax. It is a formula that underlies the size and power of multinational corporations today.

In those early days the tax haven world was in its infancy, and governments were groping in the dark to understand and to tax emerging multinational corporations. (They still are.) Relatively few tax havens existed then, focusing mostly on the financial affairs of extremely wealthy individuals. Rich Europeans looked primarily to Switzerland, while wealthy Britons tended to use the nearby Channel Islands and the Isle of Man. Wealthy Americans were busy too, as a letter from U.S. Treasury Secretary Henry Morgenthau to FDR in 1937 suggests.[9] "Dear Mr. President," it begins. "This preliminary report discloses conditions so serious that immediate action is called for." American tax evaders had set up foreign personal holding corporations in places with low taxes and lax corporation laws, he wrote, singling out the Bahamas, Panama, and Newfoundland, Britain's oldest colony. Stockholders were organizing companies through foreign lawyers, with dummy incorporators and dummy directors, to hide their identities. Though extremely rudimentary by modern standards, the basic schemes Morgenthau

outlined would be familiar to followers of today's offshore shenanigans. "The ordinary salaried man and the small merchant does not resort to these or similar devices. Legalized avoidance or evasion by the so-called leaders of the business community . . . throws an additional burden upon other members of the community who are less able to bear it, and who are already cheerfully bearing their fair share."

On the corporate side, offshore activity did not initially focus so much on tax. One great historical landmark in this respect emerged in the late nineteenth century when James B. Dill, a New York corporate lawyer, persuaded the governor of New Jersey that the state could get out-of-state corporate managements to incorporate there by passing permissive incorporation laws favorable to managers to the detriment of shareholders. New Jersey passed its first such law in 1889, then relaxed its rules again and again.[10] Corporations, including the Standard Oil Trust, began to relocate out of New York and other large centers and flock to New Jersey. Britain and the Netherlands began to follow the U.S. lead.[11]

Just before the First World War, however, New Jersey's governor Woodrow Wilson decided to check the rampant corporate abuses that had emerged as a result of these permissive incorporation laws and put in place progressive new antitrust laws and rules to make corporate managers more accountable to shareholders, investors, and other stakeholders. So corporations flocked to neighboring Delaware, which had already set the standard to be used by tax havens thereafter, by letting corporate managers effectively write their own corporate governance rules. By 1929 two-fifths of Delaware's income came from corporate fees and taxes, and it led the United States in incorporations, a lead it has never lost. An article in the American Law Reviewin 1899 noted Delaware's efforts to win the race to relax corporate standards and called Delaware "a little community of truck-farmers and clam-diggers . . . determined to get her little, tiny, sweet, round, baby hand into the grab-bag of sweet things before it is too late."

This brief digression into corporate law helps remind us what offshore is all about. It is not just about tax: In this case it is about attracting money by offering rewards to insiders, at the expense of other stakeholders, undermining or undercutting the rules and legislation of other jurisdictions.

And indeed, Delaware seems to have a long historical predilection toward offshore business: At the Constitutional Convention, Delaware's delegation fought aggressively for each state to get the

right to send two senators to Congress— putting tiny Delaware on a par with mighty New York. A Delaware delegate [12] threatened that if they didn't get their way, "the small ones would find some foreign ally of more honor and good faith, who will take them by the hand and do them justice." It is easy to see, in light of examples like this, why offshore business is so often described as unpatriotic.

Offshore corporate tax avoidance really started taking off around the time of the First World War: Before that, taxes were mostly too low to worry about.[13] When war broke out, however, a lot of countries needed to raise a lot of money fast, and income taxes rose dramatically. In the United States, the top rate of tax for individuals rose from 15 percent in 1916 to 77 percent in 1918. The nation introduced the corporate income tax only after the Sixteenth Amendment was ratified in 1913, and it rose to 12 percent in 1918, by which time corporation taxes amounted to half of all federal tax revenues. In Britain the standard rate rose fivefold during the war to 30 percent in 1919, the year after the war ended. But in 1914 Britain had done something else that was especially pertinent for the Vesteys: It had begun to tax British companies on all their income worldwide, whether or not they brought this income home.[14] And the Vesteys were furious.

They tried lobbying against being taxed—which, in the new wartime environment, was doomed to look unpatriotic and to fail. As Britain's tax authorities noted, taxes on business profits never stop you from earning the profits—they only kick in once there are profits.

But William and Edmund Vestey were having none of it. In November 1915, as fifty thousand British soldiers died at the Battle of Loos, the brothers moved overseas to cut their tax bill. Their first stop after leaving was Chicago, where they found they weren't the first wealthy Britons to move for tax reasons. "What's the matter with your people?" a local tax lawyer asked. "You are the third Englishman I've had in here this week in the same business." From there they moved to Argentina, where they paid no income tax at all—and even then, they fought to cut the residual company taxes they still had to pay in Britain.

As the war progressed, however, the brothers increasingly started to wish they could return home, closer to their food empire's real profit center. So they began to hatch up a new scheme to return and still escape the tax net.

They put into place a two-stage plan. First they returned temporarily in February 1919, taking careful legal precautions to ensure they continued to be treated as visitors, not taxable residents, and they began

lobbying. They wrote an impassioned plea to the prime minister, dressed up with appeals to patriotism and claiming their return would contribute to local employment

—arguments that multinational corporations still routinely make today. They also complained bitterly about how unfair it was that their big competitor, the American Beef Trust, faced lower taxes and gained a big competitive advantage from it.

They had pointed to one of the great problems in international tax. Each country taxes its citizens, residents, and corporations in different ways, and different countries' tax systems often clash in unpredictable ways. Multinationals based in these different countries face very different tax bills on similar incomes, enabling one to out-compete another on a factor that has nothing to do with efficient management or real productivity.

U.S. citizens and corporations formed under U.S. laws were taxed on their income from all sources worldwide, and the test of whether one was a U.S. taxpayer was based on citizenship, not on residence—a subtle but important difference. But if the corporation—even a subsidiary of a U.S.-based corporation—was formed overseas, it did not pay taxes to the United States but to the foreign country where it was incorporated. The Chicago-based Beef Trust used this to avoid paying taxes in the United States—and then used various loopholes to avoid tax in Britain, too, where it sold a lot of its meat.

The Vesteys, who were paying significant taxes, did not like it, and the British prime minster referred their claims to an official commission. William's testimony to that commission was to become a classic in the tax world, cited in academic tax papers ever since. He posed the question of double taxation that I referred to in chapter 1: When a business is spread across several countries, which country gets to tax which bit of it?

"In a business of this nature you cannot say how much is made in one country and how much is made in another," said William Vestey. "You kill an animal and the product of that animal is sold in fifty different countries. You cannot say how much is made in England and how much abroad." He had put his finger on the central problem with taxing multinational corporations today. By their nature they are integrated global businesses, but tax is national. Taxing a corporation straddling multiple jurisdictions involves gruesome complications, and if each country scrambles to get as large a share as possible of the multinational's taxes, then the corporation risks being taxed twice or more on the same income.

So as taxes rose across the wealthy nations amid the First World War, a new source of economic conflict emerged. Double taxation became a

hot issue, and businesses began to complain and to mobilize. An International Chamber of Commerce was set up in 1920, with tax squarely on its agenda from the outset.[15]

From the beginning, the emerging multinationals stayed a few jumps ahead of tax collectors.

Just as the Vesteys and the U.S. meat packers used their market muscle to squeeze their competitors at both the producer end and the consumer end, so they also began to squeeze the tax authorities at both ends. The trick, once again, was the same "transfer pricing" principle used by the banana companies that I described in the last chapter. If you own the ranches, the cattle, the freezers, the docks, the ships, the insurers, the wholesalers, and the retailers, then you can, by adjusting the prices one subsidiary charges another for goods, drive the profits away from the producer and the consumer countries, and instead take your profits at the most convenient place down the line. "And the most convenient stage," notes Knightley, "is naturally where you will pay the least taxation, preferably where you will pay none at all."

By siphoning the profits to a holding company in a tax haven, explains tax expert Sol Picciotto, the multinationals had found a way to avoid being taxed anywhere. They could now out-compete, and grow faster than, smaller, purely national firms. A system designed to avoid double taxation had, via the use of tax havens, turned into one of double nontaxation. And through this basic formula, the offshore system has become one of the main foundations of the power of multinational corporations today.

William Vestey's testimony to the official commission in 1920 reveals a man accustomed to getting his way. "If I kill a beast in the Argentine and sell the product of that beast in Spain, this country can get no tax on that business," he said. "You may do what you like, but you cannot have it."[16] He wanted to live in Britain, without paying his way, demonstrating an arrogance that pervades the offshore system, underpinned by that same old argument that bankers and other owners of footloose capital wield against our democratic representatives today: don't tax or regulate us too much, or we will move offshore.

Stung by the Vesteys' lack of patriotism after a major war, the commissioners hit back. "Are you not to pay anything for the advantage of living here?" one asked. William Vestey refused to answer. "I should

like to have an answer," the commissioner continued. "It is one that has agitated me a good deal since the witness has been in the chair." In the end, Britain refused to give in to the Vesteys. So they moved to the second stage of their plan, involving a more devious approach, something that helps us better understand the slippery world of offshore.

They set up a trust.

Many people think that the best way to achieve secrecy in your financial affairs is to shift your money to a country like Switzerland, with strong bank secrecy laws. But trusts are, in a sense, the Anglo-Saxon equivalent. They create forms of secrecy that can be harder to penetrate than the straightforward reticence of the Swiss variety. Trusts are powerful mechanisms, usually with no evidence of their existence on public record anywhere. They are secrets between lawyers and their clients.

Trusts emerged in the Middle Ages when knights leaving on the Crusades would leave their possessions in the hands of trusted stewards, who would look after them to provide benefits to the knights' wives and children when they were away or if they never returned. These were three-way arrangements binding together the original owners of the properties (the knights), with the beneficiaries (their families), via an intermediary (the stewards, or trustees). Over the centuries bodies of law grew up to formalize these three-way arrangements, and today you can enforce these things in the courts.

What a trust does, at heart, is to manipulate the ownership of an asset. You might think ownership is a simple thing: you have, say, a million dollars in the bank; you own it, and you can save it, or spend it, or take it out in ten-dollar bills and put it in your bathtub. But ownership can, in fact, be unbundled into separate strands. This happens, for example, when you buy a house with a mortgage: Until you repay the loan, the bank has some ownership rights over your house and you have other rights.

A trust unbundles ownership into different parts very carefully. When a trust is set up the original owner of an asset in theory gives it away into a trust. The trustee becomes the legal owner of the asset—though this person is not free to spend or consume it—for they must legally obey the terms of the trust deed, the instructions that tell them exactly how to share out the benefits to the beneficiaries. The trustee must obey these instructions, and apart from fees he or she may not receive any of the benefits. So a rich old man with two children might put $5 million into a bank account owned by a trust, then appoint a reputable lawyer as the

trustee, instructing him that when the son is twenty-one he should receive half the money, and when the daughter later becomes twenty-one she should get the rest. Even if the wealthy man dies before the money is paid out the trust will survive, and the trustee is bound in law to pay out the money as he is told. It is very hard indeed to break a trust.

Trusts can be legitimate. But they can be used for more nefarious purposes, like criminal tax evasion. When a trust sets up solid legal barriers separating out the different components of ownership of an asset, these barriers can become unbreakable information barriers too, shrouding the assets in secrecy.

Imagine that the assets in a trust are shares in a company. The company may register the trustee—the legal owner—but it will not register the beneficiaries—the people who will be getting and enjoying the money—anywhere. If you have a million dollars in an offshore trust in the Bahamas and the tax inspectors come after you, it will be hard for them to even start their inquiries: Trust instruments in the Bahamas are in no official register. Even if the tax inspectors or police get lucky and find out the identity of a trustee, that is likely to be simply a Bahamas lawyer who does this for a living, who may be the trustee for thousands of trusts. She may be the only other person in the world who knows you are the beneficiary, and he or she is bound by professional confidentiality to keep your secrets safe. The tax inspector has hit a stone wall.

You can make this secrecy deeper still, of course, by layering one secrecy structure on another. The assets in the Jersey trust may be a million dollars in a bank in Panama, itself protected by strong bank secrecy. Even under torture the Bahamas lawyer could never reveal the beneficiary because he or she wouldn't know.[17] Such intermediaries merely send the checks to another lawyer somewhere else, who also isn't the beneficiary. You can keep on going: layering the Jersey trust on another trust in the Caymans, itself perched on a secret company structure in Nevada. If Interpol comes looking they must go through difficult, slow, and costly court procedures, in country after country, and face the "flee clauses" that mean the asset automatically hops elsewhere at the first sign of investigation.

The trust arrangement that the Vesteys set up in December 1921, signed in the Paris offices of the British lawyers Hall & Stirling, was fairly simple compared to the great offshore embroideries that are common today. Yet even so, it took Britain's Inland Revenue eight years to know it even existed.

In the meantime, while the Vesteys' secret Paris trust ticked over quietly, a new scandal erupted.

In June 1922, seven years after leaving the country to escape British wartime taxes, it emerged that William Vestey had bought himself a title, becoming Baron Vestey of Kingswood. Plenty of people who had

made fortunes in the Great War had done this, craving the respectability of a peerage to mask the taint of war profiteering. Prime Minister Lloyd George had sold off official honors willy-nilly, causing outrage. "Gentlemen received titles," a member of parliament had spluttered in 1919, "whom no decent man would allow in his home." When challenged on his tax-avoiding activities, William Vestey did not endear himself to anyone by stating that "I am technically abroad at present . . . the present position of affairs suits me admirably. I am abroad. I pay nothing." The scandal rumbled on, but in the end nothing was done and the Vesteys returned home to Britain as they had wished. Their secret Paris trust kept the tax authorities at bay.

But even when the British tax authorities found the Paris trust, through patient detective work, they still could not get the Vesteys to pay tax on it. For secrecy is not the only subterfuge that trusts provide.

People are sometimes puzzled by one particular thing about trusts. If you must give the asset away into a trust in order to hide the asset and dodge your tax bill, is that not an oversize price to pay?

The answer is not straightforward. In part, this is a cultural question. Wealthy classes have grown to feel comfortable separating themselves from their money and leaving it to be managed by trusted strangers. Their education prepares them to recognize those who will respect their claims and whom they can therefore count on to do the right thing by them.

But there is another part to the answer, which offers further insight into the sneaky world of offshore. If you want to evade taxes or hide money through a trust, the trick is to make it seem as if you have given your asset away, while in reality you retain control of it. You can tell the tax authorities, or the police, that you really don't own the asset anymore—and only your trust lawyer need know that you are still really in control.[18] The preamble to the Paris trust deed hints at exactly that pretence. "In consideration of the natural love and affection of the settlors [the Vesteys] for the beneficiaries," it began, "and for divers other good causes and considerations." The money, it was saying, had really been given away to their dear beneficiaries, their wives and children.[19]

But what the Vesteys actually did was this. First, they leased most of their overseas empire to Union Cold Storage Ltd., a company based in Britain. In any normal arrangement, Union would have simply paid rent to the Vestey brothers. But instead Union paid the rent to two trusted lawyers and a company director in Paris. These trustees were then given

very wide powers of investment, to be carried out under the direction of certain "authorised persons." And who were those persons? Why, the Vestey brothers! So the trustees, under the Vesteys' direction, lent large sums to another company in Britain, which the Vesteys also controlled, and which they used as their own personal piggy bank.[20] They had seemed to have given away their money while retaining real control.

And here comes a point about tax havens. Reputable jurisdictions have put in place laws to make it very hard for you to play this trust subterfuge. But secrecy jurisdictions have done the opposite, specializing in providing laws to help you perfect the deceit. Many jurisdictions, for example, allows things called revocable trusts—trusts that can be revoked so that the money is returned to the original owner. If you can do that, then you have not really separated yourself from the asset. Until it is revoked, though, it looks as though you have passed the asset on, and the tax authorities cannot have it. A Jersey sham trust provides a different subterfuge, letting you replace trustees with more pliable ones later, and changing their instructions at will. Or a trust might have a "trust protector" who has influence over the trustees, who acts discreetly on behalf of the person who pretended to give the money away. A Cayman Islands "Star Trust" lets you, the original owner, make the trust's investment decisions—and the trustee is not obliged to ensure the investments are in the interests of other beneficiaries. And so it goes on. There are offshore lawyers who sit in their offices all day, doing little more than dreaming up deviant new flavors of trusts.

Trusts are not only about tax, either. As we shall see, many of the structured investment vehicles that helped trigger the latest economic crisis involved offshore trusts. Most people would be surprised, even shocked, to find out how central they are to global finance.

In choosing the trust mechanism to protect their vast wealth, the Vesteys had chosen a powerful weapon indeed. And when the Argentinian senator Lisandro de la Torre found those crates of Vestey documents buried under the guano on the Norman Star in 1934, he was probably unaware just how crafty his adversaries were in this kind of offshore subterfuge. Soon after the raid, new and incriminating Vestey documents turned up in Uruguay, and the senator achieved another coup when he got the British Foreign Office, whose diplomats were deeply uneasy with the Vesteys' business practices, to agree to turn Argentina's quest into a

multicountry joint committee of investigation.

There was no telling what such a probe might uncover, so the Vesteys went on the offensive. When their local manager died of a heart attack, William Vestey wrote to the committee and brazenly accused Senator de la Torre of murdering him. Argentina's government responded furiously, calling Vestey's letter "an unprecedented piece of insolence."

Things went downhill from there. The committee worked for two more years while the Vesteys pulled strings in London to emasculate it, and despite sixty meetings and a report filled with detail about the Argentine meat trade, they never got to see the Vestey books in London. Senator de la Torre shot himself on January 5, 1939, leaving a suicide note that, as his biographer Philip Knightley notes, "expressed his disappointment at the general behaviour of mankind."

Each time Britain's authorities tried to tax overseas trusts in the ensuing decades, William and Edward, and their descendents, kept refining their tax planning and slipping through the net. "Trying to come to grips with the Vesteys over tax," one tax officer said, "is like trying to squeeze a rice pudding."

In 1980, shortly after one such assault by the Inland Revenue, an investigation by the Sunday Times, then one of the world's most respected newspapers, revealed that in 1978, the Vesteys' Dewhurst chain of butchers in Britain had paid just £10 tax on a profit of more than £2.3m—a tax rate of 0.0004 percent. "Here is an immensely wealthy dynasty which for more than sixty years has paid trivial sums in tax," the newspaper wrote. "All that time its members have enjoyed the considerable pleasures of being rich in England without contributing anything near their fair share to the defences which kept those pleasures in being— against foreign enemies in wartime, against disorder and disease in times of peace." Edmund Vestey, the grandson of the original Edmund, put the icing on this particular cake. "Let's face it, nobody pays more tax than they have to. We're all tax dodgers, aren't we?"[21]

The Paris trust loophole was finally closed in 1991,[22] but opportunities for legal tax avoidance for Britain's wealthy remain abundant. When the British Queen finally started paying income tax in 1993 after a public outcry, the latest Lord Vestey smiled and said: "Well, that makes me the last one."

As we shall soon see, he was very far from alone.

THE OPPOSITE OF OFFSHORE
John Maynard Keynes and the Struggle against Financial Capital

IT IS WITH A STRANGELY DEFENSIVE TONE that Robert Skidelsky, the best-known biographer of John Maynard Keynes, prefaces the U.S. edition of volume 3 of his biography of the great British economist. He takes issue with U.S. economist Bradford DeLong's accusation that he has fallen under the influence of "a strange and sinister sect of British imperial conservatives."[1]

Skidelsky's work argues that for Britain the Second World War was in fact two wars, one pitting Britain under Winston Churchill against Nazi Germany, the other lying behind the facade of the Western alliance and pitting the British empire, led by Keynes, against the United States. America's main war aim after the defeat of the Axis powers, he argued, was to destroy the British empire. "Churchill fought to preserve Britain and its empire against Nazi Germany; Keynes fought to preserve Britain as a Great Power against the United States. The war against Germany was won; but in its effort to win it, Britain spent its resources so heavily that it was destined to lose both its Empire and its Great Power status."[2] Keynes himself outlined one of his central aims as he negotiated in Washington: "America must not be allowed to pick out the eyes of the British Empire."[3]

The arguments are complex, not least because Keynes's main negotiating partner in Washington, Harry Dexter White, was almost certainly passing information to the Soviet Union. But Skidelsky's account leaves no doubt that the two countries were quietly locked in a titanic struggle for financial dominance, as the thrusting new American superpower began to displace the old empire.

It was only long after the war that the two economic competitors would eventually work out a suitable arrangement for coexistence. It

happened, as I shall explain later, through the construction of the modern offshore system. This chapter, however, explores what came before it: an international arrangement that Keynes helped design, where nation-states cooperated with each other and tightly controlled flows of financial capital between them. This system was, in a sense, the very opposite of today's fragmented, laissez-faire system, where wild, unregulated, and untaxed tides of capital flow across borders with almost no restraint, much of it through offshore centers.

For all its problems, the years of the anti-offshore system that followed the Second World War were a period of tremendous, broad-based growth and prosperity—not just for the American middle classes but for the world as a whole. The collapse of the system in the 1970s and the explosion of global offshore finance after that ushered in a period of lower growth, recurring economic crisis, and stagnation for most Americans, while wealth at the top of the income pile soared.

Keynes was as complex a character as any who have taken the world stage. He crammed the intelligence, and seemingly the lives, of twenty people into one. The aging Alfred Marshall, arguably the leading economist of his generation, once declared after reading a pamphlet from the young economist that "verily, we old men will have to hang ourselves, if young people can cut their way so straight and with such apparent ease through such great difficulties."

Keynes first properly made his reputation in 1919 with his pamphlet The Economic Consequences of the Peace, arguing that the vast reparations being heaped on Germany after the First World War would ruin it, with terrible results for the wider world. He was quite right: The stringent demands for reparation helped trigger the rise of Adolf Hitler and the Second World War. Years later, while writing his General Theory of Employment, Interest and Money, arguably the most famous economics textbook of the last century, Keynes was building a theater in Cambridge with his own money, drawing graphs of receipts from the theater restaurant, collecting tickets when the clerk failed to materialize, and, improbably, turning it into a huge artistic and commercial success. He became a respected art critic, a towering civil servant and diplomat, a hyperactive editor of economic publications, and a journalist whose articles could make whole currencies swoon. He wrote a book on mathematical probability that the polymath and philosopher Bertrand

Russell said was “impossible to praise too highly,” adding that Keynes’s intellect was “the sharpest and clearest that I have ever known.” Russell felt that when he argued with Keynes, he “took his life into his hands.”

Opponents of Barack Obama have claimed that his Keynesian attempts to resuscitate the U.S. economy through deficit- financed public works constitute a Soviet-styled takeover of the free enterprise system. Yet Keynes was never the socialist bogeyman of the conservative imagination. He loathed Marx and Engels, he saw government intervention as a temporary fix, and he believed passionately in markets and trade as the best routes to prosperity. He wanted to save capitalism, not bury it.

For much of the nineteenth century, free traders had dominated policy in the United States and much of Europe: It was self- evident, many people thought, that free trade delivered prosperity and brought peace by creating economic interdependencies that made it harder to wage war. It was a bit like an argument memorably made in the 1990s by journalist Thomas Friedman, who said that no two countries with a McDonald’s—that symbol of free trade and the “Washington Consensus”—had ever fought a war with each other.[4] Keynes believed this, for a while. “I was brought up, like most Englishmen, to respect free trade,” he wrote in the Yale Review in 1933, “almost as a part of the moral law. I regarded ordinary departures from it as being at the same time an imbecility and an outrage.”[5]

He had begun to see then that finance is different. He learned of the irrationality of markets first hand, spending half an hour each day in bed speculating with his own money in the famously treacherous terrain of international currencies and commodities, diving into company balance sheets and statistics (and declaring of the latter discipline that “nothing except copulation is so enthralling”).[6] It made him a fortune, though he nearly bankrupted himself when a gamble against the Deutschmark in 1920 went disastrously wrong. “When the capital development of a country becomes a by-product of the

activities of a casino," he famously said,
"the job is likely to be ill-done."

Keynes understood instinctively the important differences between trade and finance. When two parties trade goods with each other, it is more or less a meeting of equals. But with finance the borrower is usually subservient to the lender. It is a relationship described years later by James Carville, Bill Clinton's adviser, who famously articulated the borrower's sense of helplessness when he said that if reincarnated he wanted to come back as the bond market because then "you can intimidate everybody." The interests of industrial capitalists and financial capitalists often conflict too. Financiers, for instance, tend to like high interest rates, from which they can derive considerable income, while industrialists want low interest rates, to curb their costs.

And the financiers then, as today, firmly had the upper hand. As is well known, the Great Depression that erupted in 1929 was the culmination of a long period of deregulation and economic freedom for Wall Street and a great bull market built on an orgy of debt, along with mind-bending rises in economic inequality. In the late throes of the boom the richest twenty-four thousand Americans, for example, received 630 times as much income on average as the poorest 6 million families[7]; and the top 1 percent of people received nearly a quarter of all the income—a proportion slightly greater than the inequalities suffered at the onset of the global crisis in 2007. "We have involved ourselves in a colossal muddle," Keynes wrote in the 1930s, "having blundered in the control of a delicate machine, the working of which we do not understand." The similarities with our current situation can hardly be missed.

Though there was no interconnected offshore system in his day—just the few assorted havens I described in the last chapter— Keynes still offered penetrating insights that help us understand the offshore system and are eerily prescient in light of the recent global financial and economic crisis.

When a company or government sells bonds or shares, investors hand over money in exchange for pieces of paper that give the holder title to a future stream of income. When the bonds or shares are first issued, savings are mobilized, funds are raised, and they flow into productive investment. This is generally healthy. But the next step is when things change. A secondary market appears in these pieces of paper, where

the shares and bonds are traded. These trades no longer contribute to creating new productive investment in the real world: They merely shuffle ownership. Well over 95 percent of purchases in global markets today consist of this kind of secondary activity, rather than real investment. Keynes explained what happens when you start to separate real business operations in the real world from their owners. The holders of paper, the investors, become detached from the real businesses that they are investing in, and incentives change dramatically. When this happens across borders, the problem gets worse still: "When the same principle is applied internationally it is, in times of stress, intolerable," Keynes continued. "I am irresponsible towards what I own, and those who operate what I own are irresponsible towards me."

Shuffling ownership of bits of paper may seem to promote efficiency by helping capital flow to those projects that offer the highest risk-weighted returns, Keynes noted. A little speculative trading in these markets may well improve information and regulate prices. But in the real world, when the volume of this dealing is a hundred times bigger than the underlying volume of real trade, the results can be catastrophic. "Experience is accumulating," he said, "that remoteness between ownership and operation is an evil in the relations among men, likely or certain in the long run to set up strains and enmities which will bring to nought the financial calculation."

His words seem more apt than ever in a world where credit derivatives, asset-backed securities, and other products of financial engineering have placed ingenious but impenetrable barriers between investors and the assets they own, becoming great financial tinsel that is repackaged and resold down chains of investors across the planet, at each step being distanced further from the people and businesses who populate the real world.

Now consider the offshore system in light of this. The secrecy jurisdictions, by applying a sort of super-lubricant to the flow of capital around the world, dramatically widen these chasms inside capitalism. They are the supreme generators of remoteness and artificiality: creating secrecy barriers and generating unfathomable complexity as corporations garland their financial affairs around the world's tax havens to fox the world's tax authorities and regulators, and to shield particular investors against other nations' laws and regulations. As we have discovered since 2007, the system was wildly inefficient: consider the wealth destroyed and the costs heaped onto the shoulders of taxpayers.

Capital no longer flows simply to where it gets the best return but to

where it can secure the best tax subsidies, the deepest secrecy, and to where it can most effectively evade the laws, rules, and regulations it does not like. None of this has anything to do with allocating capital more efficiently. Keynes would have viewed the explosion in offshore finance since the 1970s—and the massive capital flight it fostered—with horror.

With all this in mind, we can now turn to one of Keynes's great feats: the construction of a new world order after the Second World War that was the antithesis of the offshore system that would follow.

As Britain entered into the Second World War, Keynes went to Washington to negotiate the terms on which the nation was to receive U.S. assistance and to discuss what might come after the war. Many Americans, he soon realized, were rather more hostile to Britain than he had supposed. Roosevelt, for example, despised the British empire, mistrusted England's aristocracy, and, Skidelsky notes, "suspected the Foreign Office of pro-fascist tendencies."[8]

Americans had fairly effectively chained and muzzled Wall Street after the Great Depression, and policymakers in Washington saw the far more lightly regulated City of London—the financial heart of the hated British empire—with deep suspicion. Britain was discriminating against American goods in international trade, and Roosevelt's Republican opponents were horrified at the prospect of entanglement in another foreign war. Why help Britain again, many asked, after Britain had snared America into entering the First World War, then refused to pay its war debts and hung on to its empire. After the British army was forced into a humiliating retreat from Dunkirk in 1940, some in Washington were also reluctant to back what looked like a lost cause.

Global economic might had already shifted decisively across the Atlantic from London to New York, but Britain still held India by force, along with much of Africa and the Middle East. Keynes's combative and too-clever-by-half style fitted Americans' stereotypes of the British as super-wily imperial puppeteers, ready to bamboozle them. When Keynes first met U.S. Treasury Secretary Henry Morgenthau, who was no lover of technicalities, Keynes spoke for an hour, in great detail—and Morgenthau "did not understand one word," a Washington insider later wrote to a friend.[9] Harry Hopkins, one of Roosevelt's advisers, called

Keynes "one of those fellows that just knows all the answers."

But Keynes's problem was more fundamental. America wanted Britain to fight fascism, and it was prepared to give huge military aid under its Lend-Lease Act of March 1941, but it also saw the war as the chance to dethrone Britain and its empire once and for all. As Keynes wrote later, the U.S. administration took every possible precaution to see that the British were as near as possible to bankrupt before giving any help. "Why do you persecute us like this?"[10] he once asked his American counterparts. In response to the challenge, Britain's chief aim was, as Keynes put it, "the retention by us of enough assets to leave us capable of independent action."[11]

It was a grueling war for Keynes, in a decidedly unequal contest. He was seriously ill, diagnosed with septic tonsils and a "large heart and aorta," and he was representing an empire on its knees. When Keynes disagreed with his American counterpart Harry Dexter White, the American economist Brad DeLong wrote, "he usually lost the point because of the greater power of the United States. And in almost every case it seems to me that Keynes was probably right."[12]

As the war went on, Keynes turned his attention in Washington to negotiating the construction of a new cooperative international monetary order to govern future economic relations among the nations of the world, grounded upon efforts to restrain the international financial freedoms that had preceded and helped cause the Great Depression. The rampant capitalism of that era, founded upon an old alliance between Wall Street and the City of London, had involved freely floating currencies, strictly balanced government budgets, and free flows of capital around the world—a little like the modern global financial system. "The decadent international but individualistic capitalism," Keynes wrote, "is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous—and it doesn't deliver the goods. In short, we dislike it, and we are beginning to despise it." On this broad point his American colleagues were with him: Morgenthau said that the aim must be "to drive the usurious money-lenders from the temple of international finance."[13]

Keynes's negotiations culminated in the Bretton Woods Conference in 1944, the outcome of which would shape the international financial architecture for decades. The conference involved many nations but was an American production: The U.S. Treasury stage-managed the drafting committees and the conference to produce the desired results. U.S. Commission chairmen would prevent a vote on anything they didn't want

voted on and would arrange the discussion to stop inconvenient topics from being aired.[14] It was hard to see what the international "monkey house" of delegations from other countries would do, Keynes archly commented: "Acute alcohol poisoning would set in before the end."

Keynes had hoped that the IMF would become a depoliticized institution, overseeing automatic mechanisms to resolve global financing imbalances automatically and remove politics—and raw American power—from the equation as far as possible. He did not get his wishes, and when these matters were decided at a subsequent meeting in 1946, Keynes said acidly that he hoped "there is no malicious fairy, no Carabosse"—a reference to the wicked fairy-tale godmother figure of Sleeping Beauty, popularized in Tchaikovsky's and later Diaghilev's ballet—"whom he has overlooked and forgotten to ask to the party." Fred Vinson, a top U.S. negotiator, who felt he was the target of the remark, was heard to say in response, "I don't mind being called malicious—but I do mind being called a fairy."[15]

Many people today see the IMF and World Bank—the children of the Bretton Woods Conference—as the handmaidens of globalization, of unfettered trade and capital flows, and the instruments of Wall Street bankers. This was not the original idea. Keynes did want open trade, but finance was to remain tightly regulated: otherwise, surges of flighty capital would generate recurrent crises that would hamper growth, disrupt and discredit trade, and possibly drive fragile European economies into the arms of the communists.

Keynes understood the basic tension between democracy and free capital movements. In a world of free capital flows, if you try to lower interest rates, say, to boost struggling local industries, capital is likely to drain out overseas in search of higher returns, thwarting your original intent.[16] Investors hold a kind of veto power over national governments, and the real lives of millions of people will be determined not by their elected representatives but by what the Indian economist Prabhat Patnaik called "a bunch of speculators." Freedom for financial capital means less freedom for countries to set their own economic policies: from financial freedoms a form of bondage emerges.

Keynes's answer was simple and powerful: control and constrain the flows of capital across borders and limit the trade in currencies through exchange controls. He believed that financing was usually best when it happens inside, rather than between, countries. Capital controls would give governments more room to pursue objectives like maintaining full employment: Instead of limiting the scope of democracy in the interests

of speculators and financiers, the plan was to limit the international mobility of capital: Finance would be society's servant, not its master. "Let goods be homespun whenever it is reasonably and conveniently possible," he wrote. "Above all, let finance be primarily national." The Bretton Woods plan, for all its faults, was designed to tame the forces of international finance.[17]

Capital controls can be hard to imagine for those who have not experienced them. To get foreign exchange for overseas trips, for example, you needed official permission. Frequent international travelers, for instance, would have a section in their passports, "Foreign Exchange Facilities—Private Travel," that would be filled with official stamps and signatures authorizing access to sums of foreign exchange. Companies had to get permission to shift money across borders.

This short history helps us to see how very far indeed we have now traveled from the system created by Keynes and his American counterpart Harry Dexter White. Dismantling capital controls is one thing. But we have taken a full step again beyond that, to a world where capital is not only free to flow across borders but is actively and artificially encouraged to flow, lured by the offshore attractions of secrecy, evasion of prudential banking regulations, tax evasion and avoidance, and more. Once again, Keynes would have been horrified.

There is something else about this episode that is rather less well known.

Many mainstream economists embrace a simple idea that goes something like this. Poor countries lack capital. Foreign investment can fill the gap. So it makes sense to free up flows of capital to let capital flow into these capital-starved countries, where it can get higher returns. This may seem like a sensible idea, but what mainstream theory has failed seriously to address is that if you free up capital flows, money might not necessarily flow in. It might, instead, flow out. And the ways in which it may flow out might be unusually harmful.

Keynes understood the problem. "Advisable domestic policies might often be easier to compass, if the phenomenon known as 'the flight of capital' could be ruled out," he said. His words were prescient, for capital flight in his day was nothing when compared to the world-bending amounts that flood out of poor countries into the secrecy jurisdictions today.

He also knew there was a problem: Even in a world of tight capital controls, there would be leakage. Multinational companies needed permission to move investment capital overseas but had much more freedom in moving money for current purposes— that is, for financing trade and other day-to-day business. Of course, they could easily disguise a capital payment as a current one. To this, however, Keynes and Harry Dexter White had an answer. "What is often forgotten," the Canadian scholar Eric Helleiner notes, "is that Keynes and White addressed this with a further proposal. They argued that controls on capital would be more effective if the countries receiving that flight assisted in their enforcement."[18] In the earliest drafts of the Bretton Woods agreements, both Keynes and White had required that the governments of countries receiving the flight capital would share information with the victims of that flight. In short, they wanted transparency in international finance. Without the lure of secrecy, capital would have far fewer incentives to flee.

Enter Wall Street bankers and their lobbyists. U.S. banks had profited hugely from handling European flight capital in the 1930s, and, fearing that transparency would hurt New York's allure, they gutted the proposals. While early drafts of the IMF's Articles of Association had "required" cooperation on capital flight, the final version that emerged from the Bretton Woods conference saw that word replaced with "permitted." And through that one-word gateway drove a great, silent procession of coaches and horses across the Atlantic, laden with treasure from a shattered Europe. And the capital flight that ensued was as bad as Keynes and White had feared: A U.S. government analysis in June 1947, admitting that it only saw a part of the picture, found that Europeans held $4.3 billion in private assets, an enormous amount in those days, and far bigger than America's jumbo postwar loan to Britain that year.

American bankers were thrilled. And a new economic crisis exploded in Europe. America filled the hole with aid: the giant Marshall Plan of 1948. It is widely believed that the plan worked by offsetting European countries' yawning deficits. But its real importance, Helleiner argues, was simply to compensate for the U.S. failure to institute controls on inflows of hot money from Europe. Even in 1953, the authoritative New York Times correspondent Michael Hoffman noted, American postwar aid was smaller than the money flowing in the other direction.[19]

Henry Cabot Lodge, a Republican senator, was one of those who raised his voice to object to the stink. "There is a small, bloated, selfish

class of people whose assets have been spread all over the place," he said. "People of moderate means in this country are being taxed to support a foreign aid program which the well-to-do people abroad are not helping to support."[20] The comparison with Hillary Clinton's words about Pakistan can hardly be missed. These words would be painfully familiar today to citizens of Argentina, Mexico, Indonesia, Pakistan, Russia, Nigeria, and so many other nations that have watched powerlessly while local elites mount raids on their countries' wealth and collude with Western financiers and businessmen to hide it offshore, avoid paying tax on their income, and then expect Western aid donors to fill the gaps. The Marshall Plan had set the precedent: American taxpayers would foot the bill for policies that delighted Wall Street and its clients. What was presented as enlightened self-interest was substantially a racket, in the precise sense of a fraud, facilitated by public ignorance. As we shall soon see, the rackets have multiplied ever since.

Keynes died in April 1946, less than a year after the Nazis surrendered in Europe. The accolades poured in. "He has given his life for his country, as surely as if he had fallen on the field of battle," said Lionel Robbins, one of his most potent ideological adversaries. Friedrich Hayek, Robbins's former pupil who was just then fathering a new free-market ideology to dethrone Keynesianism, called him "the one really great man I ever knew."

Though Keynes had failed in many ways, many things he advocated were put in place, not least widespread capital controls. And events seem to have proved him right—or at least not wrong. The first two years after the war marked a brief period when U.S. financial interests dominated policymaking, and the restrictive international order was in abeyance. But the disaster that ensued, and the new economic crisis in 1947, discredited the bankers, and from the following year things became more restrictive.

The quarter century that then followed, from around 1949, in which Keynes's ideas were widely put into place, has become known as the golden age of capitalism: an era of widespread, fast-rising, and relatively untroubled prosperity around the world. As Britain's prime minister Harold Macmillan put it in 1957, "Most of our people have never had it so good." From 1950 to
1973, annual growth rates amid widespread capital controls (and

extremely high tax rates) averaged 4.0 percent in the United States and 4.6 percent in Europe. Not only that, but as the Cambridge economist Ha-Joon Chang notes, the per capita income of developing countries grew by a full 3.0 percent[21] per year in the 1960s and 1970s, significantly faster than the record since then. And from the 1970s, as capital controls were progressively relaxed around the world, and as tax rates fell and the offshore system really began to flower, growth rates fell sharply. The countries that have grown most rapidly, the top-ranking economists Arvind Subramanian and Dani Rodrik explained in 2008, "have been those that rely least on capital inflows . . . financial globalisation has not generated increased investment or higher growth in emerging markets."[22]

Average growth is one thing, but to get an idea of how well most people are doing, you need to look at inequality, too. In the offshore era from the 1970s onward, inequality has exploded in country after country. According to the U.S. federal Bureau of Labor Statistics, the average American nonsupervisory worker was actually receiving a lower hourly wage in 2006, adjusted for inflation, than in 1970. Meanwhile, the pay of American CEOs rose from less than thirty to almost three hundred times the average worker's wage. Nor is this just a story about growth and inequality. Another famous study found that between 1940 and 1971, a period mostly covering the time of the golden age, developing countries suffered no banking crises and only sixteen currency crises, whereas in the quarter century after 1973 there were 17 banking crises and 57 currency crises. A major new study in 2009 by the economists Carmen Reinhardt and Kenneth Rogoff, looking back over eight hundred years of economic history, concluded that, as reviewer Martin Wolf put it, "Financial liberalisation and financial crises go together like a horse and carriage."[23]

We cannot infer too much from these very different episodes. Other reasons exist for the high growth rates during the golden age, not least postwar rebuilding and productivity improvements during the war. The 1970s oil shocks go some way toward explaining the subsequent slide into crisis and stagnation.

Still, less drastic but nevertheless powerful conclusions do emerge. The golden age shows that it is quite possible for countries, and the world economy, to grow quickly and steadily while under the influence of widespread and even bureaucratic curbs on the flow of capital, and high taxes. China carefully and systematically restricts inward and

outward investments and other flows of capital, and at the time of writing it is growing fast. Clearly these kinds of controls, unfashionable for so many years, ought to be a policy option. Mainstream thinking on this is, at last, shifting a little: In February 2010 the IMF issued a

paper[24] outlining what would have been considered heresy just a few years earlier, arguing that capital controls are sometimes "justified as part of the policy toolkit" for an economy seeking to deal with surging inflows. Very often countries can, as Keynes believed, get along perfectly well with their own domestic credit systems and localized capital markets, without exposing themselves to the killer seas of global offshore finance.

What has happened since the golden age ended is not simply a return to the free movement of capital but financial liberalization on steroids. The offshore system that tore financial controls apart from the 1970s has been both an accelerator for flighty financial capital but also a distorting field, bending capital flows so that they end up not necessarily where they can find the most productive investment but where they can find the greatest secrecy, the most lax regulations, and freedom from the rules of civilized society. It would seem sensible to take our foot off the accelerator.

Quite soon after Keynes's death a new ideological insurgency took hold, based on an idea of the near infallibility of free financial markets, which overthrew Keynes's ideas. The Chicago economist Robert Lucas would write in 1980 that "at research seminars, people don't take Keynesian theorizing seriously anymore; the audience starts to whisper and giggle to one another." The latest financial crisis, which, I will show later, had its roots substantially in offshore finance, has helped resuscitate Keynes's ideas, at least in some circles. "If your doctrine says that free markets, left to their own devices, produce the best of all possible worlds, and that government intervention in the economy always makes things worse, Keynes is your enemy," wrote the economist Paul Krugman. "And he is an especially dangerous enemy because his ideas have been vindicated so thoroughly by experience."

Parallel with the ideological changes, however, something else began to emerge, even before the golden age ended. It first appeared in the City of London, before being embraced by Wall Street and spreading across the globe. Ideology mixed liberally with cash would create the conditions for the construction of a new world of offshore.

THE GREAT ESCAPE
How Wall Street Regained Its Powers by Going Offshore to London

AS THE BRETTON WOODS SYSTEM THAT KEYNES helped design got properly under way after the Second World War, Wall Street was tied down at home with domestic regulations, many dating from the Great Depression. Financial flows across borders were constrained, taxes were high, and the U.S. economy was growing very nicely indeed. Across the country working people were buying refrigerators, televisions, and new cars for the first time.

Wall Street bankers wanted an escape route. They found it in a new offshore market in the City of London, the financial district at the geographical center of the greater London metropolis.

Nobody quite agrees when this new strain of offshore activity first emerged, but it was probably first spotted by a financial regulatory authority in June 1955 when staffers at the Bank of England, the UK's central bank, noticed some odd trades going on at Midland Bank, now part of the globetrotting HSBC.[1] Exchange rates in those days were mostly fixed against the dollar, and banks in London were not supposed to trade in foreign currencies unless it was for financing specific trades for their clients, and they were not allowed to lend against deposits in foreign currencies. Midland Bank was apparently contravening UK exchange controls by taking U.S. dollar deposits that were not related to its commercial transactions, and it was also offering interest rates on these dollar deposits that were substantially higher than those permitted by U.S. regulations. A Bank of England official called in Midland's chief foreign manager for a chat, to ask why the bank was contravening official controls. Afterward he noted down that the Midland official "appreciates that a warning light has been shown."[2] Luckily for Midland, though, Britain was struggling to shore up its shaky foreign exchange reserves, and the Bank was reluctant to snuff out a

new area of international business. “We would be wise, I believe, not to press the Midland any further,” the Bank concluded.[3]

Regulation in the City of London in those days typically consisted of your being invited to the Bank of England for tea, where an eyebrow would be raised in your direction if you were out of line. The tradition in London then, as today, was to rely heavily on self-regulation by financial firms, in stark contrast to the United States and its regulatory authorities’ far more activist, rules- based approach. The City of London proceeded along the lines of a grand British Old Boys network, bound by elaborate rule and ritual. Discount brokers would wear top hats, and every evening in the rush hour a platoon of guardsmen would troop through the City in scarlet tunics and bearskins. “A banker could show his disapproval of sharp practice by crossing the road,” wrote Anthony Sampson in the 2005 edition of his book Anatomy of Britain. “Behind all the conventions lay the assumption of a club based on common values and integrity. It was a club which could easily work against the interests of the public or outside shareholders, through insider trading and secret deals; and it was based on cartels which could exclude competitors and newcomers. But it was also quite effective.”[4] A firm handshake and membership in the right kind of club was often enough to secure a man’s credit.

As in the United States, however, finance was still relatively closely tethered, at least when compared to today, and the City of London was deep in a slumber. “By Thursday afternoon at four,” one U.S. banker remembered, “one of the senior partners would come across to the juniors and say, ‘Why are we all still here? It’s almost the weekend.’”[5] Oliver Franks, a chairman of Lloyds Bank, compared it to driving a powerful car at 20 miles per hour. “The banks were anaesthetised,” Franks said. “It was a kind of dream life.”[6] American banks overseas were similarly quiescent.[7] For much of the time since the turn of the twentieth century they had been, as one account describes them, “courtesy stations where rich aunts could get their checks cashed or have a trust officer keep an eye on investments. Their nephews and nieces on short European tours used the bank, and so did a few vacationing businessmen.”[8] Ambitious U.S. business school graduates would prefer cutting-edge manufacturing jobs than stodgy, old-fashioned banking.

It is hard to imagine those days now: an era when international bankers took a backseat and fumed impotently at politicians’ mighty powers.

Those few years after the Second World War were, in fact, the only time in several hundred years when politicians had any real control over the banking sector in Britain. And with Midland's funny trades from 1955, and the Bank of England's decision not to interfere to stop it, that control began to unravel.

Just then, Britain's formal empire was starting to crumble too. India had secured independence in 1947, communist guerrillas were attacking British colonialists in Malaya, Egypt had broken free, civil war was breaking out in Sudan, and Ghana was preparing for independence. In July 1956, just over a year after the Bank started noticing Midland's funny trades, Egyptian president Gamal Abdel Nasser nationalized the Suez Canal. Britain and France, trying to adjust to their less magisterial postwar roles in world affairs but still driven by imperial-era motivations and arrogance, joined Israel in a three-sided invasion. It was a colossal mistake: The U.S. forced them to retreat, humiliated. "It marked, with brutal clarity, the end of Britain as a world power," said David Kynaston, historian of the City of London. It was the trigger for the collapse of the British Empire: Within a decade, an empire that had ruled over 700 million foreigners at the end of the Second World War shrank to a population of just five million.

As the empire crumbled, the pound—then fixed against the U.S. dollar at $2.80 per pound—began to totter and with it the whole edifice of solid, dependable imperial finance.[9] Coming less than a decade after Henry Morgenthau, the U.S. treasury secretary, had declared his intention to "move the financial center of the world from London and Wall Street to the U.S. Treasury," it was almost too much for the whiskery old gentlemen capitalists in London to bear.

In 1957 the British authorities, in a last-ditch attempt to rescue sterling's old imperial role, raised interest rates and applied new curbs on overseas lending to protect the pound. But the London banks, having noticed that the Bank of England had decided not to stop Midland's trades, sidestepped the new curbs by shifting their international lending away from sterling and

into dollars, in this new market. And here is the crucial part: The Bank of England not only did not stop Midland's trades, but it actively decided not to regulate the market either. It simply deemed the transactions not to have taken place in the UK for regulatory purposes. Since this trading happened inside British sovereign space, no other regulatory authority elsewhere was allowed to reach in and regulate it, either.

Banks in London began keeping two sets of books—one for their onshore operations, where at least one party to the transaction was British, which was regulated, and one for their offshore operations, where neither party was British.

A new offshore market had been born, which would become known as the Eurodollar market or the Euromarket.[10] It was no more than a bookkeeping device, but it would change the world.

The new unregulated Euromarket that emerged amid the dust and fire of Suez would grow explosively and become nothing less than the heart of a new British financial empire centered on the City of London. It would raise the City to even greater financial glories, provide a new playground for U.S. banks, and prove the key to resurrecting an old alliance between the City of London and Wall Street, helping each break the grip of their governments at home and restore them to their full powers.[11]

"As the good ship Sterling sank, the City was able to scramble aboard a much more seaworthy young vessel, the Eurodollar," wrote P. J. Cain and A. G. Hopkins, the leading historians of British imperialism. "As the imperial basis of its strength disappeared, the City survived by transforming itself into an 'offshore island' servicing the business created by the industrial and commercial growth of much more dynamic partners."[12]

Modern histories of the City of London's growth as a financial center point to the "Big Bang" of 1986—the sudden deregulation of London's markets under Prime Minister Margaret Thatcher—as the moment when London really took off in its modern form. But Tim Congdon, one of the City of London's most experienced spokesmen, spotted the real story. "The Big Bang," he wrote in 1986, "is a sideshow to, indeed almost a by-product of, a much Bigger Bang which has transformed international finance over the last 25 years. The Bigger Bang is—on all the relevant criteria—a multiple of the size of the Big Bang."[13] "An extraordinary situation has arisen where the Euromarket, which has no physical embodiment in an exchange

building or even a widely recognised set of rules and regulations, is the largest source of capital in the world."[14]

The scholar Gary Burn put it in a different light. The market's emergence, he said, was "the first shot in the neo-liberal counter-revolution against the social market and the Keynesian welfare state."

The modern offshore system did not start its explosive growth on scandal-tainted, palm-fringed islands in the Caribbean or in the Alpine foothills of Zurich or Geneva. It began its life in the City of London. American banks would soon dominate this market utterly. And, as is usual with so much that has happened offshore, very few people outside the financial sector even noticed.

Before proceeding with this tale, it is essential to understand something peculiar about the City of London.

Few British people, let alone anyone else, know that the City of London is the most important financial center in the global offshore system. Before getting properly into the strangeness of this ancient city, some of its more obvious offshore qualities are worth noting.

London's first claim to be a tax haven is the subject of this chapter: its role as the creator and developer of the Euromarkets, Wall Street's giant escape route from the checks and balances of U.S. financial regulation. Here the subsidiaries and affiliates of U.S. commercial banks have long been allowed to engage in, among many other things, investment banking—"casino banking," as some have called it—something the Glass-Steagall Act of 1933 explicitly prohibited. Over the years, as this business became more integral to their global banking models, Wall Street could increasingly pressure the U.S. government to do away with the original restrictions to allow them to do at home what they already did offshore, and this was arguably the main factor that led to the repeal of Glass-Steagall in 1999. It was the classic offshore pattern: banks find an offshore escape route, then say in Washington, "We can already do this offshore—so why not here?"—and domestic regulations get relaxed.

London provides endless loopholes for U.S. financial corporations, and many U.S. banking catastrophes can be traced substantially to those companies' London offices. The unit that blew up the insurance company American International Group (AIG), putting the U.S. taxpayer on the hook for $182.5 billion, was its four hundred–strong AIG Financial Products unit, based in London. The court-appointed examiner looking

into the collapse of Lehman Brothers in September 2008 found it had used a trick called Repo 105 to shift $50 billion in assets off its balance sheet, and that while no U.S. law firm would sign off on the transactions, a major law firm in London was delighted to oblige, without breaking the rules.[15] When the United States introduced the Sarbanes-Oxley regulations to protect Americans against the likes of Enron or Worldcom, the City of London did not follow, and more U.S. financial business flowed to London.

Another important role for London has concerned a seemingly arcane practice known as "rehypothecation,"[16] a way of shifting assets off banks' balance sheets. The U.S. has firm rules to curb the abuses, but London does not—so ahead of the latest crisis, Wall Street investment banks simply went off to London where they could do it without limit. A little-noticed IMF paper in July 2010 estimated that by 2007 the seven largest players in the market—Lehman Brothers, Bear Stearns, Morgan Stanley, Goldman Sachs, Merrill/BoA, Citigroup, and JPMorgan—had shifted $4.5 trillion off their balance sheets in this way. So this London-based practice injected trillions more debt into the financial system than would otherwise have been the case.[17]

The City of London and Wall Street banks got rich off this—and ordinary Americans will pay for it for years to come.

World oil markets are also affected by the London loophole. In June 2008, as world oil prices soared amid uproar about market manipulation, former regulator Michael Greenberger noted in testimony to a U.S. Senate Committee[18] that the U.S. Commodity Futures Trading Committee (CFTC), the regulator for energy derivatives, had been pursuing a "continuous charade that a U.S. owned exchange (ICE) located in Atlanta and trading critically important U.S. delivered energy products should be regulated by the United Kingdom, whose regulation of these markets is self evidently lacking." Almost every Russian firm listing overseas chooses London, not New York, partly because of Britain's permissive governance standards. The list of London loopholes goes on.

The next component of the City's offshore status is its role in running, protecting, and being fed by Britain's offshore spiderweb. As a reminder, this web of partly British tax havens around the world provides the City with three things. First, it captures passing foreign business and assets nearby and channels them, and the business of handling them, to London, just as a spiderweb catches insects. Second, it is a storage mechanism for assets. Third, it is a kind of money-laundering

filter that lets the City get involved in foreign dirty business but at sufficient distance to minimize the stink. In the second quarter of 2009, the UK received[19] net bank financing of $332.5 billion just from its tax havens of Jersey, Guernsey, and the Isle of Man; in June

2009 the British web as a whole held an estimated $3.2 trillion in offshore bank deposits, half the global total, according to data from the Bank for International Settlements.

London's next offshore attraction is secrecy. Britain does not practice Swiss bank secrecy, which would make its violation a criminal offense, but it uses other equally effective mechanisms. The British spiderweb is a big part of this story, as is UK trust law. When Denis MacShane, a former British foreign office minister, criticized bank secrecy at a European seminar, his opposite number from Luxembourg retorted: "Have you ever examined UK trust law? All our bankers and financial lawyers say that if you really, really want to hide money, go to London and set up a trust." [20] Britain offers all manner of other secrecy facilities. Under UK law, for example, offshore companies can be directors of UK companies, and it is usually impossible to know who the real owners are.[21]

Another London attraction is the so-called "domicile" rule, whereby wealthy foreigners can come to live in England and escape tax on all their non-UK income. In pursuit of this tax break, the world's super-rich—from Greek shipping magnates to Saudi princesses—have descended on London in hordes. Having gone out of its way to welcome wealthy Arabs since the 1980s and rich Japanese and oil-rich Africans since the 1990s, the City has more recently aggressively courted Russian oiligarchs, offering them an almost tax-free bolt-hole beyond the reach of Russian law enforcement: Alexander Zvygintsev, Russia's deputy prosecutor-general, describes "London-grad," as it is sometimes known, as "a giant laundrette for laundering criminally sourced funds."[22]

The contrast between London and New York, in terms of tolerance for criminal behavior, is stark. In January 2009, for instance, U.S. law enforcement fined the British bank Lloyds TSB $350 million after it admitted to secretly channeling Iranian and Sudanese money into the U.S. banking system. Robert Morgenthau, the Manhattan district attorney, explained how Lloyds would routinely strip out identifying features from payments from Iran so that wire transfers would pass undetected through filters at U.S. financial institutions.[23] In the City of London, this business just went on unperturbed.

"In America they send hundreds of people to jail: in this country bankers don't go to jail," explains the British author and publisher

Robin Ramsay. “There are no consequences in London.” Though Americans may roll their eyes at this, as they consider the financial crimes that have gone unpunished at home in the wake of the latest financial crisis, there is no doubt that London’s tolerance for abusive or criminal financial behavior is in a class of its own. The Paris-based investigating magistrate Eva Joly, who broke open the Elf Scandal in Paris, described another view from overseas: “The City of London, that state within a state which has never transmitted even the smallest piece of usable evidence to a foreign magistrate.”

The next part of the City of London’s offshore armory is the strangest one. It concerns an organization called the City of London Corporation. On the face of it, the Corporation of London, as it is sometimes known, is merely the municipal authority for City of London, a 1.22 square mile of prime financial real estate located at the geographical center of the physical, sprawling metropolis of greater London. But the Corporation of London is far more than a municipal authority. It is a lobbying organization for the financial sector that is so deeply embedded in the fabric of the British nation-state that it has become impossible in Britain, even after the greatest financial crisis since the Great Depression, to confront or even seriously check the power of finance. Without understanding the Corporation of London, one cannot properly understand how Wall Street has become so powerful in the United States.

At its broadest, the term City of London refers to the financial services industry based in Britain, mostly located inside the so- called Square Mile that is the City. Smaller clusters of financial services activity exist elsewhere: The hedge funds in Mayfair a few underground stops farther southwest and the newer Canary Wharf, three miles east along the Thames river, are also important, hosting the spillover from the overloaded City. Neither these upstarts nor other small financial poles in places like Edinburgh or Leeds are really rivals to the Square Mile. The Corporation of London spreads a protective mantle over them all.

London hosts more foreign banks than any other financial center. In 2008 the city accounted for half of all international trade in equities, nearly 45 percent of over-the-counter derivatives turnover, 70 percent of Eurobond turnover, 35 percent of global currency trading, and 55 percent of all international public offerings.[24] New York is bigger in areas

like securitization, insurance, mergers and acquisitions, and asset management, but much of its business is domestic, making London easily the world's biggest international—and offshore—financial hub.

The head of the Corporation of London is the Lord Mayor of London—not to be confused with the mayor of London, who runs the much larger greater London municipality that contains the City, geographically speaking, but has no jurisdiction over its nonmunicipal affairs. And this separation of powers matters.

When the Queen visits the City, she stops at the boundary at Temple Bar and waits for the Lord Mayor of the City, accompanied by assorted City Aldermen and Sherriffs. This tourist ceremony, in which the Queen touches the Lord Mayor's sword, strikingly highlights the political discontinuity between the City and the rest of Britain. When heads of state visit Britain the Lord Mayor throws more lavish banquets than the Queen. Each year the Chancellor, Britain's finance minister, makes a speech at the Guildhall, the seat of City government, and at the Lord Mayor's Mansion House, in which they justify how they have been serving the interests of finance.

The City's nine thousand–odd human residents have one vote each in municipal elections here. But businesses in the City vote too, as if they were human, with thirty-two thousand corporate votes.[25] In effect, Goldman Sachs, the Bank of China, Moscow Narodny Bank, and KPMG can vote in a hugely important British election.

The strangeness goes deeper and deeper. In fact the Corporation is so ancient and mystifying that barely any outsiders understand it.

The Corporation's website is a warren of tunneling links and unexpected, bizarre connections. A series of rituals confirm the integrity of the whole. There are 108 livery companies, including the Worshipful Companies of Broderers, and of Cord-wainers. The current Lord Mayor, Nick Anstee, is an honorary Liveryman of the Plaisterers' Company.[26] There are the Sheriffs, Aldermen, the Court of Common Council, and the "Rules for the Conduct of Life." There is the Lord Mayor's show, resplendent with arcane ritual, gilded coaches, and elderly men in long satin robes, that is watched by millions on the BBC every November.

The Corporation has existed since what tour guides and historians call time immemorial, a term taken to mean that its origins extend beyond the reach of memory, record, or tradition. There is no direct evidence, Corporation officials note, of it coming into being: They say, only half in jest, that it dates its "modern period" from the year 1067. This is the world's oldest continuous municipal democracy, predating

the British parliament and rooted in what the Corporation calls “the ancient rights and privileges enjoyed by citizens before the Norman Conquest in 1066.” This, notes the City of London expert Maurice

Glasman, means that the City is effectively outside the normal legislative remit.

The City's special privileges stem ultimately from the power of financial capital. Britain's rulers have needed the City's money and have given the City what it wants in exchange. Over the centuries the City has used this magic formula to carve out for itself privilege after privilege, exempting itself from laws it dislikes and turning itself into a state within a state: a true offshore island partly separate from Britain and protected from tides of history that have swept the British nation-state over the centuries.[27] Monarchs, firebrands, and demagogues who tried to roll back the City's special rights and privileges had occasional successes, but most came to a sticky end, and the City vigorously reasserted its rights. It was, one nineteenth-century reformer said, "like some prehistoric monster which had mysteriously survived into the modern world."

In 1937, Britain's then prime minister Clement Attlee became one of few politicians to have raised the issue. "Over and over again we have seen that there is in this country another power than that which has its seat at Westminster [the parliament]. The City of London, a convenient term for a collection of financial interests, is able to assert itself against the Government of the country. Those who control money can pursue a policy at home and abroad contrary to that which has been decided by the people."[28] In 1957 an official commission, which sparked a big shake-up of local government across Britain, opened with the memorable words: "Logic has its limits and the position of the City lies outside them."[29]

The carve-out from Britain's rules and laws has a truly ancient pedigree. When William the Conqueror invaded England in 1066, the rest of England disarmed and gave up its rights—but the City kept its freehold property, ancient liberties,[30] and its own self-organizing militias: Even the King had to disarm in the City. When William commissioned the Domesday Book, a survey of the kingdom's assets and revenues that determined taxation, the City was excluded.[31] In the momentous changes that followed—the Protestant Reformation five hundred years later when the English Church became subject to the Crown, the subsequent civil wars that broke the power of the monarchy, and the broadening of suffrage to include almost all adults—the City held on to its privileges and strengths. The Statute of William and Mary from 1690, "confirming the Privileges of the Corporation," and following a challenge to the City's

authority by the late King Charles II, illustrates the scale of the City's different status:

> All the charters, grants, letters patents, and commissions touching or concerning any of their liberties or franchises, or the liberties, privileges, franchises, immunities, lands, tenements and hereditaments, rights, titles, or estates of the mayor and commonalty and citizens of the City of London, made or granted to any person or persons whatsoever . . . be and are hereby declared and adjudged null and void to all intents.

In other words, those claims that infringe the City's ancient liberties are worthless. Earlier that century, the British crown had asked the Corporation to extend its ancient legal protections and privileges to new areas of London, outside the City, that were receiving tens of thousands of refugees from brutal land reforms known as the Enclosures. But the Corporation refused, instead shipping excess populations off to the Ulster Plantation and the Corporation of Londonderry in what is now Northern Ireland,[32] helping build a large Protestant community there and contributing to bitter future conflict. Glasman calls this the "Great Refusal": the moment where the City turned its back on London and when London's history properly became a tale of two cities, with a mayor for the vibrant, troubled, and poverty-scarred metropolis, and a Lord Mayor for the City: the world's most ancient political institution, at the disposal of finance.

For much of the last century the Labour Party, the party of Britain's working class, had a pledge into its manifesto to abolish the Corporation of London and fold it into a unified London government. The pledge would remain in place, unfulfilled, until Labour Leader Tony Blair undid it in the early 1990s. In exchange for the City's support in his successful bid for power in 1997, he agreed to remove the pledge to abolish the Corporation and replace it with one to "reform" it instead. The reform he eventually delivered reinforced the corporate vote, further diluting the humans.[33]

Today the City has an official named the Remembrancer, the world's oldest institutional lobbyist, who is the only nonparliamentary person working in the parliamentary chamber. Currently a man named Paul Double, the Remembrancer is charged "with maintaining and

enhancing the City's status and ensuring that its established rights are safeguarded,"[34] and he monitors, and lobbies on, anything in parliament that might touch on the City's rights.[35] At the time of writing in 2010 its most recent public memoranda included one arguing stridently against efforts to rein in hedge funds,[36] and another largely seeking to absolve over-the-counter derivatives of helping cause the financial crisis, and arguing against restricting them.[37] The City of London Corporation also has a pot of money at its disposal named City Cash, which it says is "a private fund built up over the last eight centuries," earning income from "property, supplemented by investment earnings."[38] City Cash funds many things, including monuments and ceremonies, stakes in the property developments[39] outside the City boundaries, free-market think tanks, and permanently staffed lobbying offices from Brussels to Bombay to Beijing.[40] The City will not provide a detailed list of its assets and holdings: some, but not all, are available on the public record. It admits to owning some of the most valuable part of London's West End bordering the world famous Regent and Oxford Streets.[41] The City's Cash is exempted from British Freedom of Information (FOI) requests, so we cannot find out what it owns. Jason Beattie, a reporter who sought to investigate this money pot, found it to be completely different from any other local authority fund he had ever encountered. "I FOI'd them to hell—and I got nowhere," he remembers. Does it own property around Wall Street, as Glasman suspects? There is no obvious way to find out.[42]

Some law made in the British parliament does apply to the Corporation, but some Acts of Parliament specifically exempt it, either fully or in part. The City is connected to the British nation-state, but it remains a constitutional elsewhere. In this the City resembles Jersey or the Cayman islands, the offshore jurisdictions that are its satellites—each of which, as I will show, has also been entirely captured by the interests of global finance.

For skittish global capital, the City's constitutional foundation matters absolutely. Finance knows that any serious challenge to the City would face the mystique of time immemorial and the extravagant skills and powers of the many servants of finance. This globe-encompassing financial services center, whose influence reaches silently into people's homes from Baltimore to Birmingham to Borneo, is founded upon an ancient constitutional platform that is unique and rather impregnable.

This detour through British constitutional history helps us understand a little more about the power of financial capital and its ability to escape offshore to fortified and deregulated spaces, protected from outside interference. It is no coincidence that the futuristic Euromarkets, this new playground for Wall Street, emerged here in this ancient City. This market and its subsequent

spin-offs would, as we shall see, ultimately play a central role in forcing through the liberalization of the world economy, whether the world's citizens liked it or not. The City had created a new banking order; a new form of money, a new market in which to trade it, and the means by which the City of London would reemerge, phoenix-like, from the ashes of empire.[43] The project to restore the City to postimperial glory, the academic writer Gary Burn notes, "was pursued unhesitantly and unstintingly, without, it seems, any prior or subsequent debate by the Prime Minister, the Treasury, by Cabinet, Government or Parliament. Central to the success of this project was the Bank of England, which after 1945 set about reestablishing the hegemony of international financial capital."

From those early beginnings the Euromarkets spread like a forest fire, fueled by political events. The Soviet Union did not want to hold too many dollars in New York, where they risked being confiscated if the Cold War turned nastier, and they did not want to invest in Sterling either: the risky money of a collapsing empire. In this new liberated Eurodollar market they found their solution: They could hold the money in dollars in London, under the protection of an ancient, rather unaccountable institution with no qualms about the political origins of money. Starting with a deposit of a few hundred thousand dollars by the Moscow Narodny bank in 1957, the Soviets began to pile in. Karl Marx would have raised his prodigious eyebrows at the irony of avowedly Marxist nations nurturing the emergence of the biggest, most unfettered capitalist system in history.

By late 1959 about $200 million or so was on deposit in the Euromarket in London; by the end of 1960 it had reached a billion, and a year later the total was $3 billion, by which time it was spreading to Zurich, the Caribbean, and beyond.

In 1963 the market received two more major fillips. The first came on July 18 when President Kennedy introduced his so- called Interest Equalization Tax on income from foreign securities, which was supposed to curb U.S. dollar outflows by making it less attractive for U.S. bankers to lend overseas. Wall Street responded by doing their lending out of the offshore, tax-free Euromarkets instead. "This is a day you will remember," said Henry Alexander of Morgan Guaranty bank when the new regulations came into force. "It will change the face of American banking and force all the business to London."[44] The second boost that year was the birth of Eurobonds: unregulated offshore bearer

bonds, which are just what the name suggests: whoever bears the pieces of paper in their hands owns them. They are a bit like ultravaluable dollar bills: No records are kept of who owns them, and they are perfect for tax evasion. Bearer bonds feature in villain-infested Hollywood movies like Beverly Hills Cop and Die Hard, and they are considered so pernicious that many countries have since outlawed them. A Bank of England memo from 1963 crystallizes the cynicism. "However much we dislike hot money, we cannot be international bankers and refuse to accept money."[45]

That year American banks were treated to a display of the Bank of England's political muscle when the Bank's governor Lord Cromer forced Britain's new prime minister Harold Wilson to throw away half his election promises and slash government spending, prompting Wilson to shout in one debate, "Who is Prime Minister of this country, Mr. Governor, you or me?"[46]

Though the Bank of England is accountable to parliament, not to the City of London Corporation, its physical location at the geographical center of the City—just across the road from the Lord Mayor's Mansion House—reflects where its heart lies: in a shared view, established over centuries, that the path to progress lies in deregulation and freedom for financial capital—with the City at the forefront. The Bank's purpose was never defined very clearly, but when the Bank's directors decided in 1991 to work out more explicitly what the Bank is for, they came up with three main goals. Two were the usual central bankers' goals: to protect the currency and to keep the financial system stable. The third was, as the Bank's then governor Eddie George put it, to "ensure the effectiveness of the United Kingdom's financial services" and to have a financial system "which enhances the international competitive position of the City of London and other UK financial centres."[47] He was effectively admitting to a Bank goal to do what it takes to protect and promote the City at the center of an overseas, or offshore, empire.

A quick numerical exercise shows how unregulated offshore finance can be so profitable, far beyond the potential merely for eliminating taxes.

Governments require banks to hold reserves against the deposits they take. Let's imagine a bank officially has to hold 10 percent of the value of its deposits in cash, and the going interest rate is 5 percent annually for loans and 4 percent for deposits. For every $100 deposit, the bank may

only lend $90 at 5 percent, earning it $4.50. The bank must pay the depositor 4 percent, leaving it 50 cents. Subtract the bank's operating costs of, let's say, 40 cents, and it has made 10 cents' profit on its $100 in deposits.

Now imagine, instead, a bank in the Euromarkets in London, which has no reserve requirements. The bank can now lend all of its $100 at 5 percent, earning $5. Subtract $4 to pay interest to the depositor, then subtract 40 cent operating costs, and the profit now is 60 cents—six times the "onshore" profits. This is grossly simplified, but it exemplifies a basic principle behind offshore's appeal. On the face of it, this looks like a cost-free benefit for everyone: In a competitive market, the bankers will pass some of those profits on to borrowers and depositors. But this is a false view. First, much of the profit will pass to the bank's wealthy owners, and to the extent that the banks do pass on these savings, offshore customers will almost always be the world's wealthier citizens and corporations. Second, the increased profits come at a cost: increased risk. The latest financial crisis has showed what happens when such risks materialize: ordinary people pay. Free money for bankers and for the world's wealthy—at the expense of everyone else—is a basic leitmotif of the offshore system.

There is another offshore secret at play here too. It hinges around why banks have to hold reserves against deposits in the first place.

Imagine you deposit $100 with an "onshore" bank. Under a 10 percent reserve requirement, the bank may lend out only $90 of that to someone else. That person now has $90 to spend, and that $90 will end up in another bank account. That next bank may then lend 90 percent of that $90 out—so $81 more will end up being lent. And the process goes on. This is a well-known principle of so-called "fractional reserve banking," and if you follow the calculations through you will find that with a 10 percent reserve requirement your $100 theoretically balloons out into $1,000, spread across the economy. Money really is conjured out of thin air like this: This is what banks do. Money is created by the act of lending it. "The process by which money is created is so simple that the mind is repelled," said the economist J. K. Galbraith. Money creation is not a bad thing in itself. The question is: how much borrowing, and how much money creation, is healthy? Regulators try to control liquidity—making sure that the amount of money sloshing around the system does not grow out of control—by enforcing reserve requirements.

But in the unregulated London-based Euromarkets, with no reserve requirements, the first $100 deposit theoretically lets the bank lend out

the full $100, which turns into another $100 deposit, leading to another $100 loan, and so on endlessly. Of course it never happened like that: If it had, we might have drowned in money long ago. No, there is only so much demand for credit at

any time, and if credit grows in the offshore market it will, up to a point, be reined in elsewhere to compensate. Offshore Eurodollars also leak back "onshore," where reserve requirements will slow down the money-creation machine again. And prudent bankers hold back reserves anyway, even when they do not have to. Controversy has, in fact, raged for decades about how much the Euromarkets contribute to puffing up the amount of money circulating in the world, boosting risk and building unsustainable wobbly pyramids of debt.

Yet some things seem clear. An unregulated market allowing potentially endless and unusually profitable money creation will expand and displace regulated banking, and lending will expand into places where it wasn't previously able to and often to where it shouldn't be. Credit quality is likely to deteriorate, out of sight of regulators. Just as the world was waking up to the ideas of Milton Friedman, who argued that governments should focus on money supply as the lever to use to manage their economies, the new London market was starting to make these levers ineffective.

If the 1960s were thrilling for American bankers in London, U.S. regulators weren't so happy. The archives from that era show that people were fretting about exactly the kinds of trouble that brought the world economy to its knees in the recent economic crisis from 2007—uncontrollable financial flows across borders, and the financing of long-term lending with very short-term borrowing, risking trouble when short-term markets dry up. "Is the growth of this market a welcome tonic, or a slow poison to the international financial system in general?" The Banker magazine had asked in the earlier years of the Euromarkets' growth.

In 1960 the Federal Reserve Bank of New York, believing that the Eurodollar markets were already making "the pursuit of an independent monetary policy in any one country far more difficult,"[48] sent a team to London to investigate. Bank of England staff charmed the American regulators and doubtless offered them a great number of cups of tea. But they did little to address their concerns, even after the Americans said the Euromarkets posed a danger to stability—and even though some British officials were nervous themselves. "I did get the impression," one Bank of England official noted in a memo in 1960, "some of them were rather keeping their fingers crossed."[49]

James Roberston, vice chair of the Federal Reserve, started to point to

another worry: the emerging Euromarket centers in the City's offshore satellites like Cayman and the Bahamas. "My primary objection is that they aren't branches in any sense of the word," he wrote. "They are simply desk drawers in somebody else's desk. Why make banks go through a sham proceeding to obtain certain privileges?" One enterprising trader at a major U.S. bank, recognizing how artificial this game was, planted a cardboard sign saying "Nassau" on a desk in his trading room in New York and recorded trades at that desk, booking them "offshore" and out of sight of regulators. After someone discovered the ploy the traders continued as before but ensured that a clerk simply copied them into a second set of books in the Bahamas.[50] Soon, a shift to computerized trading removed the need for cardboard signs anyway. As the author Jeffrey Robinson noted, "The horse hadn't merely bolted, it was living in a beach-front condo in the Caribbean."

The Euromarkets rippled outward, driven from the center in London, first to Britain's semi-independent Crown Dependencies of Jersey, Guernsey, and the Isle of Man near the UK mainland, then out to the British-held Caribbean jurisdictions, then to Asia, and finally to British-held Pacific atolls. These satellites of the City were simply booking offices: semifictional way stations on secretive pathways through the accountants' workbooks. The banks might park a person or two on each palm-fringed island while the heavy lifting work—the real business of hammering together big banking syndicates, making the accounting cogs mesh properly, and ensuring that the paperwork was legally watertight—happened in London and New York. But these fast-growing, freewheeling hidey-holes helped the world's wealthiest individuals and corporations, especially the banks, to grow faster than their more heavily regulated on-shore counterparts.

By 1963 the U.S. Treasury already was warning that the market had aggravated a "world payments disequilibrium,"[51] and one official suggested publicly that American bankers should "ask themselves whether they are serving the national interest by participating in this sort of activity."[52] That was the year that President Kennedy introduced his Interest Equalization Tax, which drove U.S. banks to London in droves. "It is hardly an exaggeration to say that leading American banks thought little about Europe before 1963," wrote the U.S. economist Richard Sylla, "and thought about little else in the decade thereafter.[53]

Once again the U.S. authorities conveyed their fears to the Bank of England and sent the U.S. comptroller of the currency to London to inspect American banks. The Bank of England's response was,

effectively, that the United States could go and screw itself. “It doesn’t matter to me whether Citibank is evading American regulations in London,” one top Bank official said, epitomizing the City of London approach. “I wouldn’t particularly want to know.”[54]

As the 1960s wore on, U.S. deficits ballooned. America was overspending overseas, in relation to its earnings, and its foreign payments sent an army of dollars outward from the United States, feeding the Euromarkets and further loosening the shackles on finance—just as Swinging London, as it became known, was breaking the constraints of fashion. Ideas about rebellion against authority percolated far into the fabric of society: James Bond’s forays offshore, to Switzerland in Goldfinger in
1964 and to Nassau in Thunderball in 1965, injected an appealingly subversive frisson into the image of tax havens and uncontrolled offshore finance, the new global hothouse for international crime.

By 1967 Robert Roosa, the energetic U.S. undersecretary for the Treasury, warned that the Euromarkets had hugely amplified destabilizing capital flows, “in magnitudes much larger than anything experienced in the past, massive movements.” The response from London always came in two forms: either “This is nothing to worry about” or “Mind your own business.”

A bizarre, Alice in Wonderland logic lay behind the Bank’s decision not to regulate these markets—the sort of logic that permeates the offshore system. If there were a run on a regulated bank in London, the Bank of England, by virtue of being its regulator, would feel some obligation to come in and pick up the pieces. In other words, regulation, as a Bank of England memo put it, “would mean admission of responsibility.” Better, then, the logic went, not to regulate them![55]

And the Euromarkets just kept blooming. More and more U.S. banks flooded to open offices in London. The publication Euromoney, in its inaugural issue in 1969, described the market as being like a child: “It stuffs itself for some time with whatever goodies take its fancy, refuses to listen to warnings that it will get indigestion, gets it, lies low for a few months, then gets hungry again.”

That year the biggest bank in the market was Citicorp (or Citibank), whose CEO Walter Wriston was a single-minded champion of the idea of freedom for financial capital, who delighted in the way that governments were once more being cowed by financial markets. “The Euromarkets are now the greatest mobile pool of capital in the world,” Wriston said in one interview. “If the British put on reserve requirements

or other controls, Bahrain is waiting. In just a couple of keystrokes, the whole market could be gone." And his love for the Euromarkets was, it seems, matched by his confidence in their resilience. When asked in

an interview in 1996 about the Euromarkets whether the world risked financial meltdown on account of increasingly risky financial activities, he said simply, "It can't happen."[56]

By 1970 the London-centered market was measured at $65 billion in all currencies and still growing fast. Daniel Davison, the head of Morgan Guaranty's London office, gushed about London's minimal regulation and generous tax treatment. It was, he said, "a banking bazaar unrivalled in history. The Moscow Narodny Bank, whether it is appropriate Bolshevik doctrine or not, sits almost cheek by jowl with the Bank of China, and rubs elbows with the capitalist banking institutions of the West. There are about three times the number of American commercial banks in the City as there are in New York. The City of London beats Baghdad as a bazaar by a country mile."

The whole character of the City began to change. City gentleman reeled at the sight of Goldman Sachs's star trader, Larry Becerra, turning up for work on a Harley-Davidson in jeans and cowboy boots, and at the sounds of "holy fucking shit" that began to fill the dealing rooms. Within a few years of Goldman Sachs's opening its first international office in the City in 1970, its London operation was accounting for a quarter of the firm's entire business and its offshore satellites a slice more. "The days of friendly co-operation and friendship changed dramatically in the mid-seventies when it became an ugly business," remarked one British banker, John Craven. "That's when unpleasant practices came in—in terms of paying investors under the table in order to take bonds and even a little bit of improper entertainment of guests in flats in London—and it undermined the whole spirit of the thing."[57]

All the time, the Bank of England quietly kept regulation at bay. In 1973 some German bankers went to see James Keogh, a Bank of England official, to ask what permissions they needed to become an authorized bank in London. "Keogh looked at us," one banker remembered, "and he said 'a bank is a bank if I consider it to be one.'" And that, pretty much, was it—apart from what the historian David Kynaston calls the "occasional, indispensable afternoon ceremony": that cup of tea at the Bank of England from time to time to explain what you are doing.[58] By that year, over half of U.S banks' foreign business was taking place in London—though a lot of that soon began shifting toward London's satellite tax havens, especially the Bahamas and the Caymans.[59]

By 1975 the invading Wall Street ruffians had fully overtaken the plodding British banks and were beating them in market after market.

"There was never any sense that old English bankers were competing with us in any way," said Michael Lewis of Salomon Brothers. "It was much more, 'how much did we have to pay them to clear out of town and do something else with their lives.'"[60]

By then, the Euromarkets had grown to exceed the size of the entire world's foreign exchange reserves.[61] At the same time, a new source of dollars had begun to feed the markets, as the OPEC oil shocks hit in the 1970s, and oil-rich countries' surpluses were re-lent through the Euromarkets to finance deficit-plagued oil consumer countries. This gigantic financial recycling via London and its satellites, to be lent out to Latin America and elsewhere, often amid great secrecy and corruption, laid the foundations for the subsequent debt crises of the 1980s.

As the Euromarket bonfire raged ever more strongly, financial capital began a new assault on the citadels of power and the democratic nation-state. Countries were no longer insulated by exchange controls and capital controls against events elsewhere. The Euromarkets seemed to have connected up the world's financial sectors and economies as if by an electric current: A shock rise in interest rates in one place would switch its effects instantly to anywhere plugged into the system. Tides of hot money once again began to surge back and forth across the globe, with the Euro-markets as a kind of anti-Keynesian global transmission belt making financial markets more sensitive to tweaks and changes elsewhere and allowing enough money to pool together in one place to allow large speculative attacks against currencies.[62] Democratic governments began to retreat in the face of financial capital. "What annoys governments about stateless money is that it functions as a plebiscite on your policy," Wriston said. "Money goes where it is wanted and stays where it is well treated. This annoys governments no end."[63]

The Euromarkets just kept snowballing: $500 billion in 1980, then a net $2.6 trillion eight years later[64]; and by 1997, nearly 90 percent of all international loans were made through this market. It is now so all-enveloping that people hardly notice it anymore.

It is fairly easy to explain why Britain welcomed the new markets, even at the cost of squeezing out British banks. There was the crude question of

money, for one thing. “We, at the Bank, have never seen any reason to place any obstacles in the way of London taking its full and increasing share,” one official said. “If we were to stop the business here, it would move to other countries with a consequent loss of earnings for London.”[65] Not only that, but Britain was rolling out a new political and economic strategy to make up for its loss of status as the world superpower: It would keep as close as possible to a leadership role in world affairs by hitching itself to the new American superpower through a “special relationship” with Washington, which endures, at least in British minds, until the present day. The economic anchor of this special relationship has been this partnership between Wall Street and the City of London, under a simple offshore formula: give Wall Street banks what they want, and they will come.

Yet if it is obvious that the British would welcome this market, it seems rather odder that the United States would let its banks dive headfirst into this unregulated offshore market, knowing they were undermining American financial controls. Several things help explain why it was tolerated in Washington too.

Wall Street lobbying was obviously a huge part of the story. There is also the classic offshore problem: what goes on overseas, out of sight, gets ignored. Many policy-makers and regulators in the United States simply failed to understand this strange new phenomenon or dismissed it as a weird, slightly unclean, but temporary anomaly[66]: a funny money best left to Europeans. “Euro-dollars, indeed!” one U.S. banker told Time magazine. “It’s hot money—and I prefer to call it by that name.” And it was hot money.

U.S. banking interests worked hard to keep this offshore playground as quiet as possible too. Bankers deliberately avoided discussing it,[67] and when Hendrik Houthakker, a junior member of the U.S. Council of Economic Advisors, wanted to tell the U.S. president about the Euromarket, he was slapped down by his superiors with, “No, we don’t want to draw attention to it.” A U.S. congressional committee report in 1975 expressed amazement at how it had flourished so far beneath the political radar for so long.[68] Yet there is a bigger reason why the United States ultimately colluded with Britain in letting Wall Street banks roam offshore.

The U.S. dollar is the world's main reserve currency. Less privileged nations are periodically constrained from spending by shortages of foreign exchange, but the nation with the dominant currency can borrow in its own currency—and it can print money to acquire real resources and live beyond its means for a long time. This "exorbitant privilege" helped America fight and pay for the Vietnam War; more recently it helped President George W. Bush cut taxes, invade Iraq, and rack up huge deficits while investors around the world continued to buy U.S. debt. Countries choose dollars as the main component in their reserves because dollar markets are large and liquid, and the dollar is trusted to be relatively stable. Everyone trades in dollars. When I was the Reuters correspondent in war-ravaged Angola in the mid-1990s, the raucous street money changers plumped up their ample brassieres not with Euros, Swiss francs, or Renminbi—but with dollars. Dollars make the world go round, and if you print the stuff, you've got it made.

To claim reserve status, a currency must have huge, deep, liquid, and sophisticated markets—and a currency subject to capital controls and stringent financial regulations is less attractive. U.S. policymakers wanted these deep markets but did not want to give up their taxes and controls. They thought, let's have our cake and eat it, by preserving the rules and constraints at home while permitting this unregulated dollar market to flourish overseas. What they had not appreciated enough was the extent to which this offshore market would rebound back into the United States, with malign effects.

By the time Margaret Thatcher and Ronald Reagan came to power in 1979 and 1981, the political classes in Britain and the United States were losing faith in manufacturing and genuflecting toward finance. Wall Street and the City of London were at the forefront of a global trend of financialization: the reengineering of manufacturing firms as highly leveraged investment vehicles and, soon, the packaging of mortgages into risky asset backed securities for offloading into global markets. Everything was for sale: school playing fields, post offices, army services, and old fish markets. In the offshore centers, the very sovereign laws of nation-states had become available for sale or rent.

After Thatcher's giant deregulatory "Big Bang" of 1986 deepened London's offshore status as a freewheeling, anything-goes financial center, "light-touch London" broadcast ever stronger antiregulatory

impulses around the world, deregulating other economies and their banking systems as if by remote control. The City became a crow-bar for lobbyists in Wall Street and around the globe: "If we don't do this, the money will go to London," they would cry; or "we can already do this in London so— why not here?" Its offshore satellites were deregulating even faster, constantly seeking to stay ahead of the others. This race has an unforgiving internal logic: you deregulate—then when someone else catches up with you, you must deregulate some more, to stop the money from running away. For the City, it was a beautiful, self-reinforcing dynamic: The more countries that opened their financial systems, the more business that would float around internationally, ready to be caught in the nearby nodes of the British offshore spiderweb and then sent up to be serviced in the City and its allies on Wall Street.

Not content with all this, the Corporation of London actively promotes international financial deregulation around the globe. With this in mind the Lord Mayor makes 20 or so foreign visits per year.[69] An official report into one such visit to Hong Kong, China, and South Korea in 2007, along with the Lady Mayoress, the Sherriff, and a 40-strong business delegation, gives a flavor of the Corporation's ambition and reach. The delegation's aim, according to the report, was to

> Lobby for China to maintain its course of economic and financial liberalisation, and encourage South Korea to adopt more open policies; Promote London as a global financial center …;
>
> Explain the UK's liberal approach to regulation and corporate governance
>
> Lobby for liberalisation and improved market access in China's banking, insurance and capital markets sectors; including highlighting the restrictive implications of ordinance 10 [which is designed to curb illicit financial flows and requires Chinese government approval for companies to list overseas,[70]] and the benefits of closer engagement with international players.
>
> Encourage South Korea to adopt more liberal policies, notably in legal services, and to follow up on Seoul's ambitions to become a regional financial hub
>
> Explain the UK's liberal approach to trade policy and regulation; and

to encourage a critical mass of similarly thinking countries.[71]

In a meeting with senior officials from Tianjin, the Chinese city chosen as a pilot for national financial reform, the report noted that Mayor Dai Xianglong had "placed great value on deepening cooperation with the City of London, which he dubbed 'the holy place' of international finance and globalisation."

The Corporation of London is a municipal authority for fewer than nine thousand souls and its job is, officially, to promote financial freedom and liberalization around the world. In partnership with the Bank of England, it is one of the most powerful players in global financial regulation today. And almost nobody has noticed it.

Political theorists have had great difficulty even seeing the Corporation of London, let alone appreciating its significance. With its politics of personal proximity, its bonds of shared identity and principle, and its elaborate ceremonials, the City manages to be at once vastly powerful and barely visible. It fits into no modern analytical framework. Mainstream modern publications about the City gloss over its free-floating status.[72] Globalization has led to whole fields of research into the actions and interactions of companies in markets, but they usually only discuss political institutions on an abstract level. Students of the philosopher John Rawls have focused on the social compact—the relationship between rulers and ruled—but have paid relatively little reference to the role of institutions or history. Even Marxists, primed not to worry much about how financial capital organizes itself, have considered the City in the context of a clash between manufacturing capital and financial capital, misunderstanding its true role. The City is, as Glasman puts it, "an ancient and very small intimate relational institution, which doesn't fit into anybody's preconceived paradigm of modernity. Here is a medieval commune representing capital. It just does not compute."[73]

And it was here in the City, just as Britain's imperial dreams collapsed in the ignominy of the Suez retreat, that the financial establishment in London began piecing together the means by which London would restore its position as the capital of a world ruled in the interests of an elite of financial investors. At the moment of its apparent destruction, the British empire had begun to

reinvent itself, back from the dead.

CONSTRUCTION OF A SPIDERWEB
How Britain Built a New Overseas Empire

AS U.S. BANKS ENJOYED THE DELIGHTS OF LONDON'S unregulated markets from the late 1950s and 1960s, the City of London began to see more clearly how the partnership might be expanded more deliberately at a global level. I have already hinted at how the City began to use offshore centers around the world as nodes in a spiderweb, which would catch passing capital by getting rid of taxes and rules and regulations and providing safe, secretive new bolt holes for the world's wealthy, and then send much of the business up to the City. Criminal money, far enough distanced from Britain itself to minimize the stink, would be turned to profit, and other money would accompany it. Meanwhile, the more that countries around the world deregulated and opened their economies to international capital, the more business would be flying around, and the more would come their way. Now I will explore the untold story of how it happened.

As I've noted, when Britain's formal empire collapsed, it did not entirely disappear. Fourteen small island states decided not to become independent and became instead Britain's Overseas Territories, with Britain's Queen as their head of state. It is a status that has been preserved until today. Exactly half of them—Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Gibraltar, Montserrat, and the Turks and Caicos Islands—are tax havens, actively supported and managed from Britain and intimately linked with the City of London. Accompanying these were the Crown Dependencies near the British mainland— Jersey and Guernsey, in the English Channel off the French coast; the Isle of Man, near the Irish republic; as well as a scattering of other territories—Hong Kong as a gateway to China, still under British control, and a variety of ex-colonial oddities in the Pacific and elsewhere.

The most important part of the modern British spiderweb, from the point of view of the United States, lies in the Caribbean: the City's gateway to

the vast markets of North and South America. Visit any of these territories and it becomes clear that they are, while half-British, set up to target the United States first of all. Eat out at an outdoor grill or beach restaurant, and your dinner will likely be overshadowed by a giant television screen fixed on a baseball game, and your food may be served by young American waitresses. Each either uses the U.S. dollar as its official currency or has a local currency called "dollar" that is pegged firmly to the greenback.

Offshore finance in the British Caribbean has old roots: Financial interests in Britain and their selected political representatives had learned the basics of tax havenry long before the British empire fell apart.

Organized crime in the United States began to take a serious interest in the U.S. tax code after the mobster Al Capone was convicted of tax evasion in 1931. His associate Meyer Lansky became fascinated with developing schemes to get Mob money out of the United States and bring it back, dry-cleaned. A slick Mafia operator—the inspiration for the figure of Hyman Roth in the film The Godfather—Lansky would beat every criminal charge against him until the day he died in 1983. He once boasted that the Mob activities he was associated with were "bigger than U.S. Steel."

Lansky began with Swiss offshore banking in 1932,[1] perfecting the loan-back technique. This involved first moving money out of the United States—in suitcases stuffed with cash, diamonds, airline tickets, cashier's checks, untraceable bearer shares, or whatever. Next, he would put the money in secret Swiss accounts, perhaps via a Liechtenstein anstalt (an anonymous company with a single secret shareholder). The Swiss bank would loan the money back to a mobster in the United States, who could then deduct the loan interest repayments from his taxable business income there. Lansky opened operations in Cuba, outside the reach of the U.S. tax authorities, where he and his associates built up gambling, racetrack, and drug businesses, becoming what the author Jeffrey Robinson called an "anti-Disneyland . . . the most decadent spot on the planet." Lansky's close ties to Cuba's right-wing leader General Fulgencio Batista helped stoke the violent anger that eventually brought Fidel Castro to power in 1959.

When Castro came to power Lansky moved to Miami, from where he plotted to find his next Cuba, with a pliable tyrant. "It would have to be small and close enough to the U.S. mainland to get tourists and gamblers in and out easily," Robinson explained. "It, too, would have

to come furnished with a thoroughly corrupt political regime, held together by a despot greedy enough to welcome the Mob with open arms; the tyrant would have to be so firmly in place that the political environment would remain stable no matter what. And the Mob's money would have to be spread so thick and wide that, if some other tyrant seized power, he'd need them to maintain his own stability."[2]

The Bahamas, then a British colony, was perfect. Formerly a staging post for British gun-running to the southern U.S. slave states of the Confederacy, and loosely governed for years by laissez-faire members of British high society,[3] the Bahamas were effectively run by an oligarchy of corrupt white merchants.[4] It would quickly become, through Lansky, the top secrecy jurisdiction for North and South American dirty money.

This much is well known. What is not widely publicized is the British authorities' reactions to this burgeoning criminal activity on its territory. A trawl of the archives reveals a curious pattern involving periodic expressions of concern, followed by a seemingly resolute lack of action. A quaint memo from a Mr. W. G. Hulland of the Colonial Office to a Bank of England official in
1961, just as Lansky began major operations in the Bahamas, gives a flavor of such worries. "We feel that this [lack of provision of an effective regulatory system] might be a grave omission, since it is notorious that this particular territory, in common with Bermuda, attracts all sorts of financial wizards, some of whose activities we can well believe should be controlled in the public interest."

London did nothing. Two years later, a "Dear Rickett" memo[5] from M. H. Parsons, a colonial administrator, to Sir Dennis
Rickett, K.C.M.G., C.B., warned that the Bahamas's white, racist[6] finance minister Stafford Sands, who had recently taken a
$1.8 million bribe from Lansky[7] mobsters, wanted to make it a criminal offense to break bank secrecy, and warned that this might annoy the United States. The proposed new legislation "will surely bring protests by the U.S. Government to Her Majesty's Government," Parsons wrote. "We would look pretty feeble if we had to say that we could do nothing to influence the course of

offensive legislation in a territory for which we still have outward responsibility. I admit the point is a ticklish one."

Stafford Sands had estimated that there was a billion dollars or more of dirty money to be tapped by reinforcing bank secrecy, and he was prepared to anger the United States to get it. It was, as the memo put it, "a calculated risk he was prepared to take." London gave the go-ahead, and Lansky built his new criminal empire.

Some locals in the Bahamas were unhappy about what was going on. In 1965 Lynden Pindling, a populist Bahamas politician, threw the ceremonial Speaker's Mace out of a parliament window to a prepared crowd, in a dramatic power-to-the- people gesture. Pindling was elected prime minister in 1967, ending white minority rule, on a platform that had included railing against the gambling, the corruption, and the ruling elites' mob connections, though several accounts say Lansky—astutely assessing the political winds—backed Pindling too.[8] The casinos, the gambling, and above all the Mob-infested offshore industry continued to boom. But when Pindling led the Bahamas to full independence in 1973, skittish offshore players fled in streams. The veteran lawyer Milton Grundy put his finger on what was going on. "It wasn't that Pindling said or did anything to damage the banks," Grundy said.[9] "It was just that he was black."

It so happened that there was a reassuringly British place, just next door to the Bahamas, where the locals were far more friendly, the British were still in control, criminals and bankers were being warmly welcomed, and offshore finance had recently started up: the Cayman Islands. In 1966, when the Caymans' first trust law was written, cows were still wandering through the town center of the capital, George Town, Grand Cayman. The town had one bank, one paved road, and no telephone system. The year afterward, Grand Cayman was connected to the international phone network and the airport was expanded to take jet aircraft. Money began to pour in.

In 1969 a British government team flew to the Cayman Islands to check on progress. The report notes a "frightening absence of certain types of expertise,"[10] adding that "the civil service still reflects in structure and staffing the out-moded pattern of a bygone age."

The report continued, "The flood of private sector activities, progressively drowning basic government functions, has placed an unsupportable burden on senior staff." Flocks of developers were arriving, "usually backed by glossy lay-outs and declaimed by a team of business-men supported by consultants of all sorts. On the other side of

the table—the Administrator and his civil servants. No business expertise, no consultants, no economists, no statisticians, no specialists in any of the fields. Gentlemen vs. Players—with the Gentlemen unskilled in the game and unversed in its rules. It is hardly surprising that the professionals are winning, hands down."

At around this time, the archives show two sets of opinions on Britain's offshore hatchlings starting to emerge within the British Civil Service. On one side sat the British Treasury, and especially its tax collectors, who were virulently opposed to tax havenry and who found the Caymans to be especially obnoxious. The U.S. authorities were getting vexed, too, and in large part because of this the British Foreign Office was broadly opposing havenry, though its position was more nuanced. On the other side of this divide sat the Bank of England, acting as the cheerleader for the new havenry and wishing to see it grow fast—though also trying to make sure that this freewheeling Caribbean offshore expansion did not spin entirely out of control. Supporting the Bank of England, with far less influence, was the British Overseas Development Ministry, which saw offshore finance purely as a trick to get the territories to pay their own way and reduce their demands for British aid without any sign that they had any concern for the inhabitants of developing nations around the world that would suffer vast drains of wealth into the Caribbean sinkholes.[11] Discreetly, within the British establishment, battle lines were drawn. The exchanges were vigorous and at times even acrimonious.

The UK Treasury put together a working party whose report in 1971 said Britain should, in effect, stop encouraging tax havenry in its overseas territories. A worried confidential memorandum from the British Foreign Office in 1973 [12] shares some of the same concern: "The Cayman Islands set up as a tax haven in 1967 and passed appropriate legislation which went considerably beyond what the UK Treasury was prepared to wear." One particularly significant Caymans bill, it noted, had quietly passed into law after an unnamed desk officer had failed, through an "administrative error," to submit the new Cayman legislation to London for consent. The effect of this, the memorandum continued, had been to drive a wedge through the Treasury's carefully constructed defenses against abuse of tax havenry. Britain later patched the holes in its own tax code as best it could, the memorandum notes—leaving, of course, elites in the United States, Latin America, and the rest of the world free to take advantage of the Caymans' offshore facilities. Despite the warning, however, nothing was done.

Further research in the archives, however, reveals something rather more deliberate than a supposed "administrative error" in the construction of the Cayman Islands as one of the world's most important tax havens. A letter from the Bank of England dated April 11, 1969, marked "SECRET," gives us a better sense of the real forces driving the changes.[13] It shows several things.

First, despite Britain's guiding hand, these territories were extremely vulnerable to shady operators—and the smaller such jurisdictions are, the easier it is for their local administrations to be captured by unaccountable financial interests based elsewhere. "The smaller, less sophisticated and remote islands are receiving almost constant attention and blandishments from expatriate operators who aspire to turn them into their own private empires," the Bank letter notes. "The administrations in these paces find it difficult to understand what is involved and to resist tempting offers." The Bank of England letter had identified something generic to offshore centers: They are small states captured by large foreign financial, and often criminal, interests. "We need to be quite sure that the possible proliferation of trust companies, banks, etc., which in most cases would be no more than brass plates manipulating assets outside the Islands, does not get out of hand."

But the Bank of England's concerns did not reflect ethical qualms about the harm these places were wreaking on other countries—the Bank was simply expressing its desire to retain power to influence events, and particularly to safeguard the Sterling Area, the British-linked currency zone that had included most British colonies and dominions and whose members enjoyed relative freedom of payments inside the zone but which were strictly constrained from letting capital flow outside the Sterling Area. Attracting foreign dirty money, by contrast, was keenly appreciated by the Bank. "There is of course no objection to their providing bolt-holes for non-residents," the letter continued, "but we need to be sure that in so doing opportunities are not created for the transfer of UK capital to the non-Sterling Area outside UK rules." In other words: no objections to looting the treasuries of the United States and sucking illicit financial flows out of Latin America—just so long as Britain's tax base and its postimperial financial network was protected. Any harm being inflicted on other countries was deliberately to be ignored.

As time went on, however, the Bank became increasingly worried that these Wild West British offshore centers were becoming weak points in the Sterling Area, allowing leakage outside the zone. In 1972, under the Bank's guidance, Britain shrank its Sterling Area to cover

only Britain and Ireland and the Crown Dependencies, excluding the new tax havens. The Cayman Islands, for its part, adopted the Cayman dollar as its new currency, at par with the U.S. dollar, and two years later this

was de-valued to 1.20 Caymanian dollars to the U.S. dollar—where it has remained ever since.

In the same year that the Sterling Area was shrunk, the officials who were trying to stop the tax havenry suddenly disappeared from the archive files. Taking their place was a new group of officials who seemed to be unaware of the 1971 report warning about the dangers of tax haven activities. They realized that the contraction of the Sterling Area hadn't solved the problem at all. In 1977 the new group appears to have rediscovered, still sitting on a shelf, unimplemented, the 1971 report warning about tax havenry. Again nothing was done. It looks to have been like institutional Ground-hog Day within the UK Civil Service: Reports were written, memos were drafted—and nothing changed. History had repeated itself within and between the departments, all in a matter of less than ten years.[14] Each time, we find the Bank of England officials working hard to fight the tax havens' corner.

At the same time, the representative of the Overseas Development Ministry, clearly supporting the Bank of England's line, seems to have been concerned almost exclusively with the ten thousand Cayman Islanders, apparently entirely blinkered to the terrible impact this may be having on, say, the several hundred million victims of capital flight in nearby Latin America. Whatever its motivations—hopeless myopia, or a cynical attempt to privilege its own dependent territories at the expense of the rest of the developing world—the development ministry ends up stoutly defending the legislation of places like the Cayman Islands, legislation designed specifically to undermine the tax authorities and economies of developing nations around the world.

A comment from a Caymanian lawyer in the 1970s highlights where the main beneficiaries of all these illicit financial flows were. His clients, he said, would periodically contact him, worrying about Fidel Castro's Cuba nearby and insisting on special clauses to compensate them should Castro invade. "I have to explain that Castro wouldn't find any [money] in the safe," he said; "they're all really held in New York or London."

A long letter in 1971 from Kenneth Crook, the newly arrived British governor of the Cayman Islands, provides a little more detail on the thinking in London in those days and on Britain's behind-the-scenes controlling role. "You, sir, and the office as a whole," he wrote in his first long report back to his superiors in London, "might find some interest in the first reactions of a pair of Diplomatic Service eyes and ears (two pairs, if you count my wife's) to this basically colonial situation."

Then, as today, His Excellency the Governor, whom the British Queen appoints on the British government's advice, was the most powerful person on the island, presiding over a cabinet of local Caymanians. They do have elections in Cayman, with revved-up political rallies and all the fun of the fair—but the governor sent from London remains responsible for defense, internal security, and foreign relations; he appoints the attorney general, the judiciary, and a number of other senior public officials. The final appeal court is the Privy Council in London. Caymanian dollar notes carry the British Queen's head, and the national anthem is "God Save the Queen."

Governor Crook was running a place with just ten thousand inhabitants: a large, part-English village. A Time magazine reporter in George Town, Grand Cayman, at around the same time advised readers that if you did not have the proper cab fare, your driver would tell you not to worry—you could just pay him the next time you happen to see him. A history published in the Cayman Financial Reviewclaims that mosquitoes would swarm densely enough to suffocate cows.

"This is no tropical paradise," Crook continued.

> I could enlarge, in terms of a magnificent but mosquito-ridden beach; of a fairly new but rather ill-designed and sadly-neglected house; of a pleasant but very untidy little town; of swamp clearance schemes which generate smells strong enough to kill a horse; of an office which will one day ere long collapse in a shower of termite-ridden dust.
>
> This is certainly an odd appointment for a Diplomatic Service Officer. How many of my colleagues, like myself, contemplating the inanities of some Head of State, have said to themselves "If only the fool would do so and so, how easy it would be." But have they really thought how it feels to be the fool in question? . . . I might invite my colleagues to try running a Parliament in the best Westminster tradition, in which one Member leaves, and as a result throws the entire Finance Committee into confusion for want of a quorum, because he has to drive the school bus—which he owns.
>
> Sir, I hope I may be forgiven if underlying this despatch so far is a note of perhaps unbecoming levity.

The governor's long letter yields a picture of an amiable and decent enough upper-class British colonial type, trying his best to understand

and cope in a strange, fast-moving new environment. In a speech in 1973, Crook told banks to remember that they were not the island's only inhabitants: People lived there too. "If you don't think about that," he said, "you might as well buy an aircraft carrier and operate from that."[15]

But on politics, and the strange relationship between Britain and its little quasi-colony, his tone hardens. "Caymanians don't want independence," Crook wrote. "They don't want internal self-government either—they are very unwilling to trust each other with effective power . . . hence they are delighted to have a Governor around; apart from anything else he's very handy for taking unpopular decisions."

Governor Crook also put his finger on a crucial subtlety of the relationship that underpins the entire edifice of offshore finance: the fact that Britain has effective control, while pretending not to be in control. "They realise that if the Governor is seen to have effective power then the others appear to be essentially cyphers. The elected politicians among them find this bad for their image," Crook wrote. "What they want is to make the Constitution look as if it obliges the Governor to do what they want, even though they know it doesn't. I think we are in the world of semantics here. The more Caymanians we can put in positions of power, the better; they will act as lightning conductors for political dissent."

Very little of substance has changed since then, as a senior Caymanian politician, who asked not to be quoted, explained to me on a visit in 2009. "The UK wants to have a significant degree of control over the jurisdiction, but at the same time it does not want to be seen to have that control," he said. "Like any boss, it wants influence without responsibility; they can turn around when things go wrong and say 'it's all your fault'—but in the meantime they are pulling all the strings. The governor can bring an agent of the crown to come here and do whatever they want," he said. "The hand has always been behind the scenes, in the shadows: it has not shown its face." Keeping the reality hidden from Caymanians is, he said, part of political leadership. "It is like having children . . . it is not necessary to tell them all the burdens and challenges you face. Eighty percent of the masses who turn up at our meetings believe they have control."

The gesture toward elected representation given to Cayman voters, plus all the money, keeps the locals happy, and Caymanians solidly support the link with Britain today. Roy Bodden, a former minister and author of a history of the Cayman Islands, remembers the Falklands War between Britain and Argentina in 1982, when influential Caymanians, not content with having helped Argentinian generals and

their wealthy friends loot their country, launched a “Mother Needs Your Help” fund. Collection tins were rattled in the street, and a million dollars raised, he said, then simply handed over to Britain for the war effort.[16]

Crucially, this remarkable degree of local support for the British connection reassures international finance that locals will not

rock the boat and disturb the business of making money. But the true bedrock of this financial center is Britain's controlling role.
If the islands became fully independent and were handed fully over to dark-skinned Caymanians, most of the money would flee.

Something else turned up in the archives too. Dated February 23, 1969, it is a cutting from the Sunday Times, written by its financial editor Charles Raw. While it is not unusual to find newspaper clippings in archive files, the presence of this particular one—closing the file, and with no attendant commentary—is intriguing. Might it have been left as a marker for historians? Something that couldn't make it into official documentation or be stated explicitly? The name of the clipping is at the least suggestive: "Why Not Turn the City into a Tax Haven?"

Raw's article, written amid one of the great boom phases of the offshore Eurodollar markets in London, is a piece of unashamed cheerleading for the City. It derides a "notorious" section of the UK tax code that gives tax collectors useful powers to curb offshore leakage, and it says London should let nonresidents get tax-free treatment for certain kinds of funds. "Most of the authorities' energies over the past few years have been devoted to stopping money going out," Raw wrote. "But perhaps it would be more rewarding to pay greater attention to money coming in." As we will see in the next chapter, similar lines of thinking were emerging in the United States.

The same Times article contains another oddity. It begins by praising a Geneva-based mutual fund group called Investors Overseas Services (IOS), which Raw says "has done wonders for the U.S. balance of payments by pumping the world's savings into U.S. shares." The article goes on to tout a new Bermuda-based fund that would "like to do the same for the UK balance of payments."

IOS, however, was no ordinary company. Raw went on to write a book about it, the title of which, Do You Sincerely Want to Be Rich?, was the line that IOS salesmen pitched around Europe, door-to-door, as they vacuumed up retail investments to channel into offshore funds. The company's founder, Bernie Cornfeld, called it "people's capitalism," and for a short time he made IOS into one of the largest foreign institutional investors on the U.S. stock exchange. His board of directors included a former governor of California, Pat Brown, and FDR's son James Roosevelt, and many of his advisers came from the Bank of England.[17]

Cornfeld bought castles in France, sailed a forty-two-foot Corsair, and drove a Lancia Flaminia convertible. He dated the Dallas soap opera star Victoria Principal and the Hollywood madam Heidi Fleiss, and his company bought banks in the Bahamas, Luxembourg, and Switzerland. "I had mansions all over the world. I threw extravagant parties," he said. "And I lived with ten or twelve girls at a time."[18]

Cornfeld had originally left the United States "looking for a less competitive market," as one obituary put it, and his company's fragmented national identity—it was incorporated in Panama and headquartered in Switzerland—was the key to its success: No regulator or criminal prosecutor, he hoped, would be able to tie it down. It was a quintessentially offshore company. The U.S. tax authorities considered it European, and others considered it American. When the authorities in France became suspicious of IOS, Cornfeld hopped to Switzerland, where he teamed up with the same secretive bank in Geneva that the mobster Meyer Lansky had been using to deposit the skim from his casinos.

At first, Cornfeld took deposits mostly from U.S. military personnel stationed in Germany. He soon began looking further afield: first targeting an estimated 2.5 million U.S. expatriates around the world, then the British postimperial expatriate networks, then traders in Hong Kong, settlers in Kenya, French rubber-planters in Laos and Vietnam, Belgian miners in Congo, the Lebanese in West Africa, the overseas Chinese, and so on. He took money with no questions asked and an assurance that depositors' secrets would be safe. When he bought his first airline, a joke went around inside IOS that he was starting up "Capital Flight Airlines," and its couriers, according to Tom Naylor's book Hot Money, spirited huge sums out of developing countries. "As civil war raged in Nigeria and international relief for the traumatised civilian population rolled in, " Naylor wrote, "IOS was on the scene to help: the international aid funds often wound up in the safe in Geneva." Even bigger sums were being bled from Latin America.

This, remember, is the company that was being held up as a model for turning the City of London into a tax haven. Even worse, by the time Raw's article emerged, IOS was already enmeshed in high-profile scandals, including illegal operations discovered in a Brazilian police raid in 1966 and a high-profile Life magazine exposé of a joint IOS-Lansky courier operation in
1967. What was
Raw thinking?

Naylor notes another curiosity about illegal offshore money, of which Cornfeld's story is a perfect example. Banks take in deposits (which are liabilities of the bank) and make loans (which are its assets), but they also hold capital, which is the safety buffer that investors put in. If loans go bad this capital serves as a shock absorber: It is the investor capital, not the deposits, that take the hit (though if more and more loans go bad and the capital is exhausted, then the bank runs into real trouble, as happened to banks in the latest financial crisis). Prudent bankers will restrict their loans up to a multiple of, say, ten times the capital buffer.

Capital is far more valuable to bankers than deposits: The more capital you have, the more you may multiply your balance sheet. And this helps us understand why banks like secret offshore deposits so much. Investigators who probed IOS said it operated under an assumption that 10 to 20 percent of its deposits were, effectively, permanent capital—that is, the owners could not withdraw it, either because it was too risky for them to do so or because they were dead. It is no wonder that Swiss bankers were so reluctant to hand over the deposits of Jews who died in Hitler's concentration camps: The deposits had essentially, the Swiss believed, become permanent reserves of bank capital. Not only that, but depositors willingly accept below-market interest rates in exchange for secrecy—boosting the profits to offshore banking.

By 1970 Cornfeld's IOS was tottering under ever more scandals. Some of IOS's Swiss employees had started complaining that Cornfeld owed them money, and an insider accountant, quietly picking through IOS's international labyrinth, realized that it was a house of cards. The company fell into the hands of a big-time criminal named Robert Vesco, whom one partner called "a sonofabitch who hurt, denigrated or corrupted everyone he had contact with." Another associate said Vesco "could talk you right out of your socks, or blast you out of them, or you would find somebody else owned your socks." Vesco had been a major supporter of the Bahamian leader Lynden Pindling but was forced out in 1973 under U.S. pressure after he was found to have secretly donated $200,000 to Richard Nixon's Committee to Re-Elect the President (CREEP), partially financing the Watergate burglary.

Although the official archives paint this picture of divisions between Britain's various departments over their sponsorship of the

growth of the British offshore zone, veterans in the Cayman Islands saw things from a very different angle. Under Britain's benign, hands-off approach to government, offshore lawyers were constructing the new offshore system.

One of the very earliest practitioners was Casey Gill, an ethnic Indian lawyer, author of a book about the Cayman Islands' offshore attractions, and one of the first to arrive at the start of the boom times.[19] "It was a slow, sleepy fishing village," Gill remembered. "The town ended just a half mile up there," he said, gesturing toward a window. "No buildings, just wooden shacks—apart from the Barclays building." In those early years, he reminisced, tax and accounting experts would arrive from around the world to give seminars, helping the Caymans to shape their laws accordingly. "They would come and say, 'These are the loopholes in our system.' Someone would say, 'We are competing with, say, Liechtenstein.' Or in those days the Bahamas was still trying to come through. Panama was there, and Switzerland." With each new piece of information from outside, the Cayman-based lawyers, bankers, and accountants got to work targeting the gaps and addressing the competitive threats from elsewhere.

"There was also the Red Threat: the Russians," continued Gill. "Investors were seeing shadows and ghosts everywhere. We had Castro clauses: If any government tries to expropriate assets, it would turn out they were simultaneously domiciled somewhere else." Many of these assets came out of Latin America. William Walker, a veteran father of the Cayman financial sector, described how the assets were handled in an interview to a visiting journalist in 1982. Most of the fourteen hundred registered companies whose names festooned the walls outside his office, Walker said, "don't require too much work—just signing occasional documents and perhaps holding two meetings a year. We funnel a lot of money from Central and South America.… Most of the money coming out of Latin America, of course, is in breach of their governments' exchange control regulations."

Gill said he was a founder member of a body called the Private Sector Consultative Committee—an association representing every branch of the burgeoning financial sector: trust practitioners, accountants, bankers, lawyers, and so on. Any government legislation that impacted on the Caymans' role as a tax haven would go through this committee. "The government has a legal draftsman. We would meet them—he would go and prepare a draft and circulate it back to us. We would

come back with suggestions, it would be redrafted and circulated to the PCSS, it would get the OK, then the government would pass it into law. The governor would send it to the Foreign and Commonwealth Office (FCO)—and they would say 'no problem.' Usually business would say 'this is what we want' and the FCO would let you do what you want to do."

I asked Gill if Britain ever said no or raised objections to the new legislation. "No. Not ever. Never." He then qualified those last words a little: There had been a case, "eight or nine years" before, when the legislation had been delayed somewhat. But his basic point was clear. While the gentlemen in London buzzed around like irritable wasps, arguing with each other and writing reports on the offshore phenomenon, the wizards of global finance—not to mention half the world's criminals—were forging their own private Caribbean domains, almost entirely free from outside interference, and under Britain's protection. And so the offshore industry grew.

As an aside, it is worth noting what happens when, for example, the Caymans hatches up a new and ingenious offshore loophole targeting U.S. tax laws or financial regulations. The United States will learn about it sooner or later and take counter measures—and so the Caymans will create new loopholes to get around those. As this battle continues, America's tax code and financial regulations grow ever more complex. Offshore rebounds back onshore, in a constant dance of ever-deepening complexity. The confusions that result create, in turn, yet more opportunities for the wealthy and their advisers to find pathways through the expanding legal thickets. Huge, costly industries grow up to service the avoidance industry.

That is not all. The U.S. tax authorities often find defenses against some of the impacts of the worst offshore schemes. Yet a developing country, blind and inexperienced to the ever-deepening offshore complexity, is all but defenseless. As it slips further behind in the battle, its elites enjoy ever more opportunities for abuse, and local politics, and people's faith in their own rulers, rot a little bit further. As this happens, the message from George Town remains the same: "Not our problem. Fix it yourselves."

One of the more dramatic milestones in this ongoing dance between offshore center and onshore regulator came in 1976 when Anthony Field, the managing director of Castle Bank and Trust (Cayman) Ltd., was served with a subpoena upon arriving at the Miami airport, on suspicion that his bank was facilitating tax evasion by U.S. citizens. They wanted him to testify before a grand jury, but he refused.[20] Fearing that Field would spill his clients' secrets, exposing the Caymans to a major

international scandal, an oppressive new secrecy law was drafted, the now infamous Confidential Relationships (Preservation) Law, making it a crime punishable by prison[21] to reveal financial or banking arrangements in the Caymans. You can go to jail not only for revealing information but just for asking for it.

It was a giant, fist-pumping "fuck you" aimed squarely at U.S. law enforcement, and it has become a cornerstone of the Caymans' success until the present day.

When the confidentiality law was enacted, Cayman practitioners remember cash literally flying in on private aircraft. "Money was still coming in large suitcases," explained Chris Johnson, a veteran accountant. "People arriving with large amounts of money would get a police escort from the airport to the bank if they requested it." It was happening all across the Caribbean. By the early 1980s, the Colombian Medellin cartel kingpin Carlos Lehder was smuggling industrial quantities of cocaine into the United States from Norman's Cay in the Bahamas, having turned it into an ultimate male libertarian fantasy. One former Medellin cartel pilot remembers being picked up by naked women at the airport. "It was a Sodom and Gomorrah," he said. "Drugs, sex, no police . . . you made the rules."[22] Lehder's goons played hide-and-seek with the U.S. Coast Guard across Biscayne Bay, landing planes on U.S. interstate highways and leaving bodies strewn across Florida. As the cocaine flooded into the United States, money flew out again, in shrink-wrapped bills loaded on wooden pallets; the Cayman Islands monetary authority would then return it to the Federal Reserve. How, the Fed asked, could this tiny island selling trinkets to cruise ships send them such a torrent of money?

The drugs money was, at least, saving Britain's development ministry tens of thousands of dollars in foreign aid. The authorities in the Caymans simply denied there was a problem and wheeled out the old offshore favorite: The scandals merely represented a case of bad apples, and the system had been cleaned up thoroughly ever since. When the next scandal came, the official response would always be the same.

Johnson remembers being involved in one bank audit where his company pointed out questionable activities, which the government simply ignored. "That, coupled with the leather-clad hot-panted secretarial staff strutting through the deep pile carpets in high heels, might also have been construed as a red flag," he said. The bank failed

two years later.

The fiascos, he added wearily in an interview in 2009 in his George Town offices, have just kept repeating themselves ever since. He continues to bump up against the confidentiality law today. “One problem we have in trying to recover the assets is

that we don't even know who the directors are…. As a liquidator, I am following the money. If I want to negotiate with a director I have no way, no clue. If I go and ask someone, 'Are you sitting on half a million dollars of my money?' that's breaking the law, and the penalty is jail. It is preposterous that these directors, some of whom sit on the boards of more than a hundred companies—one sits on over 450 boards of directors—are charging fees of up to £20,000 a company." The confidentiality law, he added mirthlessly, should be shredded.

Johnson also pointed to something else. Company law statutes in the Caymans date back to English law as far as 1862— with certain democratic provisions removed. One of these carve-outs means that directors of hedge funds or mutual funds are often indemnified from litigation. "So you can't be sued for negligence. Suppose I'm liquidating a fund and $200 million is gone. Why shouldn't I be able to sue them? The directors are steering the ship, but when it sinks they can't be sued." Other sources indicate that the companies that provide directors owe no duty of care to the company or its creditors to ensure that the directors they provide perform their functions properly.[23] No wonder directors and companies—not to mention fraudsters—love the Cayman Islands. And no wonder so many Cayman vehicles have come to so much grief in the latest financial crisis, as we shall see.

The era of suitcases of drug money flooding into the Caymans is pretty much over today. U.S. authorities began to ratchet up the pressure during the drug war, plugging some of the worst leaks. The lawyer Jack Blum explained what happened next on the Cayman Islands: "They say, 'We don't do that now.' Each time they were exposed, they would clean up the thing that was exposed. They'd say things like, 'We're in financial deals now; we're in insurance.' You go back to Cayman today, and all the guys are in pinstripe suits."

And yet the crime continues, in different, more sophisticated guises. In March 2001, the U.S. Senate Permanent Subcommittee on Investigations took testimony from a U.S. owner of a Cayman Island offshore bank who estimated that 100 percent of his clients were engaged in tax evasion and 95 percent were U.S. citizens. Dig beneath the Cayman Islands' sunny spin today, and the incentives to mischief are easy to find. "Client privacy," a government website notes, [24] "is protected by the fact that the Registrar of Companies can only release the name and type of company, its date of registration, the address of the registered office and the company's status." You cannot find a list of directors of companies in Cayman, or even a charter that describes what

a company is about, without going through a court battle. Trusts do not have to be registered—and there lies another very large and murky tale. The form and the context has changed, for sure, but at root Cayman still does what it always did: finds clever new ways to undermine the rules and laws of other nation-states.

As Britain set up its Caribbean offshore networks, it was doing something else far closer to the British mainland, in the crown dependencies of Jersey, Guernsey, and the Isle of Man. While the Caribbean havens project the City of London's global reach to cover the North and Latin American markets, the Crown Dependencies are focused on Europe. Still, U.S. businesses are highly active here. The U.S. Government Accountability Office in 2008 listed Caribbean subsidiaries of Citigroup, American Express, Bank of America, Goldman Sachs, Morgan Stanley, JP Morgan, and Wachovia, among others. Most are in Jersey and involve private wealth management services for U.S. citizens in Europe, derivatives businesses, private equity, tax avoidance, and cash management. JP Morgan alone manages well over $100 billion worth of business out of Jersey just for private equity and real estate funds. Average annual bank deposits in Jersey in 2007 were over $500,000 per person, compared with less than $30,000 in the United States.

As with the Cayman Islands and other Overseas Territories, the Crown Dependencies have an ambiguous, half-in, half-out relationship with Britain that allows them to retain a controlling hand and say, "There is nothing we can do" when somebody complains. Britain handles Jersey's foreign relations and defense, and his Excellency the lieutenant governor represents the Queen; Jersey financial regulation goes up for approval to the venerable Privy Council in London. Jersey is outside the European Union, though it cherry-picks the European laws it likes and discards the rest.

John Christensen, Jersey's economic adviser from 1987 to 1998 and now a fierce critic of its tax haven status, remembers that when Britain got embarrassed about something Jersey was doing, its civil servants would engage in a kind of theater, to get things to change but without being seen to force Jersey to change. "A lot happens around winks and nods," he said. "They would say, 'This is all a bit of a bother, but the Europeans are putting pressure on us and we don't want to put

ourselves in a position where we are required to make you do this.' Forcing Jersey to do something would reveal that Britain has the power to make Jersey change—we all knew it. These are highly intelligent people and these things don't need to be said."

Though Jersey feels exceedingly British, this facade hides an alien political system in which medieval politics combines with futuristic, high-speed offshore finance. There are no political parties, and the government is absolutely captured by global financial services. This ambiguous relationship with Britain dates back centuries. When the Prince of Wales fled via Jersey into exile in France in 1649, he was given refuge by George Carteret, a major landowner. Later the prince became King Charles II and gave Carteret a large tract of land in North America, known today as New Jersey. The original Jersey became a refuge and hothouse for European radicals, many of whom had fled first to England to escape persecution, then were shuffled off to this strange quasi-English place, partly to provide the plausible deniability that enabled Queen Victoria to avoid embarrassment in front of her various cousins in France, Belgium, Russia, Hungary, and beyond. Karl Marx and Friedrich Engels were regular visitors. In the twentieth century, officials returning from the colonies brought new colonial connections to help Jersey bankers build networks in Africa, the Middle East, and the Far East. People either moved to Jersey or kept their money there, in a trusted British environment where they could bank secretly and avoid tax. Expatriates who did not declare their income to their countries of residence, often poverty-racked African nations, knew they would never be caught.

It was not only poor countries suffering, of course. Britain's own taxpayers were too. A letter sent in 1975 to Tony Benn, a well-known British member of parliament, describes the cynicism. "I am somewhat surprised to see a Mr. Gent from the Bank of England giving advice on how to avoid paying tax—I wonder if this is really part of the Bank of England's duties?" Mr. Gent, Benn continues, "suggests that the Bank of England will not be prepared to pass on information required by the Inland Revenue! Does the UK Treasury have no control over the Bank of England? Surely Bank employees should not be working against Government Policy? And just what sort of arrangements and deals are made at these events 'behind the scenes'? It really is just a bit too sordid to be true."[25]

Martyn Scriven, secretary to the Jersey Bankers' Association, illustrated how Jersey's network grew over time.[26] He ran the

Barclays operation in Jersey, which he said catered to about one hundred thousand British expatriates. Smaller packets—up to £25,000, say—were saved in the clearing banks, while bigger packets went into the more secretive trust companies. “The biggest business developer is client recommendation,” said Scriven. “The client will say, ‘I’m happy, and I’d like to introduce you

to my friend'—and you build it up like that. You get some seriously interesting people . . . someone who goes abroad as a rigger twenty years ago for Shell may now be in charge of the company's West Africa operations." It seems reasonable, too, to imagine how client recommendation might one day deliver Nigeria's oil minister and his friends, say, or a powerful Indian businessman, or a South African casino operator. The network grows, following old colonial links. "We gather deposits from wealthy folk all around the world, and the bulk of those deposits are sent to London," Scriven continued. "The banks consolidate their balances every day, and surplus funds won't sit here—they either go to another bank or on and through to the City. If I have money to spare, I pass it to the father. Great dollops of money go into London from here." In the second quarter of 2009, the UK received net financing of $332.5 billion just from its three crown dependencies.[27]

Jersey Finance promotional literature makes a similar point. "Jersey," it says, "represents an extension of the City of Londo n."[28]

As the City of London's Caribbean havens and its crown dependencies were developing, something similar was happening in Asia. Hong Kong, which the U.S. economist Milton Friedman called the world's greatest experiment in laissez-faire capitalism, was to be the new Asian offshore jewel, a tax haven gateway to China and the subregion. Britain remained the guiding hand, while giving financiers free rein. The colony's financial secretary, Sir John Cowperthwaite, installed in 1961, had such stridently antigovernment views that he curtailed the publication of official statistics on the grounds that it would help the civil servants. When China introduced its "Open Door" policy of market reforms in 1978, opening up to foreign investment and export industries, Hong Kong was made: It was, as the financial crimes fighter Jack Blum remembered, "an 'anything goes, no- regulation' world." When Britain handed it back in 1997 China kept it as a "special administrative zone" with the same ambiguous offshore status. Hong Kong's Basic Law states that it shall "enjoy a high degree of autonomy" from China in all matters except foreign relations and defense. The close resemblance here with the British offshore arrangements is no coincidence. Chinese

elites wanted their own offshore center, complete with political control and judicial separation. “Corporations doing business in China set up Hong Kong companies with secret shareholdings,” Blum continued. “Today Hong Kong is where most of the corruption in China is accomplished.” When the G20 countries sought to approve a tax haven blacklist at a summit meeting in April 2009, Chinese premier Hu Jintao fought intransigently with Barack Obama to get Hong Kong and Macau, another notorious Asian offshore hub, excluded. He got them relegated to a footnote.

Despite Chinese control, the City of London remains deeply engaged with Hong Kong, as do Wall Street firms—often through their London offices. Hong Kong remains a smallish offshore player: Its nonresident deposits, at $149 billion in 2007, were just one-eleventh the size of the Cayman Islands’ $1.7 trillion. One day many years hence, however, it may grow large enough to become a key financial tool in Chinese global imperial strategies.[29]

Singapore set up its financial center in 1968 and soon began to attract hot money.[30] Andy Xie, Morgan Stanley’s star Asia economist, described how it had turned out, in an internal email in 2006. “Singapore’s success came mainly from being the money-laundering centre for corrupt Indonesian businessmen and government officials,” he said. “To sustain its economy, Singapore is building casinos to attract corruption money from China.”[31] Xie and two colleagues reportedly had to resign after the email became public.

By the 1980s, the main elements of the City of London’s offshore networks were largely in place and being used extensively by Wall Street. But by then the United States, long a victim of offshore erosion, was in the process of turning itself into the world’s biggest secrecy jurisdiction.

THE FALL OF AMERICA
How the United States Learned to Stop Worrying and Love the Offshore World

EARLY IN 1966 A YOUNG ECONOMIST WORKING at the New York headquarters of Chase Manhattan Bank was riding a company elevator when a former State Department operative handed him a memo. It isn't clear if Chase management knew of the memo: This came from Washington, not from Chase. But the young economist, Michael Hudson, was astonished by its contents.

Hudson had gotten into banking by chance: After studying economics at New York University in 1960 he took a job in real estate banking, and later, when an opening came up at Chase to look at what are called balance-of-payments issues, he was the only applicant. Now a respected (if controversial) American economic commentator, Hudson said his time at Chase— during which, incidentally, he fired a "nasty little twit" called Alan Greenspan[1]—taught him most of what he ever learned about international economics.

In those days Chase was the oil companies' preferred bank, and it had asked Hudson to study the petroleum industry's impact on the U.S. balance of payments to provide ammunition that would help the oil companies claim they were "good for America" and help them lobby for special government perks. One of his tasks on this project was to find out where the oil companies made their profits. At the producing end? At the refineries? In the gas stations? David Rockefeller, Chase's president, arranged for Hudson to meet Jack Bennett, Treasurer of Standard Oil of New Jersey, now part of the ExxonMobil empire.

Bennett gave him his answer. "The profits are made right here in my office," the oilman said. "Wherever I decide."

He was talking about transfer pricing, the practice I explained in chapter 1, where banana companies trailed their accounts around the

world's tax havens in order to shift paper profits into the low-tax countries and the costs into the high-tax countries. Bennett showed Hudson exactly how large, vertically integrated multinationals could shift profits around the globe, apparently without breaking the law. The company would sell its crude oil cheap to a shipping affiliate registered in zero-tax Panama or Liberia, which in turn sold it on at a high, nearly retail price to its refineries and marketing outlets. In the high-tax countries where the oil is produced and consumed, the subsidiaries buy at a high price and sell cheap, so they are unprofitable and pay little tax. But in the middle, in zero-tax Panama or Liberia, the subsidiaries buy cheap and sell dear, making vast profits. But these havens levy no tax on those profits.[2]

To this day, accounting standards effectively hide this kind of trickery, letting companies shovel results from different countries into a single category (often called simply "international") that cannot be unpicked to work out who takes what profit where. "Only the immense political power of these extractive sectors," said Hudson, "could have induced their governments to remain so passive in the face of the fiscal drain."

This kind of offshore leakage was relatively restrained in the 1960s if compared to today. Capital flows were strongly regulated, taxes were high, and the offshore system, though alive, was still a fairly modest phenomenon, and the British offshore spiderweb was in its infancy. With the golden age of capitalism in full swing, American households, and particularly the poorest, were seeing tremendous improvements in wealth and welfare; Germans were basking in their Wirtschaftswunder; France was in the midst of its Trente Glorieuses; Italy was installing the springboard for its Il Sorprasso moment, to come twenty years later, when its economy would outgrow Britain's; and Japan was unleashing its own economic miracle. In large swaths of the developing world, infant mortality was falling, economies were growing, unemployment was tumbling, and hungry children were finding food regularly on their dinner tables.

Although change was coming, the United States still harbored major and powerful opponents of the offshore system. After the Great Depression, Wall Street, diluted in a large and diversified industrial economy, had relatively little political clout to veto progressive New Deal–style legislation. By contrast, the City of London's position at the center of the globe-spanning British empire gave it the domestic political heft to sabotage any British version of the New Deal. Not only that, but British finance hadn't been so directly implicated in the

excesses of the 1920s. London was perfectly placed to provide American banks with an escape route from regulation at home. They could rebuild their powers offshore.

The brief memo passed to Hudson in the elevator suggested, however, that some Americans were hoping to transform the U.S. approach to the offshore world.

"Like Switzerland, flight money probably flows to the US from every country in the world," the memo started. But then the complaints began. The United States was not following the Swiss lead aggressively enough, it said. "US-based and US- controlled entities are badly penalized in competing for flight money with the Swiss or other foreign flight money centers." One reason the United States lagged in the quest for dirty money, it argued, was "the demonstrated ability of the US Treasury, Justice Department, CIA, and FBI to subpoena client records, attach client accounts, and force testimony from US officers of US-controlled entities, with proper US court back-up." There were also American taxes, plus risks associated with the Cold War and a view among "sophisticated" foreigners that U.S. money managers were "naïve and inexperienced in manipulation of foreign funds."[3] It also criticized investment and brokerage restraints "which limit the flexibility and secrecy of investment activity."

The message was unequivocal and strong. America ought to turn itself into a tax haven.

"They were saying 'We want to replace Switzerland. All this money will come here if we make this the criminal center of the world. This is how we fund Vietnam,'" Hudson remembers. "We wanted foreign criminal money, which was patriotic, but not the American criminal money." The operative in the elevator suggested to Hudson that he might find out how much foreign illicit money the United States might be able to get.

Fast forward 40 years, and it is clear that the wishes of whoever wrote that memo have been realized. A table in Raymond

Baker's 2005 book Capitalism's Achilles Heel outlines just how far the United States has fallen. By then, it showed, U.S. banks were free to receive the proceeds from a long list of crimes committed outside the country, including alien smuggling, racketeering, peonage, and slavery.[4] Profiting from these crimes is legal, just so long as the crime itself happens offshore. A few of these loopholes have now been closed, and U.S. law addresses some of the others, though often only in tangential, incomplete ways. But it remains true that a U.S. bank can knowingly receive the proceeds of a wide range of foreign crimes, such as handling stolen property generated offshore. The United States is wide open for dirty money, just as that Hudson memo
anticip
ated.

Tax havenry has always been contested in the United States. Only a month after coming to power in 1961, President Kennedy called for an end to the abuse of "foreign tax havens" and, as noted in chapter 1, asked Congress for legislation to "drive them out of existence." Barack Obama's cosponsorship of the Stop Tax Haven Abuse Act just before he came to power, and the subsequent evisceration of the act by offshore lobbyists, is merely a recent skirmish in an old war.

The United States, like most countries, already had some tax haven characteristics long before the day in 1966 that Michael Hudson stepped into that Chase elevator. From 1921 the United States has let foreigners deposit money with American banks and receive interest tax-free as long as it isn't connected with a U.S. business.[5] And Wall Street had ensured that the United States wasn't going to tell foreign governments about their citizens' holdings, despite the best efforts of John Maynard Keynes and his U.S. counterpart Harry Dexter White to combat capital flight with financial transparency.

When president John F. Kennedy launched his "Alliance for Progress" with Latin America in 1961—"a vast cooperative effort, unparalleled in magnitude and nobility of purpose," as he put it—he said he hoped to coax Latin Americans into repatriating all the money they had stashed in U.S. banks in order to reinvest it at home. Latin American leaders quickly pointed out that this would not happen unless the United States amended its tax laws, which promoted secret banking. Substantial pockets of secretly held foreign wealth already existed, not just on Wall

Street but elsewhere too: in Texas, for example, but also most especially in the Southern District of Florida.

Just as Latin Americans used the United States as a home for tax evasion, immigrant communities in the United States, and especially first-generation Americans, were major U.S. tax evaders. “For various cultural reasons they didn’t trust anyone—so they put it offshore,” said Mike Flowers, a former U.S. Senate staffer. In addition to the first-generation Latin Americans who live across the nation, Flowers described the large concentrations of first-generation Iranians and Russians in California, “New Asians” on the West Coast, Jewish communities in various locations, and so on. “They tend to come clean after they have kids and have been here a while,” he continued. “They get settled and then they think, ‘Oh my God, I have all this offshore money and what do I do now? If I get caught, I’m screwed.’”

In an article entitled “Miami, the Capital of Latin America,”[6] Time magazine hinted at the city’s in-between, financialized, quasi-offshore status: Miami was “Latin America’s Wall Street . . . a hemispheric crossroads for trade, travel and communications in the 21st century—a sort of Hong Kong of the Americas.” From the 1950s and 1960s, Florida became a pivot for the French Connection heroin route, for Kuomintang drugs flowing into the United States via Hong Kong (which Lansky laundered through Florida real estate), for Latin American flight money, and for Colombian drug money, often routed via the Bahamas, Panama, and the Netherlands Antilles.[7]

Jack Blum, then a Senate investigator, remembers sitting on his veranda in Miami in those days and listening to the gunfire. “This place was nuts,” he said. “The stories in the Miami Herald were so fantastic, you’d say, ‘Why hasn’t any national editor picked up on this?’” The reason, he found, was that the editors simply didn’t believe them. Blum tells of one small aircraft coming in from Colombia via the Bahamas, then getting chased by U.S. helicopters. The pilot tried to escape by flying just under a commercial jetliner, then bailing out just before landing, after first hauling overboard the cocaine with the plane on autopilot.

“The first bag goes through the roof of a house—and nobody complains,” Blum said.[8] “The second whacks the steeple off the South Miami Baptist church. The third bag falls into a community swimming pool and soaks the audience of a meeting of Crime Stoppers. The plane went down in the Everglades. The last bags probably got dragged off by alligators. He got busted.

"That happened. That happened."

By the 1980s, two-fifths of the money on deposit in Miami banks was reckoned to have originated overseas, particularly in Latin America. After 1976, the Florida region became the only one of the Federal Reserve's regions to show persistent (and huge) cash surpluses.[9] "Half the property in Miami is owned by offshore shell companies, and the largest yachts on the Intracoastal Waterway are registered offshore," said Blum. "Miami is the facility of choice for Latinex–heads of state, generals, and former friends of the CIA."

Washington did not push hard on transparency: It might frighten foreign capital owners, leading to large net outflows, and worsening an already bad balance-of-payments situation. So alternative ways were sought to stop capital from leaking out of the country. A new tax was introduced in 1963, a levy of up to 15 percent on income Americans received from foreign securities, to try to stop them from exporting capital to buy foreign bonds.[10] As we have already seen, banks instead flocked to the offshore Euromarkets to finance their activities: London-based borrowing tripled just between 1962 and 1963. Chase Manhattan and others began to book more and more loans through the Euromarkets, in London and Nassau in particular. The United States continued to bleed capital, and in 1965 the Johnson administration introduced limited controls on outward capital flows, broadening the controls in 1966 and making them mandatory in 1968.[11] "This was the first time in U.S. history there were rules to stop capital flowing out," explained Jack Blum. "And the corporate community went apeshit." In the face of all the lobbying that ensued, a compromise was accepted. Corporations could continue to keep their money offshore, and it would mostly remain untaxed and outside of these controls unless they repatriated it.[12]

In the tax world, this is a concept known as deferral: Companies may legally defer their taxes by holding profits offshore, untaxed, indefinitely. U.S. companies are only taxed on the income they bring back to the United States, usually in order to pay dividends to shareholders. Corporations know this is a bit of a game, partly depending on who is in the White House: Every now and then they are allowed to bring this un-taxed offshore money back home through amnesties. In 2004, for example, George W. Bush's administration offered his corporate friends a 5 percent tax rate instead of the normal 35 percent for companies repatriating cash. Over $360 billion whooshed back to the country through this Bush loophole, under a claim that this would

“provide jobs” as the capital returned home. Instead, however, much of it went into share buy-backs, boosting executive bonuses. The nonprofit research organization Citizens for Tax Justice, which studied the amnesty in detail,

concluded, “There is no evidence that the amnesty added a single job to the U.S. economy.”

Deferred taxes—taxes that a corporation should (in a fair world) pay this year but can choose to delay—are described by Richard Murphy, a UK-based tax expert, as “a tax-free loan from the government, with no repayment date.” This sharply reduces multinationals’ cost of capital—a very big deal indeed, especially when this is accumulated over many years—and it in turn gives them a huge competitive advantage against smaller, locally based firms.[13] When corporations dodge tax, others—that is, you and me—must pay the taxes that they won’t. The writer David Cay Johnston makes an interesting environmental comparison here. “Tax shelters are to democracy what pollution is to the environment.”[14] He is quite right too.

This concession to corporations—allowing them to defer their taxes offshore and indefinitely—has been an enormous political boost for the offshore system. “Suddenly,” Blum explains, “every major corporation uses an offshore account.” Companies focused especially on the London-centered Eurodollar market but also on Panama, then under a right-wing strongman who venerated Adolf Hitler, and on the Bahamas, where Meyer Lansky had the politicians in his pocket. In the United States, Lansky had close links to the Mob lawyer Sidney Korshak, a true American Mafia kingmaker who in turn helped build up the career of several Hollywood actors, including Ronald Reagan. Some large U.S. corporations even opened their own offshore banks.

As this happened, the interests of big-time criminals, the intelligence services, wealthy Americans, and U.S. corporations began to converge ever more strongly offshore. The system was working two transformations simultaneously: helping criminal enterprises imitate legitimate businesses, and encouraging legitimate businesses to behave more like criminal enterprises.

“The trouble is,” Blum said, “you can’t separate the channels for paying people off from the other purposes.” Although it was tax, not criminality, that most interested the corporations (and lax financial regulation that interested the banks), the big American crime families were especially pleased with the political umbrella that the corporations, and the spies, had hoisted over their offshore playgrounds. And the secrecy, in turn, provided the managers of large corporations with fabulous new opportunities for bribery, insider trading, and fraud. A new crime-friendly environment was being created for American capitalism. The

scale of this criminality can hardly be guessed at. But secrecy makes criminality possible. And in competitive markets, whatever is possible becomes necessary.

As this offshore expansion accelerated, the erosion of America from the inside gathered pace.

The oil crises of the 1970s led to high inflation: This, plus the legacy of Vietnam-era deficits, sent the dollar spiraling downward. In August 1979, U.S. president Carter appointed Paul Volcker, a renowned hard-money man, to head the Federal Reserve Board and reassure the markets. Carter cut spending, and Volcker tightened monetary policy savagely.

But Volcker had a problem. "Monetarist" theories of tackling economic problems by focusing on the money supply were coming into vogue, just at the time that unregulated Euromarkets, lacking regulation and official checks on banks' abilities to create money out of thin air, were starting to disrupt the Fed's efforts to control that very money supply.[15] Volcker called for a new cooperative international framework through the Bank for International Settlements, in Switzerland, to get other countries to stamp down on uncontrolled money creation in the offshore system. But New York bankers, in an alliance with the Bank of England and the Swiss National Bank, killed the initiative.[16]

The bankers of Manhattan began to wield the offshore system as a weapon to attack the New Deal regulations that had so effectively clipped their wings at home. In the words of Professor Ronen Palan, a leading academic authority on the offshore system, "The New York banking fraternity, led by Chase Manhattan, used the real or imagined threat posed by the Euromarket and the Caribbean tax havens—which the same banks had of course helped establish as large financial centres in the first place—to achieve their aim of more liberal financial laws."[17] If you can't beat the offshore markets, the lobbyists argued, then join them.

In June 1981, less than six months after Reagan's inauguration, the United States approved a new offshore possibility, the international banking facility. The United States was another step closer to becoming the tax haven imagined in the memo to Michael Hudson.

IBFs, as they are known, are kind of offshore Euromarkets-lite: They let U.S. bankers do at home what they could previously do only in places

like London, Zurich, or Nassau: lend to foreigners, free from reserve requirements and from city and state taxes. The bankers would sit in the same Manhattan offices as before and simply open up a new set of books and operate as if they were a branch in Nassau. Once the IBFs were in place, the banks could dispense with the subterfuge entirely and book them openly in New York. The United States had moved closer to the British offshore model.

Bankers in New York signed on to the new possibility with gusto, followed by those in Florida, California, Illinois, and Texas. In three years almost five hundred offshore IBFs had popped up inside the United States, draining money out of other offshore markets in the Caribbean and elsewhere.[18] It was a new get-out-of-regulation-free card for Wall Street and another hole in the American fortress. Not only that, but as author Tom Naylor puts it, "The US hoped to use the IBFs as a bludgeon to force other countries to relax restrictions on the entry of US banks into their domestic financial markets."

Japan followed the lead in 1986 by creating its own offshore market, modeled on the U.S. IBFs. This happened just at the start of a massive credit boom, followed by what was at the time the biggest asset market crash in history. That roller coaster had many causes, but the wildfire was stoked by the $400 billion that whooshed into Tokyo within 24 months [19] and showed local bankers what liberalized finance was all about. That year was also, as noted in chapter 4, the year of the fateful Big Bang of deregulation in the City of London, which provided Wall Street with major new escape hatches from financial regulation.

As offshore finance moved onshore, it became ever harder to tell the two worlds apart. And this, crucially, fed the giant blind spot, which persists to this day. Nearly every tax analyst took this blurring between onshore and offshore as a signal to stop trying to measure or analyze the secrecy jurisdictions, or just to focus on a few smaller, more colorful island havens. Palan, in his book The Offshore World, explains what was really happening. "Far from signalling the decline of offshore," he wrote, "the process "must be interpreted as the embedding of offshore in the global political economy."[20]

John Christensen remembers noticing this blind spot in 1986. He was working as a development economist in Malaysia and came across some odd local structures known as deposit-taking cooperatives. These

were unregulated quasi-banks that took large volumes of deposits from Malaysian widows and orphans and channeled the money offshore. In July 1985, one of these cooperatives offered him a king prawn luncheon at a sumptuous office penthouse in Kuala Lumpur, washed down with

Guinness and Courvoisier. As the lunch wore on, it became apparent that the chief financial officer, a leading light in the Malaysian Chinese Association, wanted to steer the conversation toward Christensen's childhood roots over six and a half thousand miles away in the crown dependency of Jersey, and he was especially interested in its status as a tax haven. He wanted to know if it was safe to invest.

Christensen resolved to look into the cooperatives. "The whole thing was a massive scam," he said. "The Central Bank wouldn't regulate it and nobody else would touch it. Everyone said 'keep away.'" Their international offshore dimension made it impossible for anyone locally—whether curious depositors or government regulators—to find out what was really happening: how profits were being shifted to insiders and risks heaped onto the shoulders of ordinary Malaysian depositors or taxpayers. After doing detailed research, Christensen was able to get an article published in the Business Times of Singapore in December 1985 before leaving the country as the ensuing scandal broke. Within months the central bank had suspended twenty-four cooperatives amid a massive run by depositors.

Back in Britain Christensen spent a couple of months combing libraries and seeing all the economists and capital markets experts he could find to try to understand where the money was flowing and how the offshore system worked. Nobody knew anything. "I don't think anyone understood how malevolent this thing had become," he said. "There was no useful information anywhere."

As the Vietnam War heated up, Michael Hudson worked out that the whole of the U.S. balance-of-payments deficit could be attributed to the costs of Vietnam. And the deficits, later worsened by the great Reagan tax cuts of 1981, posed a quandary. American companies needed to borrow money by issuing bonds, but if they borrowed it all at home, they would compete for funds with the U.S. government, pushing up interest rates and crimping economic growth. So it would be best if they could borrow from overseas.

But there was a hitch. A French investor, say, who wanted to buy some bonds faced a simple choice: either invest in American bonds, and pay a 30 percent withholding tax on the bond income, or hop on the "coupon bus" to Luxembourg and earn income tax-free, and in secret,

from Eurobonds. Many investors saw this as no choice at all. They shunned American bonds.

So American policymakers had a problem. The United States wasn't a tax haven, they reasoned, and they didn't want to help tax cheats unnecessarily. They wanted American companies to borrow overseas, but they wanted to keep the 30 percent tax too, for the revenue. How to square this circle?

At first, they settled for a compromise. American corporations could cook up a version of what was known as a "Dutch Sandwich"—set up an offshore finance subsidiary in the Netherlands Antilles, then use it to issue tax-free Eurobonds and send the proceeds up to the American parent. The United States could argue that it did not have to tax this income from the Antilles, under the rules of its tax treaty with this former Dutch colony via its postcolonial relationship with the Netherlands.

The U.S. Internal Revenue Service could easily have decided that the Dutch Sandwich was a sham and taxed the income. But it looked the other way. "These were Eurobonds, bearer bonds, which were virtually impossible to tax," explained Michael J. McIntyre, a top U.S. expert on international tax, who was one of very few people in the United States to have opposed this at the time. "You British people were quite happy about (the tax-free, secretive Eurobond markets). And we wanted in. We wanted to attract the hot money too."

David Rosenbloom, who was in charge of these matters at the U.S. Treasury during the years 1978–80, also remembers how questionable these officially tolerated offshore antics were. "People were very nervous. Those companies wanted access to the Eurodollar market, and they really wanted security," he said. "The Antilles structures were kind of phoney—these were paper entities; they weren't doing anything real. They existed in some notaire's desk drawer down in Curaçao."[21]

In response to the Antilles structures, the Carter administration commissioned a major survey of secrecy jurisdictions that was published in January 1981, the month Reagan came to power.

The Gordon report, as it was called, was probably the first really serious challenge to the havens in history. It condemned tax havenry as a situation that "attracts criminals and is abusive to other countries" and called on America to lead the world to crack down. Published a week before the Reagan inauguration, it quickly sank out of view. Yet the report was an acknowledgment that there was a big problem, and in this, it was new. "I can't remember any overarching 'Let's go after the havens' thing prior to the Gordon report," said Rosenbloom.

While the Bahamas and Switzerland were certainly on the radar screen, he said, the Netherlands Antilles was the big one. Eventually, the United States told the Netherlands Antilles it wanted to renegotiate the treaty.

"A whole bunch of rulings came down that scared the bejesus out of everybody," said Rosenbloom. "These were the days when people were actually afraid of our tax authorities."

But there was another hitch: Having tacitly encouraged the Antilles loophole, the United States was not in a great position to object. "From the point of view of U.S. tax policy these things were utterly objectionable, but the U.S. government had its hands completely dirty," Rosenbloom continued. "The government was in a bad position to start getting all self-righteous about this.

"The Antilles could have gotten a decent treaty that would have let them carry on doing business in some form. I was prepared to compromise. I didn't think we had the gumption to do this."

Yet the Dutch Antilles overplayed its hand. "They were holding out," Rosenbloom said. "They thought they could push the United States around in treaty negotiations. They wanted more of this and more of that, and this benefit and that benefit . . . they just held tough on all sorts of positions that we couldn't accept."

American corporations grew skittish. And out of the commotion, a new approach was hatched: From 1984, the United States would bypass the Antilles irritant entirely and waive the 30 percent withholding tax under a new loophole.[22] American companies would no longer set up fictional entities in Curaçao but simply issue their bonds at home. Foreign investors would pay no tax on their bond income.

It was a classic tax haven gambit: plug the deficits by exempting foreigners from tax, and watch as the world's hot money rolls in. It was just as the memo handed to Hudson in the elevator had anticipated.

The loophole was supposed to be available to foreign investors only. Unscrupulous wealthy Americans, of course, got around that simply by covering themselves in a cloak of offshore secrecy and pretending to be foreigners.

"The Wall Street types were as happy as clams," said McIntyre. "The rules were designed to facilitate tax evasion. It was a

very hot business: People in high places liked it and fostered it. They didn't think it was an ethical issue. . . . Nobody seemed to object, except my brother Bob and I."[23]

The effects were immense. Having set up offshore-lite international banking facilities in 1981, America, by 1984, had a thriving homegrown offshore bond market.

> "Suddenly," noted Time magazine, "America has become the largest and possibly the most alluring tax haven in the world." From then on, a drip-drip of new laws and statutes nibbled away at America's onshore defenses.

In the late 1990s, Bill Clinton's treasury secretary and former Goldman Sachs cochairman Robert Rubin deepened the offshore corrosion with a devious new piece of legislation, the Qualified Intermediary Program. And here lies another nauseating tale.

U.S. authorities wanted to protect the nation's own tax base by finding out about American accounts at foreign financial institutions. Yet they could not simply request all the information—about both foreigners and U.S. citizens—then simply sift out the U.S. tax cheats and ignore the foreigners. If it did receive information about foreigners, the United States would be obliged under its tax treaties to tell foreign governments about their citizens' U.S. investments. Those citizens would then take their money out of the United States and park it somewhere else, where it would remain secret. U.S. deficits would widen.

The answer was to outsource the screening to foreign banks. They would tell the United States only about U.S. citizens and not pass on any information about foreigners. And if the United States did not have the information, then it would have nothing to exchange with foreign jurisdiction—and it wouldn't be breaking its treaties. "The rules were designed to make it difficult for the U.S. government to learn who the tax cheats were," McIntyre explained.[24] "This evasion was intended to benefit U.S. borrowers by allowing them to borrow from the tax cheats at a reduced interest rate."[25] It was another classic offshore ruse. A tax haven sets up worthy treaties that require the haven to exchange information with foreign jurisdictions. Then they set up the structures to make sure that they never have the information to exchange in the first place. They keep their secrecy, but by pointing to their treaties they can claim that they are a transparent and cooperative jurisdiction.

Next, the banks simply lied to the U.S. authorities about what they were doing. Under cover of the Qualified Intermediary Program, members of the Swiss aristocracy would stalk the America's Cup and

Boston Symphony Orchestra concerts for wealthy Americans, then set them up with tax evasion schemes, even smuggling diamonds in toothpaste tubes to help them evade tax. Then they would check the box to confirm they were respecting American banking laws.

Rosenbloom encapsulated the cynicism in a nutshell. "The program was not aimed at identifying Americans," he said. "The program was aimed at protecting the identity of foreigners while allowing them to invest in the U.S." This narrow focus meant that only very clumsy or poorly advised American tax evaders would ever be caught.

A veteran official Washington investigator who asks to remain anonymous described how one American lawyer responded to the Qualified Intermediary Program. "This guy has a wonderful practice teaching people how to game the system," he said. "The first thing he does is put together a PowerPoint to the banks in central European secrecy jurisdictions, on how to get around the reporting obligations."

"That sonofabitch yelled at me down the phone," the investigator continued. "This is such an abuse of part of our legal culture. They fought [the U.S. government] every step of the way."

The Clinton administration, to be fair, issued proposed regulations near the end of its second term that would provide OECD countries with information about their citizens' U.S. bank deposits. U.S. banks, especially those with major deposits in Florida and Texas, lobbied hard against them. George W. Bush's administration dropped them.[26]

The United States sells financial secrecy not just at the federal level but at the state level too. Delaware is the biggest state provider of offshore corporate secrecy, but Nevada and Wyoming are the most opaque: They allow bearer shares, a vehicle of choice for mobsters and drugs smugglers, and they are particularly lax on allowing company directors and other officers to be named, hiding the identities of the real owners. Nevada does not share tax or incorporation information with the federal government and does not require a corporation to report where it does business. The IRS has no way of knowing whether a Nevada corporation has filed a federal tax return. Arkansas, Oklahoma, and Oregon are also routinely used for fraud by eastern Europeans and Russians, and, as noted, Texas and Florida are havens for illicit Latin American wealth.

In the 1990s, the U.S. government gave millions in aid to help the

former Soviet Union countries improve the security at their nuclear power plants. Much of it went missing. When the U.S. Department of Justice went looking for the money, investigators finally tracked it to anonymous shell companies in Pennsylvania and Delaware. Most cases involving financial market manipulations that the FBI has studied have involved U.S. shell companies from these states. The notorious "merchant of death" Viktor Bout, inspiration for the character played by Nicholas Cage in the Hollywood film Lord of War, alleged arms runner to the Taliban and other murderous organizations around the globe, operated through businesses in Texas, Delaware, and Florida.[27]

"US shell companies are attractive vehicles for those seeking to launder money, evade taxes, finance terrorism, or conduct other illicit activity anonymously," said Republican Senator Norm Coleman, then chairman of the U.S. Senate Permanent Subcommittee on Investigations. "Competition among States to attract company filing revenue and franchise taxes has, in some instances, resulted in a race to the bottom."[28]

A New York Times article from 1986 describes the antics of one Delaware lieutenant-general who flew to Taiwan, Hong Kong, China, Indonesia, Singapore, and the Philippines, clutching a pamphlet boasting that Delaware could "Protect You from Politics."[29] The official was, the article noted, "looking forward to a rich harvest of Hong Kong flight capital" after the British pullout in 1997. "You don't have to tell us the details of your business; you don't have to list who's on your board or who's holding office; and you don't have to use your name and address—just use your Delaware agent's." For an extra $50, you could get this in 24 hours.

Today, an "aged shelf company" will help you pretend you have been trading for years, when in fact you've just started up. "It's an effective means to create a perception of business stability," one registered agent advertises. "Most people won't ask…. There's nothing wrong with immediate gratification, as long as it's affordable!" Behind the secrecy, nobody can discover the deception. All this, and more, is yours for $299.

A limited liability corporation (LLC) might offer certified copies of the passports of that company's directors. That looks reassuring, but even with genuine passport copies you are no closer to knowing who really owns the company or its assets: These directors are probably professional nominees who work for hundreds of such corporations. Typically the nominee

director will route all queries via a company attorney who has contact with the real people, and when crime-fighters come looking, the attorney will hide behind attorney-client privilege and claim he or she cannot reveal the information. “That’s a secrecy jurisdiction right there, in his office,” one irate U.S. government investigator told me. “The lawyers are worse than the bankers. And there are the securities firms, and accountants. They are all involved.”

These LLCs are a filter between the assets and the owner, screening out the information. U.S. states cream off a few hundred dollars in fees, and crimes around the world go unpunished.

A Wyoming website boasts that “Wyoming Corporations and LLCs have a tax haven within the United States with no income taxation, anonymous ownership and bearer shares…. Shelf Corporations and LLCs: Anonymous entity where YOUR NAME IS ON NOTHING! These companies already exist and are complete with Articles, Federal Tax ID numbers and registered agents…. You may have these complete companies by TOMORROW MORNING!”

Yours for $69, plus modest state filing fees.[30]

These places are selling a cheap and very strong form of secrecy.[31] In Switzerland, information is typically retained, but secrecy laws mean locals may not disclose it. States like Wyoming have no such prohibitions on breaking the secrecy: The trick is simply to ensure no information is available in the first place. All company records may be kept outside the state—in North Korea, for instance—so even if the authorities wanted to find out what your company was about, they couldn’t. Stock can be transferred instantly and privately without filing a public notice.

With its corporate laws, the United States does not even comply with the transparency requirements of the IMF’s rather toothless IMF Financial Action Task Force, which requires countries to be able to identify beneficial owners. When congressional staffers and others have tried to change this, they have met ferocious lobbying from these states and from the American Bar Association.

“When other countries ask us for company owners, we have to stand red-faced and empty-handed,” said Senator Carl Levin. “The United States has been a leading advocate for transparency and openness. We have criticized offshore tax havens for their secrecy and lack of transparency. We have pressed them to change their ways. But look what is going on in our own backyard.

“America should never be the mattress corrupt foreign officials use to

hide their money."[32]

Secrecy is just one of several lures that individual U.S. states offer to financial capital elsewhere. Tax is another lure, though a fairly minor one. Certain types of state corporations shield residents from state income tax, asset tax, sales tax, stock transfer tax, or inheritance tax, and U.S. corporations push trademarks, patents, and other nebulous things into low-tax states in a transfer pricing game to cut state taxes. World-Com, for instance, shifted nearly $20 billion tied to "management foresight" to a Delaware company before it collapsed in 2002. Tax is never the individual states' top attraction, though: Corporations paying no state taxes owe U.S. federal taxes.

Two further lures have turned certain U.S. states into corporate havens. One involves usury; I will explore this in chapter 10. The other involves corporate governance, which is largely governed in the United States by state, not federal, laws. In both of these, Delaware plays a starring role.

What ties all these different strands together—the tax, the secrecy, the usury specialties, and the corporate governance—is the political establishment of this tiny state, where everyone knows everyone else and Democrats and Republicans alike seem to share a uniform opinion that local laws must be shaped to satisfy corporate desires, to attract business for the state—and the rest of the world can take care of itself. Only a definition of offshore like the one I use in chapter 1—focusing on how locals prioritize their own interests explicitly at the expense of others—enables us to tie together the four strands mentioned above and to understand what is going on.

A brief look at the story of Delaware helps bring this historical section of the book up to the present day.

Delaware, the second smallest of the U.S. states, is home to many of the world's biggest corporations. Conventional definitions of tax havens—those that focus on tax—fail to capture Delaware as a part of the offshore system. But something important is clearly happening here: Over half of U.S. publicly traded companies and nearly two-thirds of its Fortune 500—Coca-Cola, General Motors, ExxonMobil, you name it—are incorporated here; the little state hosted over 90 percent of all

IPOs in the United States in 2007. These corporations don't have their headquarters here; they are just incorporated there. Being in Delaware gives modest tax advantages over other states, but the killer lure is, as I've said, laissez-faire standards of corporate governance that give tremendous power to corporate managers.

Delaware has long been a refuge for financial capital. In 1899 the state government, influenced by the du Pont family, who wanted to incorporate their chemical industries,[33] adopted a new and permissive corporation law that reflected the laissez-faire spirit of an age of growing corporate power. In Delaware, the message went, company managers gain huge leeway to do what they want at the expense of other stakeholders. Other states began to follow suit. "Even as the starter's gun went off," the Chancery Court's official history puts it, "Delaware was already being accused of leading a 'race to the bottom.'" This classically offshore theme has remained a permanent character of Delaware history. In 1974 William Cary, a former chairman of the U.S. Securities and Exchange Commission, wrote in a landmark article in the Yale Law Journal that Delaware law has "watered down the rights of shareholders vis-à-vis management to a thin gruel" and that "necessary high standards of conduct cannot be maintained by courts shackled to public policy based upon the production of revenue, pride in being 'number one,' and the creation of a 'favorable climate' for new incorporations."

To be fair to Delaware, there are healthier reasons for incorporating here. Its Chancery Court has become—because of Delaware's success in attracting out-oftowners—the specialist in corporate law, with unrivaled experience and expertise.[34] And its location halfway between New York and Washington gives Wilmington a fearsome geographical edge too. Who wants to fly to Alaska to litigate?

The Delaware Chancery Court has a "business judgment rule" under which courts should not second-guess corporate managers, provided they have not blatantly violated some major rule of conduct and their decisions are approved by a "neutral" decision-making body. Whatever one thinks of this approach, Delaware has taken it to extreme lengths, granting corporate bosses extraordinary freedoms from bothersome stockholders, judicial review, and even public opinion. As Bernard Black, a professor of law at Columbia University, wrote in 1998, "Shareholders haven't been able to stop managers, and their allies on

the Delaware Supreme Court and in state legislatures, from chilling hostile takeovers through poison pills, antitakeover statutes, and judicial decisions that let managers 'treat shareholders like morons' who are incapable of understanding a firm's true value."[35]

In 2003 Delaware passed new legislation expanding the Chancery Court's jurisdiction, and the official synopsis said the aim was to "keep Delaware ahead of the curve in meeting the evolving needs of businesses, thus strengthening the ability of the state to convince such businesses to incorporate and locate operations."[36] J. Robert Brown, a professor of corporate law at Denver University and a leading critic of Delaware courts, said that "Delaware courts have all but eliminated meaningful limits on self-interested transactions."

A Reuters story in May 2010 provided a fascinating insight into one role Delaware's incorporation business played in the latest financial crisis.[37] The story examines the "dean of CDOs," a retired University of Delaware finance professor who became the sole independent director of the Delaware-based corporations behind more than two hundred mostly subprime- backed CDOs, including ones underwritten by Goldman Sachs and Morgan Stanley. Independent directors are supposed to bring unbiased opinions to company boards and ought to be what one expert terms "the cornerstone of good corporate governance."[38] Janet Tavakoli, a Chicago-based structured finance consultant, said these independent directors "are basically there just as a rubber stamp." We will see a lot more of Delaware's role in the financial crisis later, but the point for now is that allowing toothless directors for securitization deals, just like Nevada's tolerance for nominee directors who reinforce corporate secrecy, is offshore business.[39]

Richard Murphy of Tax Research UK captures the artificiality of these arrangements. "Offshore is used to repackage what happens elsewhere," he said. "It is used to change the form, but not the substance, of a transaction." A world-famous totem to this artificiality is Ugland House, in the Cayman Islands, which Barack Obama once criticized for housing over twelve thousand corporations: "either the biggest building," he said, "or the biggest tax scam."[40] When Obama said that, Antony Travers, chairman of the Cayman Islands Financial Services Authority, fired right back. Obama would be better advised to focus his attention in Delaware, where, he said, "an office at 1209 North Orange Street, Wilmington, houses 217,000 companies."

After Travers said that, I had to see the world's biggest building.

This, as it happens, is the office for the Corporation Trust, a subsidiary of the Dutch firm Wolters Kluwer. It is just at the edge of Wilmington's small financial center: a forgettable yellowish brick low-rise with a modest maroon awning: the kind you'd find outside a pizza restaurant. It sits between the scruffy little parking lot behind it and the unsightly six-story parking garage across Orange Street, and it is, legally speaking, the corporate home of Ford, General Motors, Coca-Cola, Kentucky Fried Chicken, Intel Corp., Google Inc., Hewlett Packard, Texas Instruments, and many more global corporate giants, including many of the specialized trusts and Special Purpose Entities (SPEs) that underlay the latest financial crisis. These corporations are not here for secrecy but for the corporate governance. The Corporation Trust will, as part of the service, also help your company serve and receive notices, subpoenas, summons, and the like. Delaware's government website lists 110 registered agents—these, by the way, are not regulated.[41] In 2008 Delaware hosted 882,000 active business entities: one for every man, woman, child, and baby in the state.[42]

Before visiting the building, I called repeatedly to request an interview with the management of the Corporation Trust. Each time I was promised a call back, which never came, until I eventually caught a new receptionist who put me through to the office manager, Cory Bueller. Evidently flustered, she agreed to see me. I turned up ten minutes ahead of time and was buzzed into a reception room about twelve by twelve feet, with an aging, scuffed gray-patterned carpet, two potted plants, and light-colored walls dotted with odd grease smears. Behind a glass window sat the receptionist, a slightly unshaven black man in a baseball jacket, who was replaced soon after I arrived by an attractive, well-dressed young woman in a vivid red coat, who smiled brightly and promised that Bueller would be out shortly.

Bueller came through the door in faded jeans, white sneakers, a white T-shirt, and a gray cardigan and said sheepishly that she couldn't give me that interview after all. I asked if I could have a quick nose around. That would not be possible, she said, wringing her hands. I pressed again. "Just a quick peek?" A flush of color came to her cheeks, and she declined again. She would not give me her own card but instead passed me a piece of headed paper with a phone number for Wolters Kluwer's New York press office. Back outside, I could see long rows of work cubicles through one window. It looked very similar to what I had been able to see of the ground floor of the Caymans' Ugland House. This was clearly a place for secretarial work: Bueller did confess under my

questioning that about 80 people worked there, and none were lawyers.

As late as the early 1990s, mainstream development theorists trying to work out why some states were failing, or why poverty was so widespread, all but ignored the issue of corruption. Berlin-based Transparency International (TI), founded in 1993, put corruption on the map, launching its famous Corruption Perceptions Index (CPI) two years later. The Financial Times nominated 1995 as the International Year of Corruption; and the World Bank, which had previously been so polite toward developing country elites that it all but banished the c-word from its policy documents, followed TI's lead in 1996 when its president, James Wolfensohn, accepted in a landmark speech that the bank needed to deal with "the cancer of corruption." The OECD's Anti-Bribery Convention came into force only in 1999, and the UN's Convention Against Corruption was only solidified in 2003. In many OECD countries, bribery was even tax-deductible until just a few years ago.

Even so late, the shift was very good news. But now consider this.

TI's corruption ranking is invaluable to investors trying to assess "country risk." But Nigerians already know that their country is among the world's most corrupt. They want to know where almost $500 billion worth of their oil money has gone. The corruption index gives no clues. After the brutal Nigerian president Sani Abacha died in 1998, poisoned while in the company of Indian prostitutes, it was revealed that he had raked off billions of dollars of oil money from state coffers. Two countries in particular had soaked up his embezzled wealth: Britain and Switzerland. The Nigerian finance minister Ngozi Okonjo-Iweala revealed the problems in an interview with journalist Paul Vallely of The Independent in May 2006.[43]

NGOZI: The Swiss have now returned $500 million of stolen resources. Switzerland has set the example.

VALLELY: What about the British?

She gives a long throaty chuckle.

NGOZI: Now heaven help me. It's very hard to condemn the British. On debt relief the UK has set the example.

VALLELY: So why are the British dragging their feet on the repatriation of stolen resources?

NGOZI: It's been more difficult with the British. Our president has raised it many times with Prime Minister Blair. Eventually he returned $3m. We understand there are other monies but while all the discussion was going on those monies left the country and went somewhere else.

TI's rankings suggest that Britain and Switzerland, not to mention the United States, are among the world's "cleanest" jurisdictions. In fact, about half the top 20 in the index are major secrecy jurisdictions, while the nations of Africa—the victims of the gargantuan illicit flows—are ranked the "dirtiest."[44]

Clearly, something is wrong here.

In November 2009 the Tax Justice Network published a new index based on two years of work by a dedicated team. Named the Financial Secrecy Index, it ranked countries according to how important they are in providing financial secrecy in global finance. It did this by looking at a range of key secrecy indicators and structures to see how secretive a jurisdiction was, then weighting each according to the scale of cross-border financial services activity that it hosts.

Nothing like this had ever been done before, and newspapers and television stations around the globe published the results, with some of the countries traditionally seen as the "cleanest" being ranked as among the world's least transparent.

In fifth place in the Financial Secrecy Index was the United Kingdom. Although it has by far the most important historical role in the emergence of offshore, and it is the center of the British offshore spiderweb, its own domestic secrecy structures in themselves are relatively transparent. Third and fourth most important were, respectively, Switzerland and the Cayman Islands. Luxembourg, a gigantic but hardly noticed haven of financial secrecy, came second. And which country was ranked—by a mile

—the world's most important

secrecy jurisdiction?

Step forward, the United States of America.

THE DRAIN
How Tax Havens Harm Poor Countries

BY THE EARLY 1980S THE MAIN ELEMENTS of the modern offshore system were in place and growing explosively. An older cluster of European havens, nurtured by old European aristocracies and led by Switzerland, was now being outpaced by a new network of more flexible, aggressive havens in the former outposts of the British empire, themselves linked intimately to the City of London. A state within the British state, the City had been transformed from an old gentleman's club operating the financial machinery of empire, steeped in elaborate rituals and governed by unspoken rules about what "isn't done," into a new, brasher, deregulated global financial center dominated by American banks and linked intimately to this new British spiderweb. A less complex yet still enormously important offshore zone of influence had also grown up, centered on the United States and constructed by U.S. banks. The stateless Euromarkets linked all these zones with each other and with the onshore economies, helping free banks from reserve requirements and other democratic restraints on their behavior.

While the old European havens were mostly about secret wealth management and tax evasion, the new British and American zones were increasingly about escaping financial regulation—though with plenty of tax evasion and criminal activity thrown in, of course. Players in each zone were warmly welcomed into the others, in true laissez-faire style, and as the offshore system became more interconnected it grew stronger too, as states competed with each other in races to the bottom on lax financial regulation, tax, and secrecy in order to lure financial capital. This competition also helped force offshore practices steadily onshore, making it harder to tell the two apart.

The Bretton Woods system of international cooperation and tight controls over financial flows had collapsed in the 1970s, bringing to an end the so-called golden age of capitalism that followed the Second World War. The world had entered a phase of much slower growth,

punctuated by regular financial and economic crises, especially in the developing world.

And as all this happened, and the offshore system grew and metastasized all around the global economy, a new and increasingly powerful pinstripe army of lawyers, accountants, and bankers had emerged to make the whole system work. Offshore, in partnership with changing ideologies, was driving the processes of deregulation and financial globalization. In particular, the London-based Euromarkets, then the wider offshore world, provided the platform for U.S. banks in particular to escape tight domestic constraints and grow larger again, setting the stage for the political capture of Washington by the financial services industry, and the emergence of too-big-to-fail banking giants, fed by the implicit subsidies of taxpayer guarantees, plus the explicit subsidies of offshore tax avoidance, that continue to hold western economies in their stranglehold today. The emergence of the United States as an offshore jurisdiction in its own right attracted vast financial flows into the country, bolstering bankers' powers even further. The old alliance between Wall Street and the City of London, which collapsed after the Great Depression and the Second World War, had been resurrected.

Many people supposed that by eliminating double taxation and creating nearly frictionless conduits for financial capital, the offshore system was promoting global economic efficiency. In reality the system was rarely adding value, but was instead redistributing wealth upward and risks downward, and creating a new global hothouse for crime.

The U.S. crime-fighting lawyer John Moscow summarized the problem. "Money is power and we are transferring this power to corporate bank accounts run by people who are in the purest sense of the word unaccountable and therefore irresponsible."[1]

Secrecy jurisdictions had penetrated the public consciousness, a little, but still only as marginal, dubious oddities at the exotic fringes of civilization. Under cover of this great misunderstanding, often artfully encouraged by those who wanted to conceal the true nature of the new financial revolution, the offshore system would play out in ways that would become increasingly significant in the 30 years to follow.

What was happening was nothing less than a head-on assault on the progressive New Deal in the United States; on the foundations of social democracy in Europe; and on democracy, accountability, and development in vulnerable low-income countries across the world.

Take any significant economic event or process in the last few decades, and offshore is almost certainly behind the headline and probably central to the story.

Poverty in Africa, for example, cannot be understood without understanding the role of offshore. The world's worst war for years has been the civil conflict in the Democratic Republic of Congo, which is tied in with the wholesale looting of its mineral resources—via tax havens. Large-scale corruption, and the wholesale subversion of governments by criminalized interests, across the developing world? Offshore is central to the story, every time. Nearly every effort to generate large flows of capital to developing countries since the 1980s has ended in crisis because the money has escaped offshore. Towering inequalities in Europe and the United States, not to mention in underdeveloped countries, cannot be understood properly without exploring the role of secrecy jurisdictions. The systematic looting of the former Soviet Union, and the merging of the nuclear-armed country's intelligence apparatus with organized crime, is substantially a story that unfolds in London and its offshore satellites. The political strength of Saddam Hussein had important offshore underpinnings, as does the power of North Korea's Kim Jong-Il today. Prime Minister Silvio Berlusconi's strange hold over Italian politics is significantly an offshore story. The Elf affair, discussed earlier, which helped powerful French elites float above and out of reach of French democracy, had secrecy jurisdictions at its heart. Promoters of frauds such as "pump and dump" schemes to hype up stocks, then dump them on an unsuspecting public, always hide behind offshore entities. The death of a Russian oligarch's lawyer in a mysterious helicopter crash? Arms smuggling to terrorist organizations? The growth of mafia empires? Offshore. The narcotics industry alone generates some $500 billion in annual sales worldwide[2]: To put this into perspective, that is twice the value of Saudi Arabia's oil exports.[3] The profits made by those at the top of the trade find their way into the banking system, the asset markets, and the political process through offshore facilities. You can only fit about $1 million cash into a briefcase. Without offshore, the illegal

drugs trade would be more like a cottage industry.

Financial deregulation and globalization? Offshore is the heart of the matter, as I will show. The rise of private equity and hedge funds? Offshore. Enron? Parmalat? Long Term Capital Management? Lehman Brothers? AIG? Offshore. Multinational corporations could never have grown so vast and powerful without the tax havens. Goldman Sachs is very, very much a creature of offshore. And every significant financial crisis in the world since the 1970s, including, as noted, the latest global economic crisis, is very much an offshore story. The decline of manufacturing industries in many advanced countries has many causes, but offshore is a big part of the story. Tax havens have been central to the growth of debt in our economies since the 1970s. The growth of complex monopolies in certain markets, or insider trading rings, or gigantic frauds, almost always involves secrecy jurisdictions as major or central elements.

This is not to say that all of these problems don't have other explanations too. They always do. Tax havens are never the only story because offshore exists only in relation to elsewhere. That is why it is called offshore.

Without understanding offshore, we will never properly understand the history of the modern world. The time has come to make a start in filling this gigantic hole in our knowledge and to appreciate the gravity of offshore: how it has bent the world's economy into its modern, globalized shape, transforming societies and political systems in its image.

I will now describe a rare episode where offshore's role is widely acknowledged: the case of the Bank of Credit and Commerce International (BCCI), arguably the most offshore bank in history. The story is well known, but for one or two crucial features.

The BCCI case broke open after Jack Blum, a lawyer and investigator working for John Kerry's Foreign Relations Committee, began picking up signs of wrongdoing in 1988.

Like most people, Blum initially saw secrecy jurisdictions mainly as centers for drug smugglers and other assorted lowlifes. But on a visit to the Cayman Islands in 1974 for the U.S. Senate Foreign Relations Committee, he remembers seeing a line of well-dressed men waiting to use the phone in his hotel lobby. He learned that they were U.S. lawyers

and accountants arranging to meet Cayman bankers to set up bank accounts and trusts for tax-evading U.S. clients. The American bankers were referring U.S. customers to their Canadian colleagues, and the Canadians were returning the favor. Over time, he began to notice more sophisticated tricks and to see that this was far bigger than almost anyone imagined.

"I began to see that drugs were only a fraction of the thing," Blum said. "Then there was the criminal money. Then the tax evasion money. And then I realized—'Oh my God—it's all about off the books, off the balance sheet. Offshore, there are no rules about how the books are kept,'" he continued. "I refer to offshore as a kitchen, where corporate books are cooked."

When contacts started fingering BCCI in the late 1980s, Blum already knew it had a bad smell: He had worked previously in private practice, where he remembers his team meeting the staff of Mellon Bank in Pittsburgh and telling them about BCCI. "The entire senior international staff at Mellon just about threw up on the table," Blum said. They would not, under any circumstances, accept letters of credit from BCCI.[4]

The bank was set up in 1972 by an Indian-born banker, Agha Hassan Abedi, who got backing for his venture from members of the Saudi royal family and from Sheikh Zayed Bin Sultan Al-Nahayan, the ruler of Abu Dhabi. BCCI grew superfast under a simple business model: create the appearance of a reputable business, make powerful friends, then agree to do anything, anywhere, on behalf of anyone, for any reason. BCCI larded politicians with bribes and served some of the twentieth century's greatest villains: Saddam Hussein, the terrorist leader Abu Nidal, the Colombian Medellin drug cartel, and the Asian heroin warlord Khun Sa. It got involved in trafficking nuclear materials, in sales of Chinese Silkworm missiles to Saudi Arabia, and in peddling North Korean Scud-B missiles to Syria. Its branches in the Caribbean and Panama serviced the Latin American drug trade; its divisions in the United Arab Emirates, then amid an oil boom and an offshore banking bonanza, serviced the heroin trades in Pakistan, Iran, and Afghanistan; and it used Hong Kong to cater to drug traffickers in Laos, Thailand, and Burma. It also got into the U.S. banking system, getting around the concerns of U.S. regulators by using offshore secrecy structures to make its ownership invisible. It paid off Washington insiders and built up a solid partnership with the CIA. This gave it fearsome political cover and made Blum's investigations extraordinarily difficult from the outset.

"There was an army of people working in Washington on all sides trying to say this bank was a wonderful bank," Blum said. Friends in law enforcement warned him that his life was in danger, but he pressed on. He took the case to the Manhattan district attorney Robert Morgenthau, who shared Blum's outrage and put a team together to take BCCI down. Fighting against what must have seemed like half the political insiders in Washington, Morgenthau helped shut it down in 1991 and charged BCCI and its founders with perpetrating "the largest bank fraud in world financial history."

But the most interesting thing about BCCI was its offshore structure.

Abedi split his bank between jurisdictions, registering holding companies in Luxembourg and in the Caymans, so that no regulator could see the whole thing. Different auditors were used for different parts of the bank too.[5] Yet he also wanted the credibility of being in a world-famous financial center, though it would need to be lax enough to ask few questions. That meant only one place: the City of London. In 1972 BCCI set up its headquarters in luxury offices in Leadenhall Street, at the heart of the City, and began making generous contributions to Britain's Conservative Party.[6]

A rule of thumb was that banks should lend no more than 10 percent of their equity capital to a single borrower—but BCCI was making loans to some clients worth three times its capital or thirty times the accepted ratio. In 1977 the Bank of England tightened these rules further. To get around this, Abedi dumped shaky loans in the Cayman Islands, where, as a BCCI official noted at the time, there was "obviously more flexibility in record-keeping" and which bank officials called "The Dustbin."[7] Neither the British regulators, nor those in Luxembourg or the Caymans, assumed responsibility.

BCCI also constructed an audacious but simple offshore trick: to manufacture equity capital—the foundation and safety buffer of any bank—out of thin air. The Luxembourg bank would lend money to a BCCI stockholder—one of Abedi's friends— who would then invest this money in the Caymans bank, building up its capital there. Likewise, the Caymans bank lent money to a stockholder who would use it to create capital in the Luxembourg bank. From just $2.5 million in equity capital at the beginning, BCCI had raised nearly $850 million by 1990, with the help of this offshore bootstrap.[8] Abedi also wrote off his friends' debts but kept expanding by operating a Ponzi scheme: milking the staff pension fund and taking in more deposits simply to pay its outgoings. Many of its eighty thousand depositors were relatively poor people from the

developing world who had no idea that this apparently London-based bank, backed by wealthy Arab Sheikhs, was a fiction piled on a fiction.

"There is no way to learn banking from books: it is bullshit," said Blum, highlighting the make-believe possibilities that emerge in the liberated offshore environment. "Nothing tells you how money-laundering generates products."

When Morgenthau tried to probe the bank, the Caymans authorities refused to cooperate. “We subpoenaed BCCI Overseas—they told us, ‘Sorry: the laws of Cayman don’t permit us to do this,’” he said, expressing particular irritation with the attorney general, a “crotchety British guy” named Alan Scott.[9] “We tried again. Finally, they said we had to go through the (U.S.-Cayman tax information exchange) treaty. We went through the treaty. Then they said, ‘The treaty doesn’t include local District Attorneys: go through the Justice Department. We can’t show this to you.’ The Justice department wasn’t overly cooperative either.” [10]

Morgenthau and his deputy John Moscow went to the Bank of England. “We had no cooperation from the Bank of England,” Morgenthau said. “We tried to get financial records out of London; they didn’t provide us with anything.”

With the help of Senator John Kerry, Morgenthau threatened to raise a public storm if the Bank of England did not act. Only then, finally, the Bank agreed to shut BCCI down.

In the British parliament, the scandal caused an uproar. The Bank, forced onto the defensive, claimed it had left BCCI running until 1991 because there had been no “solid evidence” of fraud until then.

It isn’t clear what other evidence the Bank needed. Indictments in the United States implicating BCCI in fraud dated back two and a half years; one stated that money laundering was part of its “corporate strategy.”[11] Price Waterhouse had issued a qualified audit report on a BCCI subsidiary in 1989; and in 1990 BCCI employees had written to the Treasury, the Bank of England, and British ministers to warn of fraud inside the bank. That same year, Britain’s intelligence services had told the Bank of England that Abu Nidal controlled 42 BCCI accounts in London; the Bank for International Settlements in Basel had expressed concern; and in mid-1990 Price Waterhouse had discovered the so-called Naqvi files, revealing widespread fraud, fictitious companies, unrecorded deposits, manufactured loans, and evidence of stealing from depositors, findings that were passed along to the Bank of England. Still there was no action, even though BCCI headquarters were only a few minutes’ stroll down the road from the Bank

“It is difficult to see,” wrote Michael Gillard in Britain’s Observer newspaper, “how the required high ethical standards [for BCCI to be allowed to operate in Britain] fit with BCCI pleading guilty to conspiring with its own officials and two representatives of Colombia’s Medellin drug cartel to commit tax fraud and launder the proceeds of cocaine sales.”

Robin Leigh-Pemberton, the Bank of England governor, neatly encapsulated London's see-no-evil offshore ethic. The present system of supervision, he added, "has served the community well.... If we closed down a bank every time we found an incidence of fraud, we would have rather fewer banks than we do at the moment."[12] That statement should have been evidence enough that the City of London was already the world's premier offshore center.

The full Price Waterhouse report on BCCI remains confidential today, on the grounds that this will disturb Britain's "international partners." It is a clear defense of tax haven London.[13]

Ever since then, Morgenthau has struggled to wake people up to offshore crimes, personally pressing four U.S. treasury secretaries to pay more attention, with little result. "I remember giving a speech a couple of years ago to talk about offshore banks. It put everyone to sleep,"[14] Morgenthau said. "Start talking about offshore money and their eyes glaze over."

Just as the BCCI scandal quieted down, another offshore tale was emerging in the oil-rich African state of Angola, where I was the Reuters correspondent. Jonas Savimbi's UNITA rebels had surrounded major towns in murderous sieges, pouring in mortar fire and trying to starve them into submission. In the city of Kuito desperate defenders were eating dogs, cats, and rats to survive, and bloodied patients were crawling from hospital beds to join armed raiding parties who would sneak out to search nearby fields, often mined, for cassava and other crops, sometimes having to fight their way back into town with provisions. The United Nations was calling it the world's worst war, and the government was under an international arms embargo, so in 1992 it turned to secretive French Elf networks—related to the ones I would later encounter in Gabon, as described in the prologue—to help secure arms supplies. A wealthy Russian-born Jew named Arkady Gaydamak put together some $800 million in financing to help Angola procure weapons from a Slovak company, repaid in Angolan oil money, via Geneva, and get around the embargo. Later, French magistrates probing these oil-for-arms deals heard from a participant that the arrangements were "a gigantic fraud . . . a vast cash pump," generating

a 65 percent margin on the biggest arms contracts."[15] The financing trails, of course, involved many tax havens.

I tracked Gaydamak down in Moscow in September 2005, where he was under an international arrest warrant for his so- called "Angolagate" deals.[16] He was eager to set the record straight and to discuss his efforts to—as he put it—bring peace to Africa and the Middle East[17] (just then he was embarking on what would be an ill-fated foray into Israeli politics).

Gaydamak had left the Soviet Union as a twenty-year-old in 1972, moving first to Israel, then to France, where he built up a translation business, mostly servicing Soviet trade delegations. "'Translator' means go-between," he explained. "If you are active in electronics, your position in the business world is usually with people in electronics. If you are a banker, you have relationships with bankers . . . but when you are a translator—a go-between—you know everybody."

In those early post-Soviet days Angola's leaders still looked to Russia as their big-power patron, but they had lost their bearings in a fast-changing Moscow. "I began to be an intermediary," he explained. "Russia was changing so quickly, everything was new: you should know where to go, how to go, how to organize. I was the so-called organizer of everything." Gaydamak became Angola's trusted man in Moscow. He knew that the big money lies in the "elsewhere" zone between jurisdictions, and in this context he gave me what must be one of the most "offshore" quotes of all time.

"In the so-called market economies, with all the regulations, the taxation, the legislation about working conditions, there is no way to make money," he said. "It is only in countries like Russia, during the period of redistribution of wealth—and it is not yet finished—when you can get a result. So that is Russian money. Russian money is clean money, explainable money. How can you make $50 million in France today? How? Explain to me!"

In other words, because Russian and international law is so full of holes, the money "redistributed" to a small oligarchy must be clean.

Some have compared the vast upward redistribution of wealth in Russia after the fall of the Soviet Union to the era of the robber barons in the United States in the nineteenth century. But there is a crucial difference. The U.S. robber barons didn't have a huge offshore network in which to hide their money. In spite of their many abuses, they concentrated on domestic investment. While they fleeced unwary investors and subverted the political process, they also built the

country's industrial prosperity. In time, the state was able to rein in their worst excesses.

But in the case of countries like Angola and Russia, the money simply disappeared offshore forever. African governments

have grown weaker and more dependent on aid from the very states that are also strengthening the offshore system. It was Africa's curse for her countries to gain independence at precisely the time that the purpose-built offshore warehouse for leaders' loot properly started to emerge. For many of these countries, "independence" really meant independence for African rulers from bothersome societies. In a sense independence was a pyrrhic victory: The colonial powers departed but quietly left the financial mechanisms for exploitation in place.

After the Cold War, Angola was in debt to Russia for about $6 billion, and in 1996 Gaydamak inserted himself into a deal to restructure the debt. The debt was shaved down to $1.5 billion and sliced into thirty-one promissory notes that Angola would pay back in oil, via a private company called Abalone, set up by Gaydamak and his business partner Pierre Falcone, with a UBS account in Geneva.[18] UBS was uncomfortable about the arrangements. "Any possible mention of one of the representatives of one or other of the parties," an internal UBS memo said, "in a newspaper article, even if a posteriori this is judged to be unfounded or indeed libellous, would not prevent, in the first instance, a Swiss or particularly Genevan judge taking an interest in the people mentioned."[19] But the deal went ahead.

Unfortunately for Gaydamak, a Swiss judge intervened in February 2001, after Angola had paid off just over half the promissory notes. The judge had found vast, mysterious flows of money out of Abalone, including over $60 million to accounts in Gaydamak's name, tens of millions more to accounts in the names of senior Angolan officials, and almost $50 million to a former Yeltsin oligarch.[20] But most of it flowed to an array of accounts in Switzerland, Luxembourg, Israel, Germany, the Netherlands, and Cyprus. Little or none of it seemed to have flowed to Russia's treasury. Gaydamak claimed that the Russian treasury got paid indirectly, via these mysterious accounts,[21] and added that this was a "classic trading operation, extremely favourable to us."

Because of the offshore secrecy, it is impossible to tell whether what Gaydamak said is even partly true. What is certain is that Angola's leaders, in partnership with Russian interests and private offshore intermediaries, cooked up a curious deal, routed offshore, with vast profits for some insiders, and with absolutely no chance of accountability to the people of Angola or Russia. The African insiders had used offshore to enrich themselves not from Angola's assets but from its debts.

The Swiss judge was later promoted away from the post, and his

replacement unblocked the notes in October 2003, arguing that neither Angola nor Russia had complained about the deal, and accepting the argument that the accounts held by the Angolan dignitaries amounted to "strategic funds, placed abroad in a time of war."

I could have chosen any number of murky African offshore episodes to explore, but I chose this one to illustrate a particular point about the scale of the draining of Africa's wealth. Gaymadak's deals represent only a tiny fraction of what the offshore system has drained from Africa. Two recent studies point directly to the sheer scale of the problem.

In March 2010 Global Financial Integrity (GFI) in Washington authored a study on illicit financial flows out of African countries.[22] Between 1970 and 2008, it concluded, "Total illicit financial outflows from Africa, conservatively estimated, were approximately $854 billion. Total illicit outflows may be as high as $1.8 trillion." Of that overall conservative figure, it estimates Angola lost $4.68 billion[23] between 1993 (when Gaydamak's main "Angolagate" deals started) and 2002, the year after his Abalone debt dealings ended. My personal belief, based on years of investigating Angola's economy and its offshore-diving leadership, is that Baker's estimate—equivalent to just over 9 percent of its $51 billion in oil and diamond exports during that time[24]—simply has to be a gross underestimate of the losses. Many billions have disappeared offshore through opaque oil- backed loans channeled outside normal state budgets, many of them routed through two special trusts[25] operating out of London.

GFI's shocking estimates complement the figures I mentioned in the prologue about the global scale of illicit financial flows: Developing countries lost up to a trillion dollars in illicit financial outflows just in 2006—that is, ten dollars out for every dollar of foreign aid flowing in.[26]

Another study emerged in April 2008 from the University of Massachusetts, Amherst, using different methodologies to examine "capital flight" from forty African countries from 1970 to 2004.[27] Its conclusions are similarly striking: "Real capital flight over the 35-year period amounted to about $420 billion (in 2004 dollars) for the 40 countries as a whole. Including imputed interest earnings, the accumulated stock of capital flight was about $607 billion as of end–2004." Yet at the same time, the total external debt of these countries was "only" $227 billion. So, the authors note, Africa is a net creditor to the rest of the world, with its net external assets vastly exceeding its debts. Yet there is a crucial difference between the assets and the liabilities. The

University of Massachusetts study concludes, “The subcontinent’s private external assets belong to a narrow, relatively wealthy stratum of its population, while public external debts are borne by the people through their governments.”

Having watched people die before my eyes in Angola; having seen an otherwise pretty six-year-old Angolan girl who, without access to basic medicine, was losing a fight with an infection that had rotted a hole in her cheek the size of a golf ball, I am seared by having witnessed some of the ways Africa’s people bear their public debts, in the forms of poverty, war, a hopeless lack of real opportunities, and the regular physical and economic violence perpetrated against them by corrupt and predatory offshore-roaming elites who float free and unaccountable above their societies. Raymond Baker, the director of GFI, was quite right to call the emergence of the offshore system “the ugliest chapter in global economic affairs since slavery.”[28]

In February 2003 Phil Gramm, a former Republican Texan senator who became vice chairman of the Swiss investment bank UBS Warburg, wrote to U.S. treasury secretary John Snow, arguing against a plan to increase international financial transparency. “This proposal will limit economic freedom,” he wrote, “and reduce the pressure that potential capital flight imposes on high-taxing countries worldwide.”[29] Illicit flows are good, Gramm was effectively saying, because it disciplines the victims.

Anyone who understands that there is a difference between wealthy rulers, who are the beneficiaries of illicit flows, and ordinary citizens, who are the victims, can see through Gramm’s position. Yet in whole sectors of the Western economics profession, such thinking has become almost an article of faith founded on the ageless blame-the-victim accusations that the losers are stupid, are corrupt, or just didn’t flagellate themselves hard enough.

Jim Henry, a former chief economist for McKinsey’s who is almost alone in having investigated this globally since the 1980s, sees the conventional roots of the global development crisis as “an economist’s fairy tale…. It leaves out all the blood and guts of what really happened.” Henry’s 2003 book Blood Bankers explores a number of shocking episodes where offshore banking led to crisis after crisis in low-income countries. First, bankers lent these countries far more than they could

productively absorb;

then they taught local elites the basics of how to plunder their countries' wealth, then conceal it, launder it, and sneak it offshore.

Then the IMF helped bankers pressure these countries to service their debts under threat of financial strangulation. Capital markets were deliberately opened up to foreign capital, according to Henry, "whether or not there were adequate security laws, bank regulations or tax enforcers in place."

He tracked down an American banker from MHT Bank who took part in a friendly private audit of the Philippines central bank in 1983. "I sat in a hot, little room at the Central Bank, added up what the Central Bank showed it had received from us on its books, and compared it with our disbursements," the banker told Henry.[30] "And nearly $5bn was just not there! I mean, it had just not come into the country. It had been disbursed by us, but it was completely missing from the Central Bank's books. It turned out that most of these loans had been disbursed to account numbers assigned to Philippine offshore banking units or other private companies. Apparently, the Central Bank gave MHT the account numbers, and we never questioned whether they were Central Bank accounts—we just wired the loans to them. And then they disappeared offshore."

Philippine officials realized what he was up to, and the following morning the banker got a big breakfast in his hotel room, courtesy of the management. Fortunately for him, he only had time to grab a bite of toast before heading to the airport. By the time he reached Tokyo he was sick, and on the flight home he went into convulsions and spent three days in a Vancouver hospital recovering from what the doctors said was "an unknown toxin."

Later, he told the New York Federal Reserve, and a friend at the National Security Council. "But apparently they just kept it to themselves," he said. "So the Philippines is still servicing all those Central Bank loans." Henry was able to confirm the banker's story on a later trip to the Philippines. He also dug up details on at least $3.6 billion of identifiable government-swallowed foreign loans that ended up with then-president Ferdinand Marcos and his closest associates.

Walter Wriston, the chief executive of Citibank from 1967 to 1984, described the thinking of many of the parties involved as private offshore banking emerged as a global force. Sitting before a picture of himself with President Marcos and his wife, Imelda (the picture, he said, "caused so much uncontrollable laughter among my colleagues that I've kept that picture on my wall all these years"), he described the pervasive

lack of understanding of, or perhaps the deliberate blindness of many toward, what was really going on. “In hindsight, the corruption and the amount of money bled off from those companies was a lot more than anybody knew about, including the United States government, Citibank, and the CIA,” he said. “We based our loans on economic analyses—will the power plant supply enough kilowatts to pay back its loan?—without realizing that we also had to account for the fact that the head of the power plant was the dictator’s brother.”[31]

As all this happened across the developing world, a pinstripe army of bankers, lawyers, and accountants lobbied inside the United States to make it increasingly attractive to these rising tides of dirty money, successfully turning it into a secrecy jurisdiction in its own right, just as the memo Michael Hudson received in 1966 had suggested. Meanwhile, they continued to capture the legislatures in small tax havens to perfect the global dirty-money system. Playing all three corners of the dirty-money triangle—the source countries being drained of illicit wealth, the increasingly offshore-like economies receiving the wealth, and the offshore conduits handling its passage—turned global private banking into one of the most profitable businesses in history. “The rise of Third World lending in the 1970s and 1980s,” in Henry’s description, “laid the foundations for a global haven network that now shelters the world’s most venal citizens.”

Henry’s calculations suggested that at least half of the money borrowed by the largest debtor countries flowed right out again under the table, usually in less than a year, and typically in just weeks. The public debts were matched almost exactly by the stock of private wealth their elites had accumulated in the United States and other havens, and by the early 1990s there was enough flight wealth in Europe and the United States to service the entire debt of the developing world—if only its income were taxed modestly. For some countries, like Mexico, Argentina, and Venezuela, the value of the elites’ offshore illicit wealth was worth several times their external debts. Today the top 1 percent of households in developing countries owns an estimated 70 to 90 percent of all private financial and real estate wealth. The Boston Consulting Group reckoned in 2003 that over half of all the wealth owned by Latin America’s wealthiest citizens lay offshore. In June 2010 Henry reckoned that the total stock of flight capital financial wealth from developing countries in 2007 had reached $7–8 trillion—more than half under the custody or management of the world’s top 50 banks.

One U.S. Federal Reserve official noted: “The problem is not that

these countries don't have any assets. The problem is, they're all in Miami."

In 1982 Mexico's President José Lopez Portillo gave a speech to parliament, outlining the offshore challenge facing his continent. "The financing plague is wreaking greater and greater havoc throughout the world," he said. "It is transmitted by rats and its consequences are unemployment and poverty, industrial bankruptcy and speculative enrichment." He blamed "a group of Mexicans . . . led and advised and supported by the private banks that have taken more money out of the country than the empires that exploited us since the beginning of time."[32]

Lopez Portillo vowed to ignore the IMF, nationalize the banks, and introduce exchange controls, and within ten days an alliance of bankers, businesspeople, and conservative Mexicans had made him back down. The IMF and the Bank for International Settlements, in Switzerland, ignoring Mexico's offshore flight wealth, ordered Mexico and other debtor nations to "put your house in order."

The economist Michael Hudson describes how he was hired in 1989 by a Boston money management firm to organize a sovereign debt fund investing in the government bonds of developing nations.[33] Huge risk premiums then meant that Argentine and Brazilian dollar bonds were yielding almost 45 percent, while Mexican bonds were yielding 25 percent. In its first year the fund, incorporated in the Netherlands Antilles, became the world's second best performing fund of its kind.

Hudson found out what was happening. "The biggest investors were political insiders who had bought into the fund knowing that their central banks would pay their dollar debts despite the high risk premiums," he said. Some of the biggest investors were people in top positions in central banks and presidencies. "We realized who has all the Yankee dollar claims on Latin America," he said. "It was local oligarchies with offshore accounts. The dollar debt of Argentina in the early 1990s was owed mainly to Argentineans operating out of offshore banking centers. The major beneficiaries of foreign debt service were their own flight-capitalists, not bondholders in North America and Europe."

This kind of simple trick is routinely practiced by so-called "vulture funds." Wealthy foreign investors buy up distressed sovereign debt at pennies on the dollar—typically at a 90 percent discount—then reap vast profits when those debts are repaid in full. The trick is to make sure that influential local government officials are secretly part of the investor group buying the discounted debt—ensuring that these local

investors will do battle inside the developing country governments to make sure the debts get paid. Their involvement, of course, is hidden behind a shield of offshore secrecy, so an impoverished nation's

citizens need never find out about the wealth that has been stolen from them or how the investors did it.

Economists have not ignored these issues entirely, but they almost always break them down into discrete, country-level local problems that only blame corrupt local elites. These matter, of course, but such analyses obscure what all the disasters have in common: offshore.

And when offshore erosion has been considered, it has been taken as an inconvenience, to be addressed with Band-Aids. As one IMF report put it: "Offshore banking has most certainly been a factor in the Asian financial crisis. A special effort is therefore needed to help emerging economies . . . to avert financial crises through dissemination of internationally accepted prudential and supervisory standards."[34]

The IMF is arguing here in an illogical circle. By helping local elites effectively place themselves above the law and creating new temptations to mischief, the offshore system entirely neuters the chance of prudent regulation and supervision that is needed to protect those countries against that very same offshore system. Imagine if those elites had to keep their money bottled up at home, or at least account for their wealth, pay appropriate taxes on it, and submit to appropriate laws. Very soon they would understand why good government is directly in their interest.

Perhaps the saddest part of all this is that it should have been obvious to anybody who gave it a moment's thought.

The stories in this chapter have been mostly about illicit financial flows drained from developing countries and into tax havens, undermining incentives for local elites to strive for better government by allowing them to remove themselves from the problems of their home countries, building safe offshore stashes that insulate and protect them against the turmoil and poverty that surrounds them. There is one more element to consider that is related to, but not the same as, the illicit offshore money. That element is tax.

Tax is the most sustainable, the most important, and the most beneficial form of finance for development. It is not just a question of revenue: Tax makes rulers accountable to their citizens, not to donors. As Kenya revenue commissioner Michael Waweru put it: "Pay your taxes, and set your country free." Tax helps countries build good government in two broad ways. First, as citizens bargain with their

rulers over tax, a social contract develops between them, helping foster representative democracy. Second, the imperative to raise tax revenue stimulates the building of institutions to do so. It strengthens state capacity.

This "no taxation without representation" formula is never perfect or even close to perfect, but historians recognize it as a cornerstone, over the very long term, of the development of democracy and representative government in the developed world. Until very recently, almost nobody spent time wondering whether this formula might work in developing countries too. The answer, instead, has been to send foreign aid.

Developing countries, by and large, have very low tax revenues, and the dynamics of tax and state-building have often been weak. Where tax revenues are high, it is often because the country is a mineral producer: These kinds of revenues make rulers accountable more to oil companies than to their citizens and fail to build accountability. Yet Africans today increasingly understand the importance of tax in their developing countries. "I have made revenue collection a frontline institution because it is the one which can emancipate us from begging," said Yoweri Museveni, the president of Uganda, which collects taxes worth only about 11 percent of GDP. "If we can get about 22 percent of GDP we should not need to disturb anybody by asking for aid; instead of coming here to bother you, give me this, give me this, I shall come here to greet you, to trade with you."[35]

Tax havens, of course, overturn the healthy dynamics by providing escape routes for their elites. It is worth briefly exploring some of the ways in which poor countries are drained of tax money through operations that, even when of questionable legality, are rarely challenged. This brings us back to the story about how countries allocate taxing rights between them.

Since the 1920s, when the League of Nations tried to get countries to agree how they would divide up the tax revenues on incomes from the various operations of multinationals, a big question has been at play. Do most of the taxing rights go to the "source" country that hosts inward investment from a multinational based in another country, which is the source of the income in question? Or do they go to the "residence" country—the multinational's home country, where it is resident?

Capital-rich countries like Britain that hosted a lot of multinationals investing overseas wanted rules giving most taxing rights to "residence" countries, while the "source" countries receiving inward investment—often poorer countries—wanted to tax the investors' income locally, at

the source. The agreements were eventually laid out in bilateral tax treaties between countries, but these treaties were heavily influenced by the prevailing models. The rich countries, led by the OECD today, have pushed for a model skewed in favor of themselves, while the United Nations favors a model that shifts taxing rights toward "source" countries, typically poorer ones.

No prizes for guessing which model has come to dominate the field of international tax. When the United Nations produced a draft model tax treaty in 1980 that was supposed to shift the balance back in favor of "source" taxation and developing countries, the OECD intervened aggressively to stop this: not only by ensuring that its own model treaty benefiting rich countries remained the preferred standard, but also by interfering at the United Nations to weaken its model. John Christensen, a former economic adviser to the British Crown Dependency of Jersey, remembers a meeting of the United Nations Tax Committee in Geneva in 2008 when Britain's representative suddenly stood up and began speaking, in what looked like an intervention coordinated with the representative from Liechtenstein. "He kept on interrupting," Christensen said. "It was a general assault on developing countries being better able to represent their interests, about providing more resources to the UN Tax Committee. He was the cheerleader. Twice the chair had to tell him 'please let us speak.' People there were really angry with him: we could all see he was blocking progress to protect the UK's and the United States' interests."

The rich countries' model is dominant today. Not only has this problem of double nontaxation of multinational corporations been allowed to happen, but billions of dollars in tax that would in a fairer world be paid in poor countries is paid in rich countries instead, quite legally.

It is worth briefly examining another role played by tax havens in the weird and wonderful world of international tax that enables companies to knock out their tax bills. Let's say a German bank or company invests in Tanzania. Under a tax treaty between Germany and Tanzania, the African country may well agree not to tax the company's local earnings for fear that otherwise German companies will simply invest elsewhere. But now even with this treaty in place, the German corporation has not solved its problem yet. The treaty may have knocked out the Tanzanian tax charge on the company's earnings, but if it sends these untaxed earnings straight back to Germany they will still be taxed there. So it sends the earnings to a so-called conduit or treaty haven, which will have a wide network of treaties, including one with Tanzania. The treaty

haven also agrees

not to tax these untaxed earnings: What has happened here is that the haven serves as a stepping-stone for these profits to emerge, along carefully constructed tax-free pathways, out from Tanzania and into the wider world, often via yet another haven where the income will not be taxed at all.

"Like two closely marked football players passing the ball to a third one who is unmarked," explains Professor Sol Picciotto, a tax haven expert, a conduit haven "can create major gaps in the defenses of tax authorities." In this case both Tanzania and Germany are deprived of tax revenues, courtesy of offshore. And this is quite legal. Many tens, and potentially hundreds, of billions of dollars of tax revenue are at stake in this game, vastly increasing the hunger for foreign aid among the world's poorer nations. South Africa's finance minister Trevor Manuel put the problem neatly. "It is a contradiction to support increased development assistance yet turn a blind eye to actions by multinationals and others that undermine the tax base of a developing country."[36]

Over twenty-five hundred tax treaties are in place around the world—an extensive but very poorly understood counterpart of the global trading and investment regime.

The Netherlands, with a wide network of tax treaties, is a good example of a treaty haven. The two biggest sources of foreign investment into China in 2007 were not Japan or the United States or South Korea but Hong Kong and the British Virgin Islands.[37] Similarly, as of 2009 the biggest source of foreign investment into India, at over 43 percent of the total, is not the United States or Britain or China but the treaty haven of Mauritius, a rising star of the offshore system.[38] And here lies another odd tale.

Mauritius illustrates how the British spiderweb is no imperial relic but a modern and self-renewing system. Although French- speaking, the country has a long history of British colonial involvement.[39] Mauritius set up its offshore center in 1989 under the tutelage of experts mostly from the City of London, Jersey, and the Isle of Man. Rudolf Elmer, who worked as a senior offshore practitioner in Mauritius from 2006 to 2008 for Standard Bank, says he trained in Jersey and the Isle of Man before being sent to Mauritius. "There is a lot of British influence," he said. "Major banks like Barclays and HSBC have built up major operations and multistory buildings in Cyber City south of Port Louis [the capital]. Six years ago there were only five. Today, I estimate about 40. It is a hot spot: it will become very prominent."[40]

Though formally independent, Mauritius is a member of Britain's Commonwealth, and its final appeal court is the Privy Council in London. Having gotten over a shaky period in the 1980s, Mauritius is now politically stable and boasts a cheap, well- educated, and multilingual labor force, and it is in the perfect time zone to serve Europe, Asia, and Africa. With over 40 tax treaties with countries in those three continents, Mauritius is a fast-growing conduit haven for investment into India and for investment into Africa from China and the City of London.

Mauritius also specializes in "round-tripping." In this practice a wealthy Indian, say, will send his money to Mauritius, where it is dressed up in a secrecy structure in order to disguise it as foreign investment before it is returned to India. Because of the treaty, the wealthy Indian can avoid Indian withholding taxes on local earnings and use the secrecy to do nefarious things—such as constructing a local market monopoly by disguising the fact that a seemingly diverse and unrelated array of competitors in a market is in fact controlled by the same interests. The construction of secret monopolies via offshore secrecy seems pervasive in certain sectors and goes some way toward explaining why, for example, mobile phone charges are so high in some developing countries.

Local elites lobby for these treaties despite the harm they can cause. "The India treaty with Mauritius is a pure treaty- shopping treaty," said David Rosenbloom, a U.S. tax expert. "Why do the Indians tolerate it? We, the United States, have a treaty with Bermuda, which is ridiculous: Bermuda doesn't even have a tax system. Countries do bizarre things. A lot of it is political. It defies rational thought."[41]

RESISTANCE
In Combat with the Ideological Warriors of Offshore

IN APRIL 1998 THE ORGANISATION FOR ECONOMIC Co-operation and Development, a club of rich countries that includes the world's most important secrecy jurisdictions, made an astonishing admission: Tax havens cause great harm. Tax havens and associated offshore activities, an OECD report acknowledged, "erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. Such harmful tax competition diminishes global welfare and undermines taxpayer confidence in the integrity of tax systems."[1]

Offshore is not only a place, a system, and a process, but it can also be considered as a collection of intellectual arguments. Through the OECD's new project—the first serious and sustained intellectual assault on the secrecy jurisdictions in world history[2]—I will explore the main arguments made by the defenders of the offshore system.

At the time the OECD project got under way, worldwide protests were rampant against the obvious failures of globalization. Yet campaigners, who focused many of their arguments on trade, all but ignored the offshore system. The OECD's new initiative, which contained a lot of baffling discussion about international tax, hardly registered on the protesters' agendas.

The new report was allowed to emerge for several reasons. First, the evidence had become impossible to ignore: The use of tax havens was "large, and expanding at an exponential rate," as the report put it. Second, the report was aimed mostly at small Caribbean islands that were not OECD members, and it glossed over the role of OECD countries in offshore.[3] Also, several OECD countries that were not tax havens pushed the report hard inside the OECD. But there is another important reason why the OECD report got through: Tax havens are so steeped in indifference to big inter-governmental bodies that although the OECD

had flagged the report for two years, almost nobody offshore had paid it enough attention to mount a serious effort to stop it from emerging.

John Christensen was in Jersey when the 1998 report came out. "Virtually nobody there took it seriously except me," he said. "Bankers were saying 'OECD who? Isn't that some sort of customs organization?'" Daniel J. Mitchell of the right-wing Heritage Foundation, in Washington, D.C., one of the secrecy jurisdictions' most vocal supporters, had a similar reaction to the Paris- based OECD. "I thought 'Ah, just a bunch of crazy European socialists.'"[4]

Still, Mitchell decided to write a couple of things on it for the Heritage Foundation and began to see that this mattered. And the OECD's follow-up report in 2000 contained a primed bomb: a blacklist of 35 secrecy jurisdictions, and a threat of "defensive measures" against havens that did not shape up. More alarming for Mitchell, it was not only the "European collectivists" who backed the OECD, but the Clinton administration too.

"Our side was caught with our pants down," Mitchell said in an interview in Washington, D.C. "Heritage, a big full-service think tank, doesn't focus on just one thing. I thought we ought to have a group to have a go at this." So he got together with Andrew Quinlan, a friend from college, and Veronique de Rugy, a Paris- educated libertarian academic, to create a small outfit called the Center for Freedom and Prosperity (CF&P) with a subgroup, the Coalition for Tax Competition, whose aim was to protect "the cause of tax competition." They lodged it at the Cato Institute, a well-funded free-market think tank in Washington.

The antitax atmosphere in Washington in those days was poisonous. A Delaware senator, William Roth, had been whipping up a hate storm against the U.S. Internal Revenue Service under a declared Republican strategy to "pull the current income tax code out by its roots and throw it away so it can never grow back."[5] In an effective piece of political theater, Roth, a manic supporter of tax cuts for the wealthy, got IRS agents to testify at hearings behind screens like mobsters, with their voices electronically distorted. His people regaled the hearings with stories about IRS agents in flak jackets storming houses and forcing teenage girls to change clothes at gunpoint—and the IRS had no right of reply. No matter that most of these claims were untrue.[6]

Mitchell began to bombard politicians with emails about the OECD reports, to write scary op-eds in national newspapers with headlines such as "Global Tax Police," and to insult the OECD publicly. Hostilities

had begun in the offshore world's first big battle of ideas.

To understand the intellectual underpinnings of offshore finance, it seems appropriate to start with Mitchell, one of the secrecy jurisdictions' noisiest and most active defenders.

He is a man of striking warmth and great personal charm. In his blog "International Liberty: Restraining Government in America and around the World," he declares, "I'm a passionate Georgia Bulldog," in reference to the mascot of the University of Georgia's gridiron team, "so much so that I would have trouble choosing between a low-rate flat tax for America and a national title for the Dawgs. I'm not kidding." In his blog he notes that Britain's left-of-center Observer newspaper called him a "high priest of light tax, small state libertarianism" and that this was "the nicest thing anyone's ever said about me."

Mitchell began to take a serious interest in politics in the Reagan era, emerging from George Mason University fascinated by conservative economists such as James Buchanan and Vernon Smith, who explored a branch of economics known as Public Choice Theory, which rejects notions that politicians act on behalf of people or societies and instead looks at them as self- interested individuals. Its followers' distaste for government dovetailed with Mitchell's budding libertarian outlook and his love for Reagan. He worked with Republican Senator Bob Packwood, then for the Bush/Quayle transition team, before joining Heritage.

His libertarian vision is of a world where government is pared back to just a few core roles, such as providing security, leaving the rest to the market. "Some people fantasize about supermodels," he said. "I fantasize about having government at five percent of GDP." (This is quite an ambition: Currently, most OECD governments take in tax revenues equivalent to 30 to 50 percent of GDP.) During our interview he retreated several times behind a personal disclaimer along these lines: "I just work

with theories; I have not worked in the real world of business."

Mitchell's specialty is a tone of calculated, arched-eyebrows incredulity when discussing people or ideas that he disdains, and his sound bites are carefully crafted to appear utterly reasonable. His short, peppy little Internet videos are clear, simple, and striking in their directness, and he sprinkles them with homespun wisdom, along with repeated references to freedom and liberty and digs at his adversaries—"international bureaucrats," "intrusive governments," and "Europeans" (especially the French, his particular bogeys)—uttered in tones of theatrical horror.

"Let me give you some frightening numbers," Mitchell said in a bouncy presentation to a "Freedom Conference" at the antitax Steamboat Institute in Colorado in August 2009. Citing a seventy-five-year projection that raised the specter of whopping tax increases, and reeling off statistics about the free-spending habits of George W. Bush (whom he dislikes), he predicted that "we will have a bigger government than any European welfare state—even France and Sweden…. I don't know if that means we have to stop using deodorant and train our army to surrender if there's a war, but we are going to be a European welfare state."

Before the OECD report emerged, Mitchell said he did his best to avoid international tax. "My bread and butter was fiscal policy issues: tax cuts versus tax increases; that kind of thing," he said. "For me, international tax—transfer pricing, interest allocations, and so on—was almost as bad as excise taxes on milk in Mongolia."

In those days there was no real ideology for tax havenry: Few people understood how important the offshore system was becoming, and in the age of rapid globalization, almost nobody questioned it. Fortunately for Mitchell, the OECD had tried to avoid looking like it was victimizing smaller jurisdictions by couching its initiative not so much as an attack on tax havens but as an attack on harmful tax competition—the race to the bottom between states to attract footloose capital by offering zero taxes and other lures. This focus gave Mitchell an immediate advantage in Washington, letting him complain that the OECD was a big bureaucracy that opposed competition.

This question of "competition" is one of the main arguments that tax havens deploy to justify their existence, and it is well worth exploring. Mitchell articulates these arguments as well as anybody.

"International bureaucracies and politicians from high-tax nations are launching a co-ordinated attack against these jurisdictions. The high-tax nations of the world want to set up something equivalent to

OPEC," he thundered, flashing up pictures of sinister-looking men in Arab headdresses. "It is an effort by high-tax nations to form a cartel that will enable the politicians to put in place worse tax policies."[7]

"Say you only had one gas station in a town," he continued in a recent presentation.[8] "That one gas station could charge high prices, it could maintain inconvenient hours; it could offer shoddy service. But if you have five gas stations in a town, all of a sudden those gas stations need to compete with each other: They have to lower prices, they have to be attentive to the needs of consumers. We see the same thing internationally, with governments."

He went further. "Imagine you are a governor of Massachusetts. You'd love to shut down New Hampshire—because it's competition. Obama and the rest of the collectivists on the left hate tax havens because they are outposts of freedom. Because of globalization, labor and capital are a lot more mobile than they used to be. If governments are trying to impose high tax rates, [people] actually have options to move either themselves, or their money, across borders. Just like if you have one monopoly gas station in town, and all of a sudden new gas stations open up, you can decide, 'I'm no longer going to shop at that gas station that was ripping me off; I can shop at the gas station that is actually giving me a better deal for my money.'" In other words, the argument goes, tax competition is beneficial, and you can't fight it anyway.

At first glance, these arguments seem reasonable. But look closer, and they collapse in a puff of nonsense. Here's why. Competition between companies in a market is absolutely nothing like competition between jurisdictions on tax. Think about it like this: If a company cannot compete it may fail and be replaced by another that provides better and cheaper goods or services. This "creative destruction" is painful, but it is also a source of capitalism's dynamism. But what happens when a country cannot "compete?" A failed state? That is a very different prospect. Nobody would, or could, as Mitchell put it, "shut down New Hampshire." What does it actually mean for a country to be "competitive"? Governments obviously do not "compete" in any meaningful way to police their streets. They do, perhaps, compete to educate their citizens better, but this kind of "competition" points to higher taxes to pay for better education.

The Geneva-based World Economic Forum (WEF) provides a more comprehensive answer, defining competitiveness as "the set of

institutions, policies and factors that determine the level of productivity of a country." It uses 12 competitiveness "pillars," including infrastructure, institutions, macroeconomic stability, education, and efficiency of goods markets. One could quibble with the categorizations, but taken together they form a sensible enough selection. Most of them require raising appropriate levels of tax.

It turns out, in fact, that the most "competitive" countries on the WEF's measure are the higher-tax countries. There is plenty of variation, of course: Sweden, Finland, and Denmark, the world's three highest-taxed countries, were ranked fourth, fifth, and sixth most competitive in the 2009–10 index, while the United States, with lower (but still not very low by world standards) taxes, is second. But the really low-tax economies like Afghanistan and Guatemala are the least competitive.

Dig further into the data, and other interesting facts emerge. Countries that spend a lot on social needs—something Mitchell opposes—score best on the competitiveness scale."[9] Higher taxes help countries spend more on education, health, and other things that help their workers "compete."

What applies to tax applies to laws and regulation too. What does it mean for a jurisdiction to have a "competitive advantage" in being a heroin smuggling entrepôt or offering lax enforcement on child sex tourism? It may bring in revenue, but in the sense that countries do "compete" with others, it can clearly bring great harm.

Mitchell's world of beneficial tax competition emerges from a sub-school in economics that clings to a 1956 paper by the economist Charles Tiebout, who explored what happens (only in theory, you understand) when markets are perfect and free citizens flee in hordes from one jurisdiction to another at the drop of a tax inspector's hat. This is not, of course, how the world works—but libertarians and defenders of tax competition stretched Tiebout's ideas like rubber to make their intellectual shield for the havens. Mitchell also points to lists of secrecy jurisdictions, claiming they tend to be wealthier than other jurisdictions, and takes this as evidence that offshore is a good thing. This is like an argument that points to the private jets, yachts, and palaces owned by a rich dictator and his cronies as evidence that corruption generates wealth. Well, it does, in a way, but "generating" this kind of wealth is not exactly what we should aim for.

Yet there is one area where Mitchell is probably right. Tax rates have been tumbling for years around the world: Average

corporate tax rates, for example, fell from nearly 50 percent in 1980, Mitchell says, down to just over 25 percent today. This is, in large part, the result of tax competition between jurisdictions and with tax havens as the sharp edge of the ax. “When I go in for my salary review, I always say it’s because of the great papers I write for Cato that is forcing governments all over the world [to cut taxes],” Mitchell says. “But the real story is tax competition . . . and tax havens are the most powerful instrument of this tax competition.”

It is a hard point to prove, but it is reasonable to think that while the world has fixated on ideas and ideologies as the driving force behind global tax-cutting and financial deregulation, tax competition may have been the bigger force.

Many economists see this as a nonstory, though. Although tax rates have fallen, tax revenues have been fairly steady. Since 1965 personal income taxes in rich-world OECD countries have remained remarkably stable at 25 to 26 percent of the total tax haul,[10] and total corporation taxes have even risen slightly, from 9 to 11 percent. Some say this proves that tax competition does not matter. But look behind the numbers, and an unhappier picture emerges.

Though rich countries have preserved their overall tax revenues, corporations and rich folk have paid much less as a share of revenues. Corporate profits, on which their tax liabilities are assessed, have increased sharply.[11] Meanwhile, the rich have not only seen their wealth and income soar, but they have shifted their income out of “personal income tax” categories and into “corporation tax,” to be taxed at far lower corporate tax rates. For example, the richest four hundred Americans booked 26 percent of their income as salaries and wages in 1992 and 36 percent as capital gains. By 2007 they only recorded 6 percent as income and 66 percent as capital gains.[12] The same has been happening across all high-income categories and in all OECD countries since at least the 1970s. So falling corporation taxes are being masked by rich people’s tax dodges.[13] The working population has seen its personal income taxes and social security contributions rise over the last 30 years, as their wages have stagnated. Mitchell is right to say that tax competition is real, and it bites.

Look at how tax competition smites developing countries, and a bigger story emerges.

One of the only studies ever made was a short IMF paper in 2004[14] that notes how little attention has been paid to how international tax

competition has been affecting developing and emerging-market economies and takes what it calls a "first look at those issues."

Its results are remarkable. Tax rates have fallen at least as fast as in rich countries, if not faster, and furthest of all in sub- Saharan Africa. But tax revenues fell sharply too: Just in the short 11-year period from 1990 to 2001, corporation tax revenues in low-income countries fell by a quarter. This is especially troubling because developing countries find it much easier to tax a few big corporations than to tax millions of poor people, so corporate taxes are a bigger deal for them.

One reason for the falling corporate tax revenues has been special tax incentives. In 1990, only a small minority of poor countries offered these incentives; by 2001 most of them did. The IMF's first detailed study on this in July 2009 concluded[15] that these tax incentives, which are supposed to attract foreign investors, slash tax revenues but do not promote growth.[16]

As I have mentioned, tax, not aid, is the most sustainable source of finance for development. Tax makes governments accountable to their citizens, while aid makes governments accountable to foreign donors. Tax competition is destroying developing countries' tax revenues and making them more dependent on aid. Brazilians talk about tax competition in terms of a guerra fiscal—a tax war—a term that reveals far better what is really happening here and echoes the words of U.S. Senator Carl Levin when he says tax havens are "engaging in economic warfare against the United States and honest, hardworking Americans."

Mitchell has another presentation he likes to make: what he calls "The Moral Case for Tax Havens."[17] A video from October 2008 gives a flavor.

"The vast majority of the world's population lives in nations where governments fail to provide the basic protections of civilized society," says Mitchell (cue pictures of Kim Jong-Il, Robert Mugabe, and Vladimir Putin, looking sinister). "Tax havens protect these people from venal and incompetent governments by providing a secure place to hide their assets.

"One reason why Switzerland has such an admirable human rights policy of protecting financial privacy is that they strengthened their

laws in the 1930s to help protect German Jews wanting to guard their assets from the Nazis." (Cue grainy pictures of Hitler saluting from a staff car and a Gestapo officer rounding up frightened women.) "And what about the Argentine family," he continues, "and the risks that their life savings are wiped out by devaluation?" Put it offshore, he says, and the money is safe.

Again, his arguments are persuasive—right up to the point where you stop to think about them.

First, the story about the origins of Swiss bank secrecy is no more than an appealing fiction. The argument about it being set up to protect Jewish money first appeared in the November 1966 Bulletin of today's Credit Suisse. It wasn't true. The reason bank secrecy was strengthened in 1934 was a scandal two years earlier when the Basler Handelsbank was caught in flagrante facilitating tax evasion by members of French high society, among them two bishops, several generals, and the owners of Le Figaro and Le Matin newspapers. Before that, there was professional secrecy (such as exists between doctors and their patients), and violation of this secrecy was a civil offense, not a criminal one as it is today.[18] The law had nothing to do with protecting Jewish secrets.

Next, if a country is misruled, why should it only be the wealthy elites who get to protect their money by going offshore? If a country has unjust laws, then providing an offshore escape route for its wealthiest and most powerful citizens is the best way to take the pressure off the only constituency with real influence for reform. Keep their money bottled up at home, and pressure for change would come fast. Even then, there is no need for offshore secrecy to protect your money. If I am a Tanzanian with a million dollars in London earning 5 percent, and I ought to pay tax on that income at 40 percent, then I owe my government twenty thousand dollars in taxes for that year. I should pay that. Britain could tell my government all about my money, but that would give Tanzania no power under any international agreement to "confiscate" my million dollars. An Argentine family can protect its money from hyperinflation by shifting it to Miami—but secrecy plays no part in this protection. Put it in a normal bank account, exchange the information on the income, and pay tax on it. The principal remains quite safe.

On the question of people needing to protect their cash from tyrants, Mitchell might like to answer this. Who uses secrecy jurisdictions to protect their money and bolster their positions? The human rights activist, screaming in the torturers' dungeons? The brave investigative journalist?

The street protester? Or the brutal, corrupt, kleptocratic tyrant oppressing them all? We all instinctively know the answer.

Ah, but, Mitchell then retorts. “Your personal data may be sold to kidnappers who then grab one of your kids.” Transparency threatens homosexuals in Saudi Arabia and Jews in France “victimized by corrupt and/or despotic governments. Without the ability to protect their assets in so-called tax havens, these people would be at even greater danger.” The answer, he says, is to “place your money in a bank in Miami, since America is a tax haven.”[19]

This one carries a shading of truth—but no more. Kidnappers don’t need tax data to know that someone has money. And the very wealthy have bodyguards and are relatively rarely kidnapped: The lower and middle classes are usually the victims. More importantly, though, good tax systems promote better governance (and hence less kidnapping), as all the research indicates. By helping elites loot their countries, secrecy jurisdictions are causing exactly the problems Mitchell says he is worried about.

And then we get to the question of freedom. Mitchell is quite clear about his views. The high-tax welfare state, he says, is “a prison for the human soul. It’s making pets out of all of us. It’s going to put us in a little cage, control our freedom, control our lives—that’s what we need to fight against.” Tax is bad, and tax havens are the answer.

In this worldview personal property is inviolable, and tax is theft. “It makes sense,” Mitchell says, “to protect your family’s interest by putting your money someplace like Hong Kong, where the politicians from your country can’t find out about it. And if they can’t find out about it, they can’t steal it.”

Leaving aside the question of whether or not this is a general incitement to criminal tax evasion, it is worth asking if tax is th eft .

Property rights, as the philosopher Martin O’Neill points out, emerge from a general system of legal and political rules that includes the rules of taxation. To say tax is theft, then, is to use a system of which tax is a central part as your weapon against taxation. It is to argue in an illogical circle.

Corporations, too, emerge from states, legally speaking. “The state is the only institution in the world that can bring a corporation to life,”

explains Joel Bakan in his best-selling book The Corporation. "It alone grants corporations their essential rights, such as legal personhood and limited liability.... Without the state, the corporation is nothing. Literally nothing."[20] To say that corporation tax is theft is, again, simply illogical.

You can find any number of other illogical eddies, ironies, and contradictions in the world of offshore. Secrecy jurisdictions routinely say their role is to promote efficiency in financial markets—but the cloak of secrecy they provide directly contradicts the idea of efficient markets, which require transparency. In an article entitled "Why Do I Have to Deal with People Like Dan Mitchell?"[21] the University of California, Berkeley, economist Brad deLong points to several of Mitchell's articles—including one praising Iceland for its tax-cutting, deregulated economic policies, just before Iceland's economy collapsed, and one entitled "A Better Way to Chastise France," urging the United States to eliminate withholding taxes on all dividends paid to foreigners, so as to suck tax-dodging capital out of "oppressive high-tax nations." So Mitchell contradicts himself: Tax havenry does "chastise" other nations after all.

Monetary policy is another case where offshore cheerleaders find themselves confused. Generally, these cheerleaders have supported the Monetarist doctrine, which argues that you tackle inflation and unemployment by managing the quantity of money. Yet it is ironic that this doctrine began its rise with a paper by Milton Friedman in 1956, the very year when the offshore Eurodollar market and the offshore system properly took off. But the offshore system directly undermined monetarism: In a world where capital flits effortlessly to unregulated offshore worlds, and where banks can create money willy-nilly, governments struggle to control their money supplies. "The use of quantity of money as a target," Friedman himself finally conceded in 2003, "has not been a success."

Tax avoidance is another case in point. Tax havens endlessly promote themselves as delivering "tax efficiency" to corporations—but this tax avoidance is inefficient. "If tax abuse is needed to ensure an investment is viable," notes the accountant Richard Murphy, "it's a misallocation of resources to do it."

Another offshore antitax favorite is the old claim that tax cuts actually raise revenue partly because people will be less inclined to dodge taxes. Therefore tax competition, driving down tax rates, must be a good thing. This has been bundled together in many Republican minds with another big idea embraced by the antigovernment libertarian world

of offshore: It is essential to cut taxes to starve the beast of big government. Or, as the antitax zealot Grover Norquist memorably put it, government should be cut "down to the size where we can drown it in the bathtub."[22] There is a problem with all of this, of course. Many people think tax cuts boost revenue. Starve-the-Beast-ers think tax cuts are useful ways to cut revenue. They can't both be right. Bob McIntyre of Citizens for Tax Justice explains how he thinks the two conflicting theories have thrived side by side for over a quarter of a century. "It's simple," he said. "On Mondays, Wednesdays and Fridays Republicans say that cutting taxes raises revenues. On Tuesdays, Thursdays and Saturdays they say cutting taxes reduces revenues so much that it forces government to cut back—to starve the beast. And on Sundays they rest." In truth, most serious analysts don't believe that tax rates, on their own, make all that much difference. Obviously, real businesspeople invest and hire workers where there is demand for their products, strong infrastructure, and a healthy and educated workforce. Most studies show that corporate tax rates are a relatively minor factor in business location in most areas of business. Tropicana won't grow oranges in Alaska just because it is offered a tax break there. In the golden age of 1947–73, the U.S. economy grew at nearly 4 percent a year—while the top marginal tax rate varied from 75 to over 90 percent.[23] I am not arguing that those tax rates caused that growth. But high taxes clearly don't need to choke off growth.

And if tax cuts are the answer to reducing tax evasion, as Mitchell suggests, then he might like to explain the great global eruption of international tax evasion, not to mention the sudden plague of capital flight, from the 1970s onward—just as tax rates went into freefall worldwide.

Here is the real story: As tax havenry exploded and finance became freer, tax evasion and capital flight followed.

By 2000, as the OECD project on tax havens' harmful tax competition rolled forward, Mitchell and his allies began to firehose Washington with letters, emails, and presentations. Almost nobody was articulating the counterarguments.

The OECD was soon on the defensive. Then the havens themselves began to mobilize. In January 2001 the secretary general of the British Commonwealth invited the OECD to set up a joint working

group, with equal representation for small member states (that is, the tax havens). This group began to festoon the OECD in red tape, and the whole project got bogged down in arcane haggling. The havens also set up a body called the International Tax and Investment Organisation to coordinate

defenses, and they linked up with Mitchell and the Center for Freedom and Prosperity.

Then George W. Bush came to power.

Until then, President Clinton's treasury secretary, Larry Summers, had backed the OECD, even proposing sanctions against the havens in his last budget. Bush's first treasury secretary, Paul O'Neill, initially seemed unsure about the issue, even saying, to Mitchell's alarm: "I support the priority placed on transparency and cooperation."

The Center for Freedom and Prosperity ramped up the pressure. They organized eighty-six congressmen and senators, including big hitters like Jesse Helms and Tom DeLay, to urge O'Neill to ditch the OECD's project. Milton Friedman, James Buchanan, and other conservative economists signed on. Letters flooded into the treasury. Mitchell thundered about the "Parisian monstrosity," and a Cayman Islands official popped up at the United Nations to rail against "Big Brother" and the "big bully syndrome." The lobbyists neglected to mention that the Caymans were effectively governed from London. The British Commonwealth repackaged the havens' critiques in Washington and lambasted the OECD as a bullying, coercive bureaucracy.[24]

The Caribbean havens also persuaded the powerful U.S. Congressional Black Caucus to act, and to send O'Neill a letter warning that the OECD initiative "threatens to undermine the fragile economies of some of our closest neighbors and allies." The caucus made no mention of the effects these havens had on vastly bigger African nations, of course, or of the fact that the main Caribbean beneficiaries from offshore activities were rich white bankers, lawyers, and accountants.

Mitchell pounced on something else. No OECD country—not Switzerland, not Luxembourg, and certainly not the United States or Britain—was on the blacklist.

"The OECD, a rich man's club of industrialized nations, is launching this anti-tax haven jihad, but they omitted to blacklist their own members," he said. "They are a bunch of racist hypocrites. Powerful white-governed nations in Europe are targeting less powerful nations in places like the Caribbean. Somebody needs to tell the bureaucrats in Paris that the era of colonialism is over."[25]

This time, Mitchell had a point. And he soon got his breakthrough. On May 10, 2001, O'Neill wrote in the Washington Times, a conservative newspaper set up by the Reverend Sun Myung Moon that is a regular

supporter of tax havens, that the OECD's mission was "not in line with this administration's priorities."[26] The United States, O'Neill continued, "simply has no interest in stifling the competition that forces governments—like businesses—to create efficiencies." The article looked almost as if Mitchell had written it himself.

The United States, O'Neill added, "does not support efforts to dictate to any country what its own tax rates or tax systems should be."[27] It was the offshore contradiction to end them all. "Don't interfere with our rights as sovereign states!" the havens cry—while interfering merrily in other nations' sovereign laws and tax systems.

The OECD's project was dying. As Marty Sullivan of TaxAnalysts put it, the initiative "slowly dissolved into a series of toothless pronouncements, a mixture of cheerleading and scorekeeping. The OECD started to abandon its confrontational approach."[28] The OECD watered down its blacklist criteria; tax havens were now "participating partners" and escaped the blacklist merely by promising to shape up—and they need only shape up if everyone else—including the hard nuts like Switzerland or Britain or the United States or newly independent Hong Kong—did too. In other words, it would never happen.

Two months after O'Neill's letter, Senator Carl Levin, fighting a lonely rearguard action, estimated that the United States was losing $70 billion annually from offshore evasion: "a figure so huge that if even half that amount were collected it would pay for a Medicare prescription drug program without raising anyone's taxes or cutting anyone's budget." When Levin noted that fewer than six thousand of more than 1.1 million offshore accounts and businesses were properly disclosed to the IRS, O'Neill's response was simple and clear.

"I find it amusing."[29]

A July 2001 OECD deadline to avoid defensive measures came and went, and the organization later publicly said it had no intention to pursue them in the future. Mitchell's colleague Andrew Quinlan subsequently warned, for good measure, that just ten days of lobbying could shut down the OECD's U.S. funding.

The end result is neatly summarized by Jason Sharman, who wrote a well- researched book about the episode. "The OECD," he wrote, "had to give up its ambition to regulate international tax competition."[30] The tax havens had won.

A lot of the tax havens' arguments hinge on the rightful scope of state power. Democracies have long supported the principle of progressive taxation, as outlined by the Scottish economist Adam Smith: "It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion." In the United States, as in many countries, the principle of progressive taxation has evaporated. It may not seem like that at first glance: The richest 1 percent of Americans paid just over 40 percent of all federal income taxes in 2009. The right-wing Tax Foundation claimed this "clearly debunks the conventional Beltway rhetoric that the 'rich' are not paying their fair share of taxes." Yet in 2009 the richest 1 percent owned almost half of all financial assets in the country—and the proportion was rising. This is not a story about high taxes on the wealthy but about stratospheric wealth and inequality. And the 40 percent refers only to income taxes—as exemplified by the income reporting of the four hundred richest Americans noted earlier in this chapter, rich people usually convert most of their income into capital gains, which is taxed at far lower rates than income; then there are payroll taxes and state taxes, the burden for which tends to fall on low- and middle-income people more heavily than the rich. For the four hundred richest Americans, their effective tax rate was far lower: just 17.2 percent and falling. Count offshore tax evasion by wealthy Americans, which income statistics don't see, and the picture skews further. "A quarter century of tax cuts," wrote the tax author David Cay Johnston, "has produced not trickle down—but Niagara up."[31]

During my long interview with Mitchell in Washington, we went out to a modest eatery near the Cato offices, where we bumped into Richard Rahn, a Cato staffer and a former chairman of the Cayman Islands Monetary Authority. Rahn is a gruff, serious man who wears an eye patch, and when Mitchell introduced us with great bonhomie, Rahn scowled back at him, declined to shake hands with me, muttered something about "European Commies," and stalked out. A year or so later I looked Rahn up, and this time he agreed to talk. This time he was more personable: After first hawking me around the Cato offices as a crazy European curiosity, he then handed me a little maroon passport-sized booklet containing the text of the U.S. Declaration of Independence and the U.S. Constitution. "It looks like an EU passport, doesn't it?" he rasped, twinkle-eyed. "One, of course, is an instrument of oppression. The other is a document of freedom."

"I have ancestors who fought in the American Revolution," he said, sitting me down in his own rather Spartan office. "Genetically I don't like foreign governments." After making me buy Mitchell's book for $20 (I already had a copy but didn't want to spoil Rahn's mood), we began to talk.

Rahn is not a shill for wealthy interests but someone responding, at least in part, to deep personal conviction. "You people upset me . . . I often wonder if you people are evil, or just ignorant," he declared. "Tax oppression is causing misery around the world." He said this was well established in the literature and cited some recent Bulgarian studies to back his case. "When international bureaucrats want to attack places for not imposing bad taxes," he continued, "well, I think that fits into my definition of evil." He described a "conspiracy of the international bureaucratic class" to raise taxes: not so much an organized plot but a constant effort to raise revenues to feed the bureaucrats' own well-being and privileges.

Perhaps there is a little truth in this. But his next point is worth tackling, for it is a foundation for the intellectual edifice of offshore.

"Capital is the seed corn of economic growth. Without capital, there is no growth. It is suicidal to tax your own seed corn." Along with this argument comes the tax havens' Exhibit A in their own defense: that they help smooth and promote international flows of capital, channeling it efficiently to capital-hungry developing countries, where it can grow productively and benefit everyone.

Rahn's seed corn contention contains a kernel of truth: Capital certainly can and does promote investment and economic growth. Helping it flow efficiently, at first glance, seems like a good idea. But here is where the arguments fall apart.

First, financial capital isn't the only kind of capital. Social capital—an educated and experienced workforce, a trustworthy business climate, and so on—matters more. Having seed corn is just one factor in achieving a good harvest, along with rain, good soils, fertilizer, and the human capital, knowledge, and confidence to put it all together. "Access to capital is not, in fact, the decisive constraint on economic growth," wrote the economist Martin Wolf. "It is social and human capital, as well as the overall policy regime that matter."[32] These, of course, need tax dollars.

Second, tax isn't only about revenue, the first of four "Rs" of taxation. The second "R" is redistribution, notably tackling inequality. This is what democratic societies always demand, and as the

painstakingly researched book The Spirit Level attests, it is inequality, rather than absolute levels of poverty and wealth, that determines how societies fare on almost every single indicator of well-being, from life expectancy to obesity to delinquency to depression or teenage pregnancy. The third "R"
i s representation—rulers must bargain with citizens in order to extract taxes from them—and this leads to accountability and representation. The fourth is repricing—changing prices to do things like discourage smoking. Secrecy jurisdictions directly undermine the first three, if you think about it, and possibly the fourth too.

Then there is the small matter of the evidence. One might think that capital should flow from rich countries, where it is plentiful, to low-income countries, where it is scarce, promoting productive investment, growth, and better lives for all. In the real world, this has not happened. The low-income countries that have been growing the fastest, like China, tend to be those that have been exporting capital,[33] not importing it. Countries need, above all, sound institutions, good infrastructure, and the effective rule of law—exactly what the offshore system undermines.

This is not such a surprise. A country can only absorb so much capital, just as an acre of land can only take so much seed corn. Capital loans to low-income countries haven't found their way into productive investment, but instead they have washed back into private bank accounts in Miami, London, and Switzerland, leaving public debts behind. Waves of financial capital, processed "efficiently" offshore, have led to financial crisis after crisis. In many low-income countries, as the economist Dani Rodrik puts it, "capital inflows are at best ineffective, at worst harmful."

And that is not all. Much of the world's wealth derives from what economists call rents: the kind of unearned income that flows effortlessly to oil-rich rulers. "Oil is a resource that anaesthetizes thought, blurs vision, corrupts," as the Polish writer Ryszard Kapuscinski put it. "Oil expresses perfectly the eternal human dream of wealth achieved through lucky accident, through a kiss of fortune and not by sweat, anguish, hard work. In this sense oil is a fairy tale and, like every fairy tale, it is a bit of a lie."[34]

Nearly every sane economist since Adam Smith has agreed that it is very good, and very efficient, to tax rents at very high rates. One kind of rent comes from market monopolies or oligopolies, such as those enjoyed by pharmaceutical patents and Big Pharma; by the government-sanctioned licenses afforded to the Big Four accounting

firms identified in chapter 1; by taxpayer-guaranteed international banks; or by the one-and-only Fédération Internationale de Football Association (FIFA), the super-wealthy international governing body of world football.

The global headquarters of most major players in all these highly profitable industries are located offshore, most especially in Switzerland—directly against every notion of economic efficiency. FIFA, for example, used its monopolistic position in 2010 to force poor South Africa to place it in a special "tax bubble" for the 2010 World Cup, shifting its revenues from a poor African nation to that of the company whose luxurious $200 million Zurich headquarters happens to lie just a few hundred meters from where I am writing this chapter.

Offshore is not only about tax, of course. When it comes to failures of regulation, the simplest, and commonest, argument that tax havens make is to deny responsibility and use the "just a few rotten apples" defense: The system is basically clean, but occasionally bad ones get through. Immediately after the collapse of BCCI the president of the Cayman Islands Bankers Association, Nick Duggan, said: "BCCI, is a unique worldwide situation and does not reflect on the local banking community at all."[35]

Another argument is like the one on tax: Offshore promotes "efficiency" by driving financial innovation and being what the offshore writer William Brittain-Catlin calls a "seller of novelties on the financial market, a sweetshop for capitalism, developing new flavours." The financial crisis exposed what most of this financial "innovation" really involves. Innovative forms of abuse are to be resisted, not encouraged.

The next offshore regulation argument involves deflection. Anthony Travers, chairman of the Cayman Islands Financial Services Authority, uses this technique widely. In a 2004 article in The Lawyer entitled "Framing Cayman,"[36] he sought to explain why some of the biggest economic scandals in world history—BCCI, Enron, and Parmalat, in each of which Cayman played a pivotal role—were in fact not the Caymans' fault at all.

Parmalat was brought down by its Cayman-based finance subsidiary Bonlat Financing, which had fraudulently claimed to hold nearly 4 billion euros in assets. According to Travers, the missing Bonlat billions "never existed at all, save in a document forged in Italy by a corrupt Parmalat

executive. If that is the nature of the fraud in relation to Bonlat, how precisely is the ‘part’ of

the Caymans 'substantial'?" In other words, though the Caymans was central to the fraud, it is blameless because the fraudsters were actually elsewhere. He said a similar thing about BCCI. "Had BCCI not been so licenced [as a deposit-taker] by the Bank of England, at a time when the Caymans banking regulator was on secondment from the Bank of England," Travers wrote, "its subsidiary would not have been licenced in the Caymans." As for Enron's 692 opaque Caymans subsidiaries: "These were on balance sheet consolidated subsidiaries which owned the overseas Enron operating assets, thereby lawfully deferring US taxation," their profits "properly accounted for and audited." Enron's Caymans limited partnership LJM No. 2, Travers continued, was "a victim and not a perpetrator"—the perpetrators were Delaware limited partnerships. In other words, the frauds were carried out elsewhere. And he added, "None of the financial recklessness that has brought about much of the current global crisis occurred in or involved the Cayman Islands."[37]

The breathtaking chutzpah of Travers's claims is leavened by the fact that his arguments contain a truth: The frauds could not have happened only in the Cayman Islands. They required culprits elsewhere too. "The charlatans responsible for this type of behaviour," Travers notes, "are far closer to Westminster than the Caymans."

Quite so. But he is deliberately missing the point: This is how the offshore system works. Offshore structures always serve citizens and institutions elsewhere—so the beneficiaries are always elsewhere. This is why it is called "offshore." Plausible deniability is the whole game. The fraudsters may well be elsewhere, but offshore is what makes the fraud work. Secrecy jurisdictions are to fraudsters what fences are to thieves. These arguments from the Caymans are like those of one who is caught fencing stolen property blaming the police for not stopping the thieves who stole the property in the first place.

The Caymans is a place "which has pledged to meet the highest and quite new international standards of tax transparency," Travers continued, then added a more menacing note. "If it were not for a quirk in the laws of defamation," he said (noting that jurisdictions cannot sue for libel), "comment of this sort would be actionable."

On September 11, 2001, two months after the OECD's tax haven project died, with Al-Qaeda's attack on the United States, a new tale of

hypocrisy and deception began that continues up to today.

After the attacks the George W. Bush administration suddenly wanted better cooperation and transparency from the secrecy jurisdictions on terrorist financing, though it wanted to leave offshore tax evasion alone. The problem was how to do this, given that the two practices involve exactly the same jurisdictions, structures, and techniques.

The answer came in the form of one of the slyest offshore tricks ever devised.

The best way for countries to share information with each other is through so-called "automatic" exchange of information— where they tell each other about their taxpayers' financial affairs as a matter of course. This happens routinely inside Europe and between a few other countries, and although the system is leaky—it needs shoring up to cover all sorts of loopholes—it works well enough. Privacy is not invaded: Tax authorities keep the information to themselves, just as doctors keep details of their patients' hemorrhoids and venereal diseases confidential. Doctors and tax authorities need the information and can share it with others who need it, but they don't publicize it.

But there is another way of sharing information, known as "on request": A country will agree to hand over information about another country's taxpayers—but only on a case-by-case basis, only when specifically asked, and only under very narrow conditions: You must be able to demonstrate exactly why you need the information. In other words, when you request the information you must already know, more or less, what it is. No "fishing expeditions," or general trawls to find tax cheats, are allowed.

You can't prove criminality until you get the information, and you can't get the information until you can show the criminality. Catch–22's Captain Yossarian would have appreciated the double bind. "On request" information exchange is a fig leaf. It lets tax havens claim they are transparent while continuing business as usual.

The "on request" model, of course, is the one that got the Bush administration's endorsement. Instead of transparency, we got a very conditional transparency: only when there is permission to be transparent. The "on request" standard has become the OECD's model too.

It is hard to know how much information is exchanged "on request" globally, but Geoff Cook, chief executive of Jersey Finance, confessed in March 2009 that in the seven years since Jersey signed a tax agreement with the United States, it exchanged information with American investigators on just "five or six" cases.[38] Compare that to the

million-plus U.S. offshore accounts and businesses Senator Levin identified, and clearly the system is a joke. Requests for information can take months or years to process—and the assets under investigation can be shifted elsewhere in hours or even minutes.

It gets worse. After the financial crisis struck in 2007, the OECD, by now at the mercy of the secrecy jurisdictions, set up another piece of sleight of hand to respond to public pressure. At the urging of G20 leaders the OECD set up a blacklist for tax havens, and the way to get off the blacklist was to sign 12 agreements to share information with other countries, using the OECD's hopeless "on request" standard.

The OECD began to claim that a major crackdown was under way. "What we are witnessing is nothing short of a revolution," boomed the OECD secretary-general, Angel Gurría. "By addressing the challenges posed by the dark side of the tax world, the campaign for global tax transparency is in full flow." Newspaper articles ran headlines like "Bank Secrecy Is Dead," and British prime minister Gordon Brown declared the aim of the blacklist was to "outlaw tax havens."

As the new OECD push got under way, tax havens rushed to negotiate new agreements in order to sign the requisite 12 that would get them off the blacklist. At the latest count a third or so were with Nordic states, especially with such global economic giants as Greenland, San Marino, and the Faroe Islands—and another third or so were with other tax havens. The havens did sign a few with larger economies, though as usual, nobody bothered about the developing countries, which suffer most from offshore abuse. India, China, Brazil, and most of Africa were entirely absent from the list. Five days after the G20 had declared that the era of banking secrecy was over, the OECD's blacklist was empty.[39]

"The blacklist has been a sad joke," said Professor Michael McIntyre of Wayne State University Law School, who knows this area better than almost anyone. "The OECD program has provided a patina of respectability to countries that are actively assisting taxpayers in evading taxes in their home country."[40]

The blacklist, in short, was a whitewash.

After a temporary setback during the financial crisis, the offshore system is now growing again at ferocious speed. And the OECD insists to this day that its next-to-useless "on request" form of information exchange is "the accepted international

stand
ard."

As with tax, so it goes on regulation. International authorities have long recognized the problem that the global patchwork of fragmented financial regulation offers seamlessly integrated global banks vast opportunities to play the game of arbitrage between different jurisdictions, especially offshore. So world leaders are pretending that something is being done to constrain bankers' impulses. The Bank for International Settlements, in Switzerland, is the biggest of these, along with the Financial Stability Forum that it hosts, set up in 1999 to deal with financial risks and crises. Between them, they have presided over the biggest global financial crisis since the Great Depression.

"Whenever the cops come calling the banks have a ready response for the particular regulator in each country," explained Jack Blum. "No one sees the whole picture and it's really no one's job to even try. When the big and scary stuff happens, the bankers and their friends trot out the Bank for International Settlements and the Financial Stability Forum as proof of effective coordination and regulation. But these things are glorified fig leaves. They have produced absolutely nothing of real value beyond a few minor process quick fixes."

Rich governments cannot be trusted to do the right thing on tax havens and transparency. Many will demand more transparency and more international cooperation, even as they work to frustrate both. They will call for reasoned debate as they engage in character assassination, secret deals, and worse. They will talk the language of democracy and freedom, the better to defend unaccountable, irresponsible power and privilege.

Civil society is, thankfully, beginning to stir. The current thought leaders are Global Financial Integrity in the United States and the Tax Justice Network (TJN) in Europe, whose expertise has been invaluable for this book. John Christensen, TJN's director, remembers holding an expert briefing on offshore for staff in the Senate buildings, in Washington D.C., and seeing a senior congressional staffer with tears in her eyes as she described her happiness at seeing civil society at last begin to engage, after spending so long battling to get any traction on offshore issues, in the face of the ferocious Washington right-wing counter-lobbies. "She said she had waited for years for civil society to take an

interest in this." A much greater mobilization is now required.

How do all these shaky doctrines—the OECD's information exchange standards, the contradictory double act of tax-cutting increasing tax revenues, and tax-cutting acting to Starve the Beast, and Mitchell's offshore incoherences—continue to thrive? The author Jonathan Chait provides a good answer.

"The lesson for cranks everywhere," he wrote, "is that your theory stands a stronger chance of success if it directly benefits a rich and powerful bloc—and there's no bloc richer and more powerful than the rich and powerful." But the last word here goes to Bob Mcintyre of Citizens for Tax Justice, who has spent much of his life battling with the armies of lobbyists in Washington. "There are so few of us," he sighs wearily, "and so many of them."

THE LIFE OFFSHORE
The Human Side of Secrecy Jurisdictions

IN 2009 I MET UP WITH A FORMER PRIVATE BANKER, Beth Krall, in attempt to understand a question that had been nagging me: How do private bankers who shelter the wealth of gangsters and corrupt politicians justify what they do?

We met in the bustling café at Kramer Books, off Dupont Circle, in Washington, D.C., where she was living, one Sunday in 2009. She had left private banking and had joined the nongovernmental sector. Dressed in a striking black and white coat, she still looked very much the stylish international financier.

Aged 47, and with nearly 24 years in the banking business, Krall (which is not her real name) was still coming to terms with her past life. She hated what she had seen and was clearly unsettled by exposing the horrors she had experienced, but she adamantly refused to reveal any of the client details she had sworn to protect. She was wary of disrupting the many friendships she had made in the industry and was careful about what she would and would not say.

Krall's last offshore posting was in the Bahamas, the island archipelago with over three hundred thousand residents that has been an important offshore center since the golden age of American organized crime in the early decades of the last century. A few months earlier, a practitioner in the Caymans had warned me to watch for my personal safety if I go "asking all these questions" in the Bahamas. Krall said she was unsure what might happen to her if she went back, as she was partly breaking the private bankers' code of silence. "I don't want to have concrete shoes put on me," she said, without smiling. One reason for her fear was something that had angered her in the first place: that so many of the people she dealt with were powerful members of society in their countries. One case involved "very prominent people in world politics."

Unusually, for a foreign banker in the Bahamas, Krall became closely involved in local Junkanoo cultural celebrations, a mixture of Latin

American and Caribbean carnival traditions that a dedicated website calls "the greatest cultural event of not only The Bahamas, but also the world at large." She seemed distressed, while we talked, at the thought that fellow members of her Junkanoo group—not to mention many other friends she had left behind in Nassau—might judge her criticism of the country's offshore industry "anti-Bahamian." When we spoke she was still working up the courage to tell them why she could not go back. She was still redefining her relationship with the offshore values within which she had made her career: that secrecy is good, whatever brings in the money is good, and if you break the code of silence you are sloppy or treacherous.

People want to do the right thing, and it is easy, offshore, to be seduced into the idea that what matters is doing the right thing by your peers—and the rest of the world can take care of itself. In the rush to make a career, one can only make progress by ignoring the structural implications of what one does. She is one of very few to recognize the full moral weight of what she was doing and to step away.

Krall was born in Leicester, England, and took her banking exams straight after school, starting in Britain's Midland International bank in 1980 before moving to a partly state-owned Swedish bank and then, in 1987, to Chase Manhattan in Luxembourg to work in its "back office"—the administrative side, where Chase was a paying agent for certain Eurobond issues. She moved to a Brazilian bank, Banco Mercantil de São Paulo, then to Cititrust in the Bahamas, where she ran evaluations and accounting for their mutual funds business. From this point onward, Krall declines to identify her employers precisely.

She became a client relationship manager with the private banking arm of a well-known British bank in the Bahamas. They worked with what were euphemistically called "managed banks" or shell banks, an offshore specialty. These have no real presence where they are incorporated, so they can escape supervision by responsible regulators. A shell bank will typically be operated through an agent in the tax haven jurisdiction, perhaps a famous global bank, which provides a reassuringly solid name and address to back the shell but will otherwise carry no responsibility or even real knowledge of what the shell is actually up to. So a shell bank might be incorporated in the Bahamas, for example, but its owners and managers could be anywhere.

Shell banks handle business that many banks will not touch. U.S. senator Carl Levin notes that they are generally not examined by regulators, and virtually no one but the shell bank owner really knows

where the bank is, how it operates, or who its customers are. The bank Krall worked for provided a well-known name to reassure the Bahamas regulator. I asked Krall how much due diligence her British bank did on these entities. “Ha ha. Yeah,” was her initial reply. “These banks would send quarterly statements to the Bahamas Central Bank—but it wasn’t our job to monitor them.”

There would literally be brass plates in her British bank’s reception area saying “Banco de X”—perhaps an Argentinian bank using the Bahamian address and phone number of the British bank on their headed notepaper. The Bahamas regulator could not find out what was going on back in Argentina, and vice versa: the classic offshore “elsewhere” technique. Predictably, some of these banks failed, despite being audited and passed by Big Five accounting firms,[1] and Krall remembers taking calls from angry depositors. “People were on the phone in tears, with their life savings gone, and I was saying to them, ‘There is no point coming on a plane to look for the money because there is no money here.’” The money never was there.

With the terrorist attacks of September 11, 2001, prompting the United States to legislate against shell banks, a bank in the Bahamas now had to employ two senior bankers and keep its books and records there to be judged real enough to do business. “That means a bank maybe with a room or suite in a building, with two people in it—that’s a bank now,” Krall said. She pointed me to the current website of a Bahamas-based trust company that will provide you with exactly that: the appearance of being a real bank, including two staff members as directors of your bank and a place to keep the books and records. Such a set-up can allow business almost as usual, yet still check off the regulators’ boxes.

Krall moved to a big European bank, again as a client relationship manager—in effect, someone who finds wealthy clients and keeps them happy. Trawling for business, she was routinely pointed toward Latin America, where she traveled frequently.

“On the immigration form you would write that you are going for pleasure—though your suitcase would be full of business suits and portfolio evaluations, or marketing materials and presentations explaining the advantages of a trust in the Bahamas.” The client’s name would be absent from the portfolio evaluations: In fact, the bank would not even record it as the account

name. “You’d cut off the account name and number so it was just a list of securities and holdings: you could never attach it to anyone.” It was nerve-wracking, sometimes, going through airports, but she always got through unchallenged.

Apart from the anxiety about getting caught, Krall said there was rarely, if ever, a feeling you were doing anything wrong, despite often helping clients break the law. Part of what she called “managing not to check into your conscience” was that there were always cases where you could believe you were helping someone. For example, countries like Brazil have “forced heirship” dictating who in a family gets the assets after the parents die—and an offshore trust may be a way to get around this. Krall cited a case she knew of in another country where forced heirship would have granted the assets to a playboy son instead of to the family’s preferred beneficiary, a daughter with special needs. As I explained in the last chapter, human stories like this are commonly used to justify oceans of wrongdoing in the offshore world.

Krall would cold-call top lawyers and asset managers, hoping to get into what is known in the trade as the “Beauty Parade,” the lineup of obliging banks that clients and their representatives will look for to manage their riches. The key is to build a relationship of trust, mixing the good and the bad. With the good trust you offer a solid, safe return on the assets; the bad trust is a confidence that you will keep their identities secret and will break laws on their behalf. In pursuit of these elusive relationships, Krall went to polo games, the opera, orchestral concerts in Rio de Janeiro, and umpteen working breakfasts, lunches, and dinners in the most expensive restaurants in town.

Despite her growing qualms, Krall ended up working for a Swiss private bank in the Bahamas. This was no ordinary bank: It had only a hundred or so clients. It was also the only bank where she actually saw a suitcase full of cash. “My bank never once had a client walk through the door,” she said. “The bankers and their clients go on big game hunting trips, or to the ballet in Budapest. That is where it happens.” From her tone, she made the “it” sound like some sordid sexual act.

Her bank was run out of Switzerland, and the Bahamas was purely a “parking space” or transit point for money: an extra layer of secrecy. A major driver was, of course, the imperative to receive and store the proceeds of crime. “I felt I was prostituting my personality, just to get money in the bank,” she said. “I came to realize that the system I was involved in contributes to the perpetuation of poverty in the world.” She thought a bit, then added, “But I did enjoy the adrenaline. When it fuels

you, you don't question what you otherwise would."

Her colleagues hailed from old European aristocratic circles. While Krall was perfectly good at her job and had close working relationships with top lawyers, asset managers, and so on, a gap remained. "They went to parties with royalty, with ambassadors," she said. "I wasn't in their circle."

At the time, laws in the Bahamas were being tightened a bit, following a feeble global crackdown, and she moved sideways in the bank to work as a "compliance officer." These days, offshore bankers make a big show of their "Know Your Customer" rules, to keep out the bad money. Depositors may have to supply a certified copy of a passport, for example, and divulge where their money came from. Jurisdictions like the Bahamas and the Cayman Islands put these requirements into their statutes, and banks must comply; they employ compliance officers like Krall to enforce this.

That, at least, is the theory.

In her new job Krall began to learn of the many devious avenues around the rules. "You would ask for the source of funds— and they could tell you anything," she replied. "You didn't ask for documentation." Another compliance officer Krall knew was expressly forbidden from seeing certain files. A loophole in Bahamas law let institutions waive due diligence checks on clients if they were referred from a financial institution in a jurisdiction where the legislation is supposed to be good. Once in a while a bank would uncover a money-laundering case to show it is enforcing the law: They were happy to do this, Krall said, provided it did not expose anyone the bank would not want to upset. Legal frameworks that distinguish between the criminal and the legitimate have eroded away offshore, replaced by networks of trust that distinguish between the well established and respectable, on the one hand, and the unknown and dispensable, on the other.

Individuals with sums to launder or invest with minimal taxation want to know that they are dealing with people who can be trusted not to have moral qualms. If the bankers don't know you, you will have to jump through many hoops; if you are a long- standing and trusted client, the rules fall away. These trust-based networks, deferential to the aristocracy of wealth and privilege and resistant to formal laws, are the ultimate source of comfort for the banks' wealthy clients. The similarities with un-spoken Mafia codes of behavior are no coincidence at all.

"These banks are competing with each other, but they also scratch each others' backs," Krall said. "The heads of these banks are part of a

circle of friends and business associates, where the whole social circle revolves around it: a social structure intertwined with a business relationship. They will pass business between each other."

"The law says you must report suspicious activity to the Financial Intelligence Unit [FIU] or the police," she continued. "But in a very small place, everyone knows everyone and their cousin. I couldn't trust a report being handled confidentially or through proper channels. There is a huge chance that someone in the FIU or the police will be close to people in the bank where you work . . . and this could cause me harm for raising the issue."

Krall was supposed to check for suspicious movements through the accounts—of which there were plenty. She raised many red flags. Her managers "would say, 'This was a commission' [on a contract]." Were these bribes? Commissions on what?

"I went back, and never got an answer."

One Swiss-based trust company that had a relationship with her bank displayed almost no information on their website, bar some photos of a nice fountain in Geneva. "The crap they brought to us was unbelievable—there is no way a responsible trustee should take this on. You would have no idea who the trust settlors were; what the assets were or where they came from. I objected strongly—but the bank took them on."

Over time her qualms grew, and she began to find herself in a very lonely place. "I couldn't even tell my boyfriend. I was supposed to abide by bank secrecy," she remembered. "It wasn't easy for him, with someone walking through the door at the end of the day, pale, drained, and sick, with stuff going on he can never know about." Other compliance officers whom she chatted with also felt their powerlessness. "There was a fear abroad," she remembered. "You have this dilemma: the difficult news you will give to directors may not be appreciated. Most people want to do their job, protecting the bank and country from the taint, as well as doing their ethical, moral, and legal duty. You go into the job with that mind-set."

I chatted to Krall about my own recent experiences in the Cayman Islands: about what happened when I revealed to one of my first interviewees in the Caymans that I had links to an organization that had been critical of tax havens. That meeting ended in minutes. I had been referred to this interviewee by a mutual friend, and after our meeting my friend got emails stressing how "uncomfortable" she felt, and requesting promises on promises that I would never identify her.

People I met in the Caymans almost always seemed to find it distasteful, or changed the subject, when I asked questions

such as whether or not one might balance the prosperity of the fifty thousand–odd islanders against the interests of 350 million North Americans, 600 million Latin Americans, and the same number again in Africa. Even more surprising to me was that despite the confidence with which I hold my own views, I found myself feeling shy, almost ashamed, expressing them on the Cayman Islands, from the first day.

Krall recognized this shifty feeling immediately. “When I was planning to leave the Bahamas friends were kindly introducing me to other private banking opportunities,” she said. “The thought of continuing in that profession made me feel disgusted to the point of being physically nauseous, yet here were my dear friends, working in exactly the same industry, being helpful. How could I say to them directly there was no way I could do that work anymore, while they were still in it?”

“I felt that ‘unclean’ feeling from every direction: unclean for having done that kind of work and yet unclean with feeling as though I was being, somehow, not truly and openly honest with my friends.”

Stephanie Padilla-Kaltenborn, an American mother of two and an old friend of mine who lived until recently in the Cayman Islands, recalled soon becoming aware of unspoken limits of curiosity and candor in the secrecy jurisdiction. “It’s a feeling when you live there that there’s something under the surface and I did not want to look,” she said. “I knew the answers would be more complicated than I could deal with. You cannot talk to people—it’s a strange invisible line you can’t cross. It’s a semi-chosen state of mind—a self-censorship.”

Krall’s experiences, and her treatment, are echoed in the widely publicized case of Bradley Birkenfeld, the gregarious old Bostonian UBS director who recently helped the U.S. Internal Revenue Service dismantle a $20 billion UBS program to help wealthy U.S. residents evade taxes and forced Switzerland to accept a new, somewhat more transparent tax treaty with the United States. Birkenfeld described in court how UBS bankers would frequent events like the UBS Trophy yacht race off Rhode Island, the Art Basel contemporary art fair, classic car shows and concerts, and—his personal favorite—a ten-thousand-dollar-a-head evening with Elton John at the Waldorf Astoria in 2005, illegally soliciting client business. “I’d say, ‘Do you want to go to Wimbledon, have lunch and see the match?” Birkenfeld recalled.[2] “‘Do you want to come

to Oktoberfest and drink some beer and look at hot girls? Whatever you want to do.' I would go to the Cannes Film Festival, the Venice Film Festival, the Bangkok Film Festival." On one occasion, he smuggled diamonds into the United States in a toothpaste tube. His star client, Oleg Olenicoff, explained how impressive the Swiss bankers' performance was while courting his tax-evading business. "It's all very proper and precise," Olenicoff recalled. "You feel you're in the German Reichstag with all the generals there!"[3]

While visiting the Caymans in 2009, I was chatting with a former senior Caymanian politician at his house when a thickset, dark-skinned Caymanian, probably in his forties, wearing a blue polo shirt, khaki shorts, and sunglasses, walked in and introduced himself as "The Devil."

I still do not know his name, though my sober and well-connected host vouched firmly for him. The mystery stranger said he had serious credentials in international law enforcement so—this was all I could think of—I tested him by showing a photo on my phone that I'd recently taken of Robert Morgenthau, the Manhattan district attorney, a legend in the business. Not a sophisticated test, for sure, but my stranger passed it without hesitation.

He said he had spent years probing some of the global sins that freewheel through the Cayman Islands and chatted about several cases, many of which I'd never heard of. One concerned Imad Mugniyah, whom I later discovered to be a senior Hezbollah official killed in Syria in 2008; another was about a Cayman company fingered in the transfer of missile technology to Iran (later I checked with the U.S. Office of Foreign Assets Control and discovered this was still a very live investigation). He touched on some Cayman operations of the international arms dealer Victor Bout that never reached the media. He spoke of Cayman hedge funds, mutual funds, and special purpose vehicles, and he described these sectors as being riddled with crime, though he declined to go into any real details. At this point, he supplied me with a health warning.

"If we discuss this with you, you will end up like Salman Rushdie. There are things here not to be discussed. I mean it," he said. "This is a wicked, vicious place."

He said he had become too interested in certain stones that would normally, and deliberately, have been left unturned—and this had made

him an enemy of the establishment. This, he said, was why he called himself "The Devil"—for that was how they treated him now.

"You have to have a deep soul," he continued. "They carry out economic isolation—they destroy your credibility and your integrity. They will strip you of your dignity. We operate here under a code of silence—omertà. They will tell you this is not so."

"There is a cabal here…. These people in [the] firms get together—it is an informal thing—and say this guy is causing trouble. You will get hints: Be careful! from your boss. I got this." Powerful Masonic and other networks are at play; the cabal does not include Caymanian politicians, he said, but added, "They will give the politicians a call and tell them what to do." My host—the only dissident I encountered on the island—interjected, adding that this cabal was "spoken of in terms you'd speak of a ghost."

"The very difficult part of this," The Devil continued, "is that a few people here—those people who have committed what the international community would consider unlawful acts—they get the CBEs, the OBEs [British royal decorations] . . . they sit on boards, they have high status, and they are looked on as statesmen."

He described another avenue around the legislation. Cayman boasts of its intrusive Know-Your-Customer laws, which are fairly strong—on paper. Yet it was just as Krall had found it in the Bahamas: The rules fall away if you are a trusted part of the network. "If I do not have a relationship [with an institution] they will want to know even my underwear size," The Devil said. "But if you have an established relationship with a bank over time, the rules don't apply to you. If you are established as a well-to-do person, your credibility isn't questioned." His words remind me of an internal memo at the Riggs Bank brought to light in 2004 by the U.S. Permanent Committee on Investigation. "Client is a private investment company domiciled in the Bahamas," it said, "used as a vehicle to manage the investment needs of beneficial owner, now a retired professional who achieved much success in his career and accumulated wealth during his lifetime for retirement in an orderly way." The "retired professional" was the Chilean torturer-in-chief and former dictator Augusto Pinochet.

Beneath the Caymans' standard official line that it is a "transparent, well- regulated and co-operative jurisdiction" lies a more fiendish reality.

Later I recounted my "Devil" story and Krall's tale to an accountant who had worked in the Caymans, who nodded fiercely

when I mentioned the reference to Salman Rushdie. “Yes, yes, it’s serious,” he said. “It’s not naive to take these threats seriously. You will be the first to go to prison if something goes wrong.” He told me about several mysterious offshore deaths, including that of a Swiss banker, Frederick Bise, who was found dead in 2008 in the hatchback of a burning car in Grand Bay, on the Caymans, with blunt force injuries to his head.

My interlocutor, a former hedge fund administrator, compliance officer, and chief accountant, described how he slowly grew to see what was going on.

“I started feeling bad three or four years after I arrived,” he said. “We ran business through the accounts, which was kind of dubious: you’d get information here and there and put it together—but you could not ask questions. Even if you had indications, you could not speak up. I did speak up, and the result was that I got less information at meetings. Information was sort of prediscussed: I felt that a kind of show was going on.”

He came under suspicion and was overloaded with work: twelve hundred hours of overtime in a year, with no compensation. “The CEO said, ‘This is part of your job.’”

“We replaced 40 to 50 percent of our staff within two years: people who do not fit into the system for any reason are pushed out. Ask questions, and you can get fired, or given so much work [that] you [eventually] resign. It is not done obviously: they won’t call you into meetings and say, ‘Stop asking questions.’ These are highly intellectual, well-educated people: they have their own way of communicating. You learn to read between the lines. They will not say, ‘I am threatening you.’ They will say, ‘This person does not fit into the picture.’ I have been in the business for years, and I know what they mean.”

Most people working offshore only see fragments of the big picture, so cannot understand what is going on. “For example, if there is a trust set up in the Caymans, and the securities portfolio is in Switzerland, you will get very little information in the Caymans: you won’t know the reason why things happen. The ones who commit the crimes—those people who set up the trust or the Special Purpose Vehicle—will often sit in New York or London. The employees in many cases are honest people, trying to do their best: it will be the lawyer, or the CEO, or the chief operating officer, who knows the truth.” Once you become part of senior management, then “you are part of the inner circle and things become much clearer. You are part of the plot. You know what the real

products and services are, and why they are so expensive."

An old offshore saying encapsulates it: "Those who know don't talk, and those who talk don't know."

Other subtle checks on troublemakers abound. To stay in the Caymans, for example, you need a work permit. Any expatriate who causes trouble—whether a seconded police official, lawyer, regulator, or auditor—can have his or her work permit revoked by the "Cayman Protection Board," which grants permits. Foreigners in the Caymans are made painfully aware of their vulnerability on this.

"If you blow the whistle and stay on the island—and this is general in offshore centers—you don't have whistle-blower protections at all. If you speak up in one place, the network works in a way that you will never get work again. It is suicide, physically and economically. There is no way you would find protection." My interlocutor chopped the palm of one hand with the other for emphasis.

"Have you seen the John Grisham film The Firm? It's worse. It's not only the lawyers—it's the whole political environment."

Before visiting the Caymans in 2009, I had contacted island authorities to request interviews and told them I had done work for the Tax Justice Network (TJN), the expert-led organization that criticizes secrecy jurisdictions like Cayman. On arrival, the government spokesman Ted Bravakis said because of this there was "no willingness to engage." A decision to shun me, he said, had been taken "at the highest levels of government."

Earlier, I had emailed a top official in the Cayman Islands regulatory apparatus, requesting an interview. He copied me into an email to local practitioners, criticizing efforts by his predecessor, Tim Ridley, to help me get interviews during my trip. "I do wish Tim would stop hawking this chap around as if to say he is doing us a favor," the official wrote. "We are going to prepare a factual anodyne piece in writing but will decline any on the record interview." I told him he may not have meant to copy me in on the mail. "Quite so," he replied, then put his finger squarely on an important truth about such places. "I have no problem with you understanding how the world at large regards the comments of TJN," he said. "I say so directly at every opportunity and meet with uniform agreement."

In the official's "world at large"—the offshore environment—there is no

opposition to the establishment consensus, it seems. There is, in fact, something generic about island life that encourages the group-think that the official describes. In his novel Snow Falling on Cedars, the writer David Guterson captures an essence of it. “An enemy on an island is an enemy forever. There is no blending into an anonymous background, no neighboring society to shift toward. Islanders were required, by the very nature of their landscape, to watch their step moment by moment.” The social and political inhibitions islanders feel, he continued, “are excellent and poor at the same time—excellent because it means most people take care, poor because it means an inbreeding of the spirit, too much held in, regret and silent brooding, a world whose inhabitants walk in trepidation, in fear of opening up.”

In the island goldfish bowl, you cannot hide. This ease of sustaining an establishment consensus and suppressing troublemakers makes islands especially hospitable to offshore finance, reassuring international finance that they can be trusted not to allow democratic politics to interfere in the business of making money. In the British tax haven of Jersey, three local sayings encapsulate the constant social pressure: “Don’t hang your dirty linen out in public,” “Don’t rock the boat,” and “If you don’t like it, there’s always a boat in the morning.”

This groupthink does not originate with the island havens, which are just fortified nodes in bigger global power networks led by Britain and other large powers. But they have, with their intolerant environments, come to host and protect cultural concentrations of antigovernment, kick-the-poor attitudes that originate elsewhere. In the absence of reliable dissent, these attitudes have flourished, unchecked.

John Christensen, Jersey’s former economic adviser who turned dissident, describes encountering extremist right-wing offshore attitudes when he returned to his native island in 1986 after working overseas as a development economist.

In this year of the City of London’s “Big Bang” of financial deregulation, he found a tax haven amid a spectacular boom. Old town houses, tourist gift shops, and merchant stores in Jersey’s beautiful capital St. Helier were being knocked down and replaced by banks, office blocks, car parks, and wine bars. An employment agency told him he could have any job he wanted; he had three offers the next day. He began employment with an accounting company, working with over 150 private clients.

The firm practiced reinvoicing: the practice I described earlier, where

trading partners agree on a price for a trade but record

it officially at a different price to shift money secretly across borders. Global Financial Integrity, in Washington, D.C., estimates that about $100 billion is drained from developing countries each year just from reinvoicing—about as much as all foreign aid from the rich world to the poor. It is just one part of a much larger picture of outflows of capital. “This was about capital flight . . . shifting capital out, and evading tax: the really nasty stuff,” Christensen said. “I saw this stuff coming in daily.” The accountancy firm provided a fax number, headed notepaper, a bank account, and a veneer of exceedingly British solidity and respectability.

Christensen worked there for 20 months, mostly handling clients based in South Africa (where much of the work involved evading antiapartheid sanctions), Nigeria, Kenya, Uganda, and Iran. Working undercover, he systematically combed through hundreds of client files and gradually put pieces together. He learned that a very senior right-wing French politician was using his political influence to secure planning permission on behalf of developers with whom he was involved, in a series of property deals. The Jersey link meant nobody in France could find out what he was up to. “You don’t get that information from a cursory look at the file,” he said. “I got hold of this guy’s name by talking to an office in France: they told me ‘I’ll have to speak to the Senator about that.’ If you work there long enough, they get to know you, and get comfortable telling you things. The market rigging, the insider trading: I was sitting there thinking, ‘Holy shit—this is dynamite.’ These were very prominent families; this would be on the front pages if it got out.”

But even today Christensen, like Krall, won’t tell tales about the particular secrets he encountered, having signed oaths and contracts for life. “If I transgressed those I could be thrown into a pit forever.”

Reinvoicing is just one more workaday business sector in the world of offshore finance, and his firm and colleagues saw it as good business practice. “They rationalized it in all sorts of ways: foreigners were protecting their money from political risk or unstable currencies. People in Africa are poor because they don’t work hard enough or they are corrupt; countries are poor so we send them aid money. That kind of thing. They didn’t want to think about economic systems.”

He moved through various jobs, and each time he expressed unease about the origins of some of the money, much of it from Africa, he was brushed aside. One Friday, ahead of the habitual office binge-drinking session, his section supervisor told him she didn’t want to discuss these things and didn’t “give a shit about Africa anyway.” Her attitude,

Christensen said, was typical. “Profitability was sky-high, and nobody made the connection between their actions and criminality and injustice elsewhere. None of the financial intermediaries involved—banks, law firms, accountants, and auditors—bothered to report or even question illicit transfers.”

He met an old childhood acquaintance, now a chartered accountant, drunk in a pub, and told him all about his recent experiences in India and Malaysia. “No interest. He was in a bubble: last night’s party, which car I was driving, who’s screwing whom—that was it. I can’t tell you how much of a shock it was to come back. There were really extreme views I was picking up on in Jersey: deep racism; sexism; the repressive feel; the awful in-your-face and aggressive consumerism I’d never seen before—and an almost fanatical hatred of any progressive ideas.”

Progressive legislation takes years to seep to Jersey from outside. Britain abolished its antisodomy laws in 1967, but Jersey only repealed its law, under subtle pressure from an embarrassed Britain, in 1990. “There was this ‘don’t speak out’ mentality,” Christensen said. “In London, all my mates had taken antiracism, and stuff like that, as normal. Back in Jersey, I got, ‘You don’t do that here, sonny.’”

He turned up at a cocktail party on a motorcycle and was assailed by a guest, a senior Jersey business figure, who said his crash helmet was an infringement on his liberty. “He was anti-seatbelts, anti-tax, and anti-government. He would say apartheid was good for black South Africans; that we should reestablish colonialism; that ‘these people’ had been much better off under white governments.” Christensen clashed with Sir Julian Hodge, a pillar of the Jersey banking establishment: “a mega- apologist for apartheid; a mega-pusher for empire; a libertarian beyond anything I’ve met.” He remembers a stand-up row at a public meeting with the Reverend Peter Manton, a Jersey senator and Anglican minister who had also said publicly that “the blacks” in South Africa were better off under apartheid than anywhere else (Manton was subsequently prosecuted for sex offenses and later died).

Offshore can feel like an adolescent fantasy of the world, where white men sort things out over Scotch whisky and see the rest of the world as a consumable resource. At a government committee meeting exploring sexual discrimination and equal opportunities for women, Christensen remembers a senior politician made a show of falling asleep and snoring. Another politician, who ran his own business, went further. “He said, ‘If any of my girls got pregnant I would sack them immediately: nobody wants to see a pregnant girl behind the desk.’ That is how he

referred to all women—girls."

"The ruling classes realize they don't need to worry about the Democrats coming to power in the U.S., or Social Democrats coming to power in Germany, or Labour coming to power in Britain," Christensen continued. "They realized they didn't need to fight the fight at home: they already had this flotsam and jetsam of the empire strewn across the globe, with their red post boxes and British ways of life, and incredible subservience to the English ruling class. In Jersey I was amazed by how fawning the local politicians were to outsiders with money. There was this idea, 'We can take over our own little places, and the locals will be grateful to us. The checks and balances aren't there; the press isn't there; and they resent interference from outsiders.' Happy Days: Wall Street and the City gentlemen had found a way around the threat of democracy."

Offshore attitudes are characterized by amazing similarities of argument, of approach, and of method, and some striking psychological affinities, in a geographically diverse but like-minded global cultural community of offshore. A peculiar mixture of characters populates this world: castle-owning members of old continental European aristocracies, fanatical supporters of the American libertarian writer Ayn Rand, members of the world's intelligence services, global criminal networks, assorted lords and ladies, and bankers galore. The bugbears for this zone are government, laws, and taxes, and its slogan is "freedom"—at least for wealthy elites.

And these attitudes fit seamlessly with another characteristic of small jurisdictions: collective inferiority complexes where residents see themselves as plucky defenders of local interests against the predations of big, bullying neighbors. From this worldview of mistrustful self-regard, it is but a short step to a libertarian, leave-us-alone worldview that sees any self- advancement at the expense of outsiders as valiant resistance against tyranny. This worldview, of course, dovetails closely with offshore's ethical framework, which holds the rights of citizens and governments elsewhere to be inconsequential, which sees democracy as a "tyranny of the masses," and holds the very idea of society with disregard, even contempt. Providing facilities for foreign tax evasion clearly fits this framework, as does a general hatred of tax.

This concentration of extremist attitudes in Jersey was self-reinforcing,

as Christensen explains. “Most liberal people like myself left,” he said. My socially liberal friends from school, almost all of them left Jersey to go to university, and almost all of

them didn't go back. I can't tell you how dark it felt. I have never been a depressed person but I went into a big one there.
Everything I valued seemed of no significance.
There was no one I felt I could turn to."

He almost left but was persuaded to stay by an academic researcher who was putting together a new framework for understanding tax havens, and who persuaded him how important it was to understand the system from the inside. "I went under-cover not to dish the dirt on individuals and companies, but because I couldn't understand it—and none of the academics I spoke to could either. There was no useful literature." He did not even tell his brother what he was doing and kept this cover for
12 years. He grew roots: He became president of the Jersey Film Society, raced high-speed catamarans, and started a family. He never made a secret of his distaste for the system, but his lighthearted capers, such as founding the island's first and only Jean-Claude Van Damme Appreciation Society, helped politicians to see him as a lightweight and therefore not a threat.

When he was appointed economic adviser in 1987, he began to feel the full force of what it means to stand out against an accepted, all-embracing consensus. Occasionally, he said, the pressure was so severe that he physically lost his voice. "Tension gets me around my neck. At times, in meetings . . . there were moments when I was literally choking with anger. It took real strength to stand up and say 'I'm sorry, I don't agree with this.' I felt like the little boy farting in church: I felt so lonely during those committee meetings; nobody ever supported me."

Many people who came to see him as economic adviser wanted him to join their Masonic lodge, and he frequently received the secret signal. "It was a finger twisted back on itself in a handshake," he said. "These were mainly people I knew vaguely, who would come into my office: 'Blah blah,' general talk, then quite openly: 'Are you interested in joining this lodge?' I always said I would consider it, and I never did. The type of people doing this were bankers, senior merchants, and senior politicians. You don't look at people's hands: you feel a lump there when you shake. For me it felt slightly dirty—covert, as if we were all part of some dirty deal; a schoolboy thing."

"Their thinking is very much of the Old Boy network—you are either one of us, or you are against us," he continued. "It means they can trust you to do the right thing without having to be told—an insidious meaning of the word trust." He was labeled untrustworthy and was frequently called

"Not One of Us." The media was captured. The dominant newspaper in Jersey was owned for many years until 2005 by a company chaired by Senator Frank Walker, head of the powerful Jersey Finance and Economics Committee and one of the most vociferous cheerleaders for Jersey's finance industry. As a Financial Times editorial said in 1998, "That is akin to [UK Chancellor] Gordon Brown or [Germany's finance minister] Oskar Lafontaine owning all their country's national newspapers. Few on Jersey see it as odd."[4] Walker left the newspaper in 2005, and it does carry dissenting views and plenty of decent reporting. Yet its overall editorial tone and content staunchly favor the tax haven industry.

Patrick Muirhead, an experienced former BBC radio journalist who spent time as the anchorman of Jersey's nightly ITV news until 2004, described the atmosphere.

"In an island of 90,000 souls, one is only removed from another by the smallest step of separation," he said. "My co-host's home became a popular salon for politicians and decision-makers. In such an atmosphere of closeness, any meaningful challenge becomes impossible. 'You rub people up the wrong way,' she said, primly dismissing my methods. After I left, my integrity, professional ability and popularity were trashed by a hostile and defensive Jersey media and island population."[5]

Unaccountable elites are always irresponsible, and I got my own taste of Jersey's moldy governance on the very first day of a visit in March 2009, when I bought the Jersey Evening Post and read its front-page story, entitled "States in Shambles."

"The States resembled a school playground yesterday as foul language and personal insults flew across the chamber," read the text. Senator Stuart Syvret, a popular but controversial local politician, had complained publicly in the States assembly, Jersey's parliament, that the health minister was whispering in his ear. Syvret, the newspaper reported, "stood up and said: 'On a point of order, I am sorry to interrupt the minister. But the minister to my right, Senator Perchard, is saying in my ear "you are full of f*****g s**t, why don't you go and top yourself, you bastard." Senator Perchard immediately responded by saying: 'I absolutely refute that. I am just fed up with this man making allegations.' The BBC, which was broadcasting the sitting live, had to apologise for

the language."

Syvret has been a regular victim of efforts to suppress dissent. "Any anti-establishment figure here is bugged," said Syvret.[6] "There is a climate of fear. Anyone who dares disagree is anti-Jersey, an enemy of Jersey. You are a traitor, disloyal. There is all this Stalinist propaganda." A few weeks after my visit, eight police officers arrested him and jailed him for seven hours while they ransacked his home and personal files, including his computer files. The next day Syvret's blog administrator told him someone had clumsily been trying to hack his passwords. His blog describing his incarceration summed up the atmosphere. "Come to Sunny Jersey. The North Korea of the English Channel!"

In October 2009, having been accused of leaking a police report about the conduct of a nurse, Syvret fled to London and claimed asylum in Britain. He returned in May 2010 to fight an election and was arrested at the airport. Not long afterward, he outlined his views about Jersey plainly.

"It is an utterly lawless jurisdiction. Jersey is an environment under the grip of a wholly criminal regime. So absolute—and absolutely corrupted—is all meaningful power in Jersey that the island possesses less scrutiny and fewer checks and balances than a Balkan state."[7]

Corruption could tarnish Jersey's international reputation. Skittish financiers dislike places that are chaotically corrupt, as do onshore regulators elsewhere. Secrecy jurisdictions steeped in sleaze confront this by putting on a strenuous theater of rectitude that involves repeatedly projecting the essential message that they are clean, well-regulated, transparent, and cooperative jurisdictions—burnished by carefully selected comments and praise from toothless offshore watchdogs like the IMF's Financial Action Task Force or the OECD.

It is hard to construct coherent intellectual justifications for hosting secretive offshore finance, so the usual technique is to engage the messenger, not the message. Attacks on dissidents mostly consist of mean-spirited little slurs and innuendoes: "This person is ignorant, motivated by envy, economically illiterate, unreliable, or mentally unbalanced; this person cannot be trusted." Geoff Southern, a dissident deputy, said he now tries to avoid pointing in public: Last time he did he appeared in the Jersey Evening Post in a stunningly Hitler-like pose. He and his friend, Senator Trevor Pitman, wearily describe being tarred with terms like "Destroyers of Jersey" or "The Enemy Within": They are accused in public of being driven by personal bitterness; hints are dropped about darker motives. When we spoke, both Southern and

Pitman's wife, Shona, another deputy, were being prosecuted for helping elderly and disabled residents fill in requests to opt for postal votes, albeit in breach of an arcane electoral law. They were later found guilty and fined. The amorphous finance industry is, locals say, ultimately behind the

attacks. “The finance industry is like an amoeba,” said another Jersey politician, who declined to be identified. “You attack it, and it absorbs that, and attacks back. It is the parasite in the island. It has taken it over; it controls us and decides on everything that happens here.”

John Heys, a tour guide at Jersey’s world-famous Durrell Zoo, and his friend Maurice Merhet, a former printer and pig farmer, now retired, tell a similar story. “We live in a dictatorship,” Heys said, jabbing his finger at the table. “This is not a democratic country. John Christensen is public enemy number one. We call them the Junta, and people are afraid to stand up against them.” Heys showed me an email sent by a government minister to a dissident friend who had, in a cheeky Christmas message, pointed out the large sums stashed in secrecy in Jersey, amid global poverty. The minister responded—mistakes included:

> Hi
> Trait
> or
> Please refrain from sending me your unsolicited garbage . . . I am surprised you still decide to live in this “tax haven” island.ifs its so bad why do you not leave to live somewhere else . . . good riddance I would say…. but perhaps NOT because you get a damm good living here no doubt perhaps funded by banks and your morgage lende r . . . in fact my family have lived in Jersey for several generations and I am so very proud of it but to listen to traiterous idiots like you makes me furious. .
>
> I would not have the nerve to wish you a happy christmas in fact I hope you continue to to live a miserable existence in your traiterous world
> Do not respond

In tiny states everyone knows everyone else, and conflicts of interest and corruption are inevitable. There are no independent think tanks or universities; a small and vulnerable civil service; no clear division among the legislature, the judiciary, and the executive; and no second chamber to scrutinize the States Assembly’s deliberations. When Christensen was Economic Advisor, the public could not attend committee meetings and there was no written record of parliamentary debates on major laws. These problems extend to the governance of the finance industry. In Jersey there are no credible and truly independent processes for internally scrutinizing or regulating offshore

finance. A 2002 publication from the Association of Accountancy & Business Affairs, one of the most detailed academic analyses of Jersey's politics, puts it concisely. "Most Jersey politicians are in business," it said. "They lobby for business and promote business interests. They draft, refine and pass legislation. They have also sat on regulatory bodies, effectively acting as 'gatekeepers' adjudicating on complaints and malpractices. Politicians sit on the boards of the companies that they are supposed to regulate."[8]

Close relationships are inevitable in a small island, but it is precisely because of this that Jersey needs extra checks and more transparency, to weigh against the inbuilt tendency toward conflicts of interest. This is especially important when Jersey plays such a major role in international finance. This affects you and me.

Extreme economic inequalities are tolerated offshore—and often welcomed as incentives for the poor to work harder. It is an ethos memorably summarized by the economist J. K. Galbraith as "the 'horse and sparrow' theory of income distribution and tax: if you feed a horse enough oats, some will pass through to the road for the sparrows."[9]

This soak-the-poor attitude is a constant theme as Jersey seeks to stay ahead of other jurisdictions in its race to attract capital. In 2004 Jersey cut the corporation tax rate from 20 percent to zero, except for finance, which pays 10 percent. This tax cut blew a hole in the budget big enough to finance Jersey's entire benefits system, so they made hundreds of redundancies and introduced a tax on consumption, hitting the poor especially hard. Shona Pitman, a States deputy, calls this the "tax the poor to save the rich" approach.

Super-wealthy people and corporations can actually negotiate the tax rates they will pay. For most of the 1990s, wealthy people wanting to take residence sent their lawyers directly to Christensen's office to negotiate their rates. Jersey would insist on a minimum annual tax payment, and the millionaire or billionaire would then simply remit to Jersey the amount of money that, when calculated at Jersey's flat 20 percent tax rate, would reach this sum. Christensen's predecessors had settled on a £25–
30,000 tax payment each time; Christensen raised this to £150,000—which meant remitting income of £750,000 each year to Jersey. If you had worldwide income of £10m, say, your effective tax rate would really be 1.5 percent. A similar principle applies to corporations. For a Jersey International Business Company, the top rate starts at 2 percent and falls from there depending on how much profit they plan to book in Jersey.[10]

"Jersey has the social structure of a Hilton hotel," explained Jerry Dorey, a Jersey senator. It contains "a collection of alienated individuals who are just here to make money."

At the time of writing, six of Jersey's ten ministers are multimillionaires. "This is a parliament of wealthy people," said the dissident Jersey deputy Geoff Southern. "I think there is still a resentment that peasants have got into power."

One winter night in 1996, toward the end of his time in Jersey, Christensen opened the books for a reporter from the Wall Street Journal who was investigating a fraud ring involving a Swiss bank operating out of Jersey that had been ripping off American investors and who posed some very precise questions. The story, entitled "Offshore Hazard: Isle of Jersey Proves Less Than a Haven to Currency Investors," ran on the Journal's front page several months later.

Jersey's finance industry and politicians went into spasm: This was one of the first times Jersey's supposedly clean and well- regulated finance sector had been challenged in a serious global newspaper. The end of the article quoted a senior civil servant who, everyone in Jersey knew, was Christensen. He knew that in talking to the reporter, he was effectively resigning.

"From then on, they would have done anything to get rid of me. But I had tenure: The only way they could do it was to find me guilty of professional misconduct or in bed with a choirboy. The tension was incredible." He did not leave immediately: His second son was born the following month, and it took him some time to serve out a long notice period.

Now that he is a dissident, the barbs continue to fly across the English Channel. "Grapes come no sourer than those trodden by Mr. Christensen, who once worked in Jersey and was passed over for promotion," the Jersey Evening Post thundered later. "Ever since, he has worked unceasingly to undermine the Island that foolishly slighted him." A quote from Jersey, published in France's Le Monde newspaper in April 2009, called him a "traitor to the nation." He attacks Jersey, the whisper goes, because he was not promoted as chief adviser. Insiders in the Jersey establishment have confirmed that it is semi-official policy to attack him in exactly these terms.

Offshore thrives on narrow self-interest combined with a culture of collusion. Its defenders are neurotically quick to impute mean motives

and a hidden agenda to their critics. But men angling for promotion do not usually speak freely with the Wall Street Journal as they raise their voices in dissent.

The offshore intolerance is not confined to small jurisdictions. Rudolf Elmer, a Swiss banker who worked for several banks in several offshore centers before becoming a whistle-blower on some of the corruption he had seen, felt the pressure in Switzerland, a country of 8 million people.

Not long after speaking out and returning to Switzerland, he began to notice two men following him to work. He saw them in the parking lot of his daughter's kindergarten, then outside his kitchen window. Then his wife was followed, and the men offered his daughter chocolates in the street. In 2005 he was imprisoned for thirty days, accused of violating Swiss bank secrecy. There has been no determination as to who might have been following him.

"I was bloody naive to think that Swiss justice was different," Elmer said. "I can see how they might control a population of eighty thousand people in the Isle of Man," he said. "But 8 million people? How can a minority in the banking world manipulate the opinion of an entire country? What is this? The Mafia? This is how it works. Jersey, the Cayman Islands, Switzerland: this whole bloody system is corrupt."[11]

Ruling class ideologies that for years were beyond the pale in the larger democracies have been allowed to grow offshore, without restraint. As offshore finance has grown increasingly influential in the global economy, rebounding back and reengineering the onshore economies in ever more significant ways, so its attitudes have flourished, gaining the strength and confidence to capture the perceptions and attitudes of public life. This offshore consensus is evident in the intransigent arrogance of bankers who, having nearly brought the world economy to its knees, ask for still more and continue to threaten to relocate elsewhere if they are regulated or taxed too much. It is visible in the demands of the super-rich, who have come to expect and demand tax rates below those of their office cleaners. It is visible in the actions of the Irish musician Bono, perhaps the world's most prominent poverty campaigner, who legally shifts his financial affairs offshore to the Netherlands to avoid tax and is still warmly welcomed in high society. The United States, the greatest democracy the world has known, is now in thrall to the worldviews of unaccountable, abusive, and often criminalized elites.

To a very substantial degree, indeed, we have offshore finance to thank

for that.

RATCHET
How Secrecy Jurisdictions Helped Cause the Latest Financial Crisis

THE PRACTICE OF USURY, OR THE LENDING OF MONEY at excessive interest rates, has a nasty historical taint. The prophet Ezekiel included it with rape, murder, and robbery in a list of "abominable things." Plato and Aristotle called it immoral and unjust, and the books of Exodus, Deuteronomy, and Leviticus forbid it. In Dante's Inferno, "lewd usurers" sit in the seventh circle of hell, and the Koran states that "whoever goes back to usury will be an inhabitant of the Fire." When the ancient Greeks deregulated interest rates, indebted Athenians ended up being sold into slavery.

One can argue about the merits and evils of usury, but in a deregulated market the poor and vulnerable inevitably pay the most. Annualized rates of 400 percent or more are not uncommon.

Historically, the United States regulated lending rates carefully. In 1978, however, a new era began when the First National Bank of Omaha started enrolling Minnesota residents in its BankAmericard Plan. At the time, Nebraska let banks charge interest up to 18 percent a year, while Minnesota's usury limits were 12 percent. Minnesota's solicitor general wanted to stop the bank from charging higher interest rates. Could the Nebraska bank "export" the 18 percent rate to charge Minnesota residents?

The Supreme Court ruled that it could—and Wall Street noticed. If one state removed interest rate caps entirely, Wall Street could export this deregulation across the United States. Then in March 1980, South Dakota passed a statute eliminating its anti-usury interest rate caps entirely. The statute was, according to Nathan Hayward, a central player in this drama, "basically written by Citibank." A new opportunity for U.S. banks had opened up: By incorporating in South Dakota, they could roll out credit card operations across the country and charge interest rates as

high as they liked.

Then came Delaware. The tale of its Financial Center Development Act of 1981 is a story about 10–15 powerful people who came together to pass an enormously significant piece of legislation, from which many of them, along with friends and colleagues, reaped huge wealth.[1]

David Swayze, a grizzled and affable lawyer who was chief of staff to Delaware's then governor, Pierre S. "Pete" du Pont, picks up the story.

"What Citibank did [in South Dakota] was not lost on the other money center banks," Swayze said. "They wanted some—but they didn't want to be in South Dakota. It's cold out there."

Hayward, who is du Pont's second cousin and was a du Pont cabinet member at the time, picks up the story. "Pete [du Pont] inherited a state that was in bad financial shape," he said. "There had been a continuous stream of red ink and the deficits were hidden with tricks and budget games." After being elected governor in 1976, du Pont had overseen an improvement in state finances, and he was a shoo-in for reelection. "We weren't on a cocaine high," said Hayward, "but we were beginning to feel pretty good."

In early June 1980, a group from Chase National Bank came to the venerable University & Whist Club in the state's commercial capital, Wilmington, to meet Delaware officials.[2] The link man was Henry Beckler, an ex-Chase banker at the Bank of Delaware, and he had already persuaded Chase to manage some of its foreign operations out of Delaware. "Henry Beckler's son and my son went together to school," said du Pont. "When you put a statute like this together you have to talk to the banks. He was very important, he asked them what things we should be putting in there."

Du Pont, who is reminiscent of an aging, if less handsome, Mitt Romney, comes from a family that has dominated Delaware politics for over a century, and he seems to have been a surprisingly passive player given his position. His memory of the episode was not so fresh, and he is clearly not a detail guy: Three or four times when asked to explain the episode he replied vaguely, ending by saying something like, "It was good. It was very good." When challenged about certain Delaware corporate forms offering ironclad secrecy, he offered no detailed rebuttal, just: "I don't think that's right. It all works nicely." But he did put his finger on one important element of the process: the small-town groupthink that let it happen. "One of the nice things about Delaware is that it's a small state," du Pont said. "We all have the same ideas."

Hayward says the aim of the June meeting was "to listen to New York

bankers who were friends of the Delaware bankers who had helped us. They said, 'We'd love it if Delaware allowed market rate banking.'"

The Chase team wanted this rushed through in a few weeks, well ahead of the November 1980 gubernatorial elections. That was too tight. But what happened next was remarkable. Confirmed by several interviewees, by a 1981 New York Times investigation,[3] and by du Pont's official biography, it is a testament to the ability of elites in small offshore jurisdictions to create and sustain a consensus in their favor.

Frank Biondi, a powerful Democrat lawyer,[4] and Chuck Welch, du Pont's general counsel, went to see Hayward. "[They] said that the locker room on this was very small," Hayward remembers. "If the idea got out in public, the Democratic candidate for governor, a downstate farmer named Bill Gordy, is going to grab onto this and the Democrats in the House and Senate will make this a big campaign issue. We'll lose the battle before we even get suited up in our armor."

Du Pont was popular, and Republicans weren't that worried about the state election, but they did fret that if this story got out, it might affect the campaigns of other Republican candidates, including U.S. presidential nominee Ronald Reagan.

"Gordy was one of the unsung heroes of the whole story," Hayward continued, "a good old pig farmer. Frank [Biondi] and Chuck Welch got into a helicopter in Wilmington and went to see him and said, 'Bill, we want you to know what we're working on. We're here to ask you to keep your mouth shut and not make it an issue in the campaign.' Bill Gordy, God bless him, said yes."

The entire Democrat establishment in Delaware seems to have bought into the silence. And not just them. "If you go back and read the News Journal," said Hayward, "you will not find one mention of it in the press in the campaign season."[5] This

proposal was circulating among Delaware's entire top business and political elite, including a couple of "populist" legislators who saw this—usury—as a threat to the basic consumer. "We had all these major bankers in Delaware through the whole summer," said Glenn Kenton, another key player, reeling off names like Citicorp's CEO Walter Wriston and Chase's president Tom LaBreque. "Nobody found out about it. It's just an amazing thing."

Still, inside this rarefied secret circle, a pushback did materialize. "The most significant counterforce, though not overt, was the local banks," said Swayze. "In the cold citadels of privilege there was a fear the big banks would run rings around them."

Wall Street began to apply pressure. Chase stiffened Delaware spines at a meeting at the Wilmington Club in June, threatening to pull up stakes for South Dakota.[6] "The banks would come down and say, 'Now if we come [and build these institutions], are you guys, meaning the government, you're not going to cut us off at the knees here?'" du Pont explained. He agreed to form an informal task force to look into Chase's plan and promised to reply by September.

In the end, Wall Street and Delaware's bankers settled on a compromise. To protect the local banks, they promised clauses to prohibit the outsiders from touting for local retail business. By mid-August the local banks were on board, and the task force turned to the legislative process. A special session of the legislative assembly was called outside of normal procedures to insulate this from the democratic process. As the Delaware Lawyer explained it, the special session's purpose "was to prevent the proposal from becoming encumbered in the 'horse trading' that typically occurs in the regular session."

While bigger states saw laws regulating economic activity as complex moral, political, and economic issues, Delaware was seeing them instead through an offshore lens: as pieces of sovereignty that could be sold to make locals rich.

Chase had opted for Delaware, not South Dakota, partly because it did not want to be following in Citicorp's slipstream. "Chase said, 'We're not going to the same place Citicorp is going,'" Kenton remembered. Citicorp, he added, had said we're "only out in South Dakota because we had to go someplace. But if you are going to open up, count us in too."

As Wall Street interest grew, Delaware kept brainstorming for still more business. Biondi suggested talking to JP Morgan, where he had some connections: It did not issue credit cards, but Delaware hoped to find other business. “We went up to see Morgan and we said, ‘What do you want?’” Kenton explained. “And they said, ‘We’re just getting the heck taxed out of us up here and we need to have a low-tax environment.’” So Delaware served up the offshore classic of a regressive state tax structure: the richer you are, the lower your tax rate. They set the bank franchise tax at about 8 percent on income under $20 million, then 6 percent on $20–25 million, and so on, until the really big incomes got away with just 1.7 percent. The goal, as Swayze put it, was “sheltering the indigenous banking community against competitive threats on the one hand, and attracting and growing the business of newly created Delaware bank subsidiaries of non-Delaware bank holding companies on the other.”[7] As for the lost tax dollars from the banking behemoths—well, American taxpayers elsewhere could pick up the tab for that.

Biondi’s firm Morris, Nicholas, Arsht & Tunnell represented both Chase and JP Morgan, and both he and his firm are frank about their role in the local bonanza. “The Chase Manhattan and J. P. Morgan banks hired Morris, Nicholas’s Frank Biondi to draft the law,” the firm’s official history notes, “and help convince the state legislature to adopt it.”[8]

Biondi himself adds, “Did I lobby the state legislature? You’re damn right I did.”

So Chase and JP Morgan, in effect, wrote the law through their local representatives. The NewYork Times noted later that it was drafted without any written analysis by a Delaware official, and that Biondi’s drafts got their primary reviews from other bank attorneys.[9] Biondi denies any conflict of interest, saying he disclosed his connections to all parties.

On November 4, 1980, du Pont was reelected as governor of Delaware, and the draft legislation was unveiled in public two months later, on January 14. Du Pont’s administration gave the state general assembly the deadline the banks demanded: pass the bill by February 4 or the deal was off.[10]

The bill sailed through on February 3, and du Pont signed the Delaware Financial Center Development Act two weeks later. Delaware was to remove interest rate ceilings on credit cards, personal loans, car loans, and more. Banks would have powers to foreclose on people’s homes if they defaulted on credit card debts; they could establish places of business overseas

or offshore, and they got a regressive state tax structure to boot. And crucially, because Delaware law could now be "exported" to other states, this was to be rolled out across America.

Two hundred years of legislation capping interest rates in the United States had now lost all force.[11]

Despite the timing—the bill was passed less than a week before Ronald Reagan took office as U.S. president—all interviewees stressed that this came purely from Delaware and the New York bankers, not from Washington. "Lawmakers quickly realized," wrote du Pont's biographer, "that the Financial Center Development Act was favored by almost everybody in the state's power structure—and by the powers most likely to contribute significantly to their future election campaigns."[12]

Out-of-state banks flooded into Delaware, and the credit card industry took off. Within months the credit card giant MBNA had opened its first office in a vacant supermarket; within a decade it had over $80 billion in outstanding credit card debt. "Every night helicopters took off from here carrying receipts and paperwork from all the credit card business," said du Pont. "It gave us 25 years of growth and revenues growing every year." Before 1980, Delaware's revenue just from the bank franchise tax had trickled in at just $3 million–odd per year. By 2007 it was taking $175 million.[13]

Just as Ronald Reagan prepared his assault on America's unions, American workers began to trade their union cards for credit cards.

Two months after the bill's passage, the NewYork Times summed up.[14] "To bankers and their supporters the law is modern and comprehensive, drafted in a thoughtful manner. To some state officials, legislators and consumer advocates, both in Delaware and elsewhere, the bill was stampeded through the Delaware Legislature, is one-sided and, as one critic put it, a banker's 'dream.'"

"Bankers say the possibility that the Delaware plan could be enacted in other states is a sign of healthy competition among the states and a reflection of the current emphasis on states' rights," continued the article. "Their critics say it illustrates the ability of powerful private interests to pass laws with national ramifications by singling out and exploiting the weakest and most malleable states."

The same Times article noticed something else. "Many legislators say they did not read the 61-page bill before agreeing to sponsor it and did not understand the complicated measure before voting on it." Harris B.

McDowell, the majority whip for the

Democrat-controlled Senate, said he was told at the last minute. "I confess I have no expertise in the banking area," he said. "I am mystified by the bill." He voted for it on a promise that it would create jobs. Others said the only hearing for the bill, which lasted just three hours, was handled and timed in ways that prevented many legislators from attending and inhibited rebuttal. Delaware's Consumer Affairs Department never saw the bill before its passage, a deliberate exclusion that Kenton defended by saying that he and du Pont shared the "bias" that "banks should charge what they want in fees."

> "I didn't see any sense in running that fundamental principle by anybody who doesn't agree with it," he added.

This pattern will be familiar to offshore legislators worldwide. In Delaware, bankers had found a small and malleable legislature, used special legislative tricks to stymie bothersome objectors from other stakeholders, worked hard to keep objectors in the dark, reassured bamboozled legislators that all would be well, and created "ring-fences" giving special exemptions to outsiders that were not available to locals.

Most important was this typically offshore feature that made all these things possible. "It's small, you can get the leadership together because of that," Biondi said. "The leadership was accessible at the governor's office but also in the legislature and in the business community." Du Pont made exactly the same point. "I used to say to them, if you've got a problem, you come on in and around this one table, we can put together all the people we need to solve your problem, whatever it may turn out to be. And we'll talk about it. We're small enough. We can move fast. We can get things done."[15] Swayze agreed and added a detail. "There were significant forces in the New York legislature opposed to this," he said. "Delaware took advantage of the fact that New York couldn't turn the dreadnought around in the harbor. We're small, we take advantage of opportunities, and we can fill that void."[16]

> In other words, we can give the bankers what they need, faster than anyone else. Delaware is a legislature for hire.

Once Delaware fell, the banks then wielded it as a crowbar against other states. Thomas Shriver of the Pennsylvania Bankers Association warned that Delaware is "a very viable option if the Pennsylvania Legislature doesn't enact a bill we have proposed." Robert Erwin, head of Maryland's consumer protection division, warned that if other states gave in to the "pressure" from Delaware, "then it becomes a game of Russian roulette among the 50 states, trying to outdo themselves."

With interest rates caps removed, the credit card industry took off, and Americans splurged on debt. By mid-2007, as the global financial crisis emerged, U.S. consumers owed nearly $1 trillion on their credit cards[17]—and that is not to mention loans people took out against their homes to pay the credit card bills. Not a single one of those interviewed for this book who were involved in the passage of the Financial Center Development Act showed any signs of doubt that it was a very good thing.

The respected liberal lawyer Thomas Geoghegan points to the significance of this episode.[18] "Some people still think our financial collapse was the result of a technical glitch—a failure, say, to regulate derivatives or hedge funds," he wrote. "No, the deregulation that led to our Time of Troubles was of a deeper, darker kind. The problem was not that we 'deregulated the New Deal' but that we deregulated a much older, even ancient, set of laws . . . the laws against usury, which had existed in some form in every civilization from the time of the Babylonian Empire to the end of Jimmy Carter's term, and which had been so taken for granted that no one ever even mentioned it to us in law school. That's when we found out what happens when an advanced industrial economy tries to function with no cap at all on interest rates."

This probably overstates the case: There is no single explanation for the latest crisis. Still, Geoghegan has identified an important contributing factor. The elimination of usury caps spilled out into a wide variety of financial fields.

Credit card debt, money market funds, and numerous other instruments that fueled the borrowing binge and the crisis—the removal of interest rate caps—had effects that are incalculable.

Having helped deregulate and boost the supply of debt, Delaware also set about getting a share of the demand side. It did this by setting itself up as a major player in the securitization industry—the business of parceling up mortgages and other loans, including on credit cards, and repackaging the debt and selling it on. Once again, Delaware did this simply by establishing the exact legal framework that corporations demanded.

The Delaware Financial Center Development Act of 1981 itself contained a section eliminating "affiliated finance companies" from all state taxes. These act like banks but aren't formally banks, so they fall

outside banking regulations. Along with structured investment vehicles and their like, these are a core part of the global "shadow banking system"[19] that dragged the world into economic crisis from 2007. These companies were especially prominent in the United States, notably in Delaware. In 1983 a new International Banking Development Act got Delaware into the new offshore game of international banking facilities. When that was enacted, Chase and several other banks promptly moved foreign offshore activities to Delaware.

Biondi outlines several other statutes that followed and his role in them.

"I wrote those bills with my boys here," he said. The 1986 Foreign Act Development built on the 1983 legislation designed to let foreign banks take advantage of Delaware's regressive bank franchise taxes. New tax legislation in 1987 enticed banks that wanted to get into dealing securities. "My staff and I wrote it," Biondi explained. "We represented Morgan, Chase, Citicorp, Bank of New York, and Bankers Trust." Biondi's team also wrote the Bank and Trust Company Insurance Powers Act of 1989, authorizing banks to sell and underwrite insurance.[20] The Delaware Statutory Trust Act of 1988, giving huge flexibility to people setting up such trusts, and "the protection of trust assets from creditors," made Delaware the top jurisdiction for setting up so-called Balance Sheet CDOs, which allowed banks to offload their assets onto other investors and were another important contributor to the crisis.[21] A new act in January 2000 allowed Limited Liability Partnerships: a major contributor to the degradation of corporate governance, which I will soon explore in detail. There was also the Asset-Backed Securities Facilitation Act of 2002, which further opened the securitization spigots.

All these helped Delaware become, as one expert put it, "The Jurisdiction of Choice in Securitisation."[22]

Even more broadly, Delaware has played a central role in transforming global banking from its traditional fare of funneling savings into productive investments toward more speculative, risky, fee-based banking models. "Delaware recognized the quantum shift in the financial services industry toward fee based activities," said Swayze, "and it provided the legislative and regulatory framework to accommodate that shift."[23]

Now here is the big point. I do not claim that this story constitutes an explosive new revelation about the ultimate causes of the latest mortgage and financial disasters. This was just one among the many

tangled roots of the crisis—though an important one. My point is to show just what a tax haven is: a state captured by financial interests from elsewhere. Mark Twain said that

history does not repeat itself—but it rhymes. My next story, from thousands of miles across the Atlantic Ocean in the British tax haven of Jersey, rhymes almost perfectly with this tale from Delaware.

In June 1995 the director of Jersey's Financial Services Department met with a partner in Mourant du Feu & Jeune, a member of the so-called "Offshore Magic Circle," made up of the ten or so law firms most active offshore. They discussed a corporate form known as the Limited Liability Partnership (LLP).

A letter then began to circulate in Jersey political circles, dated October 9, 1995.

"My firm has been working with the UK partnership of Price Waterhouse (PW) and English solicitors, Slaughter and May, to find a method of obtaining some limited liability protection for the partners' personal assets without completely restructuring PW's business and losing the cultural benefits of a partnership," the letter said. After surveying several jurisdictions, it continued, Jersey was deemed the most suitable. "We are therefore seeking support of your Committee for the introduction of a Special Limited Partnership Law in Jersey during 1996."

In short, the private firms wanted to write a new law for Jersey. In fact, a draft law had already been prepared in London.

The letter urged Jersey's powerful Finance and Economics Committee to consider the law by December, then have it debated in the States Assembly the following January or February. "We would also propose that we would prepare any necessary subordinate legislation required in connection with the Special Limited Partnership Law. We appreciate that this is a very short time scale."

"It would be very important for PW and I believe, Jersey's finance industry, that the correct messages are sent to the media," the letter continued, proposing that Jersey's PR firm Shandwicks and Price Waterhouse's media team get straight to work.

The Big Four accounting firms—PricewaterhouseCoopers (PWC), Ernst & Young, KPMG, and Deloitte Touche—are giants: PWC employed over 146,000 people and generated $28 billion in revenues in 2008, making it the world's largest professional services firm. Auditors also occupy a very special place in the global economy. Their audits are the main tools by which societies know about, and regulate, the world's

biggest corporations: In a sense, they are the private police forces of capitalism.[24] Audit failures lie behind most great corporate scandals: Enron, WorldCom, and most of the collapses related to the latest financial crisis. Because of the extreme dangers bad audits pose to corporate capitalism in general, and to you and me in particular, governments try to regulate this profession with extra care.

Since the middle of the nineteenth century, limited liability has been part of a grand bargain at the heart of corporate governance. If a limited liability company goes bust, owners and shareholders may lose the money they invested, but their losses (or liabilities) are limited to that: They are not liable for additional debts the corporation has racked up. This concept was controversial when it was first introduced: It was feared that it would erode standards of accountability, but it was justified on the grounds that these investor protections would encourage people to invest and boost economic activity. But there was a caveat: In exchange for the gift of limited liability, corporations must agree to have their accounts properly audited, and have these audits published, to open a true and fair window into what they were up to. It was an early-warning system to keep the risks manageable.

By contrast, a general partnership is very different from a limited liability company. Investors in a partnership are experienced professionals who should know what they are doing, and they have unlimited liability. When things go wrong they are personally liable for all losses: Creditors can theoretically take even the shirts off the partners' backs. Since they have given up the right to shift losses onto the rest of society, partners are held to less stringent standards of disclosure. Partners were also subjected to "joint and several" liability, in which a partner is liable not only for his or her own mistakes but also for the mistakes of others in the partnership.[25] All this helps focus auditors' minds on doing their job properly—and to police their colleagues too.

Konrad Hummler, the managing partner of an unlimited liability company, Wegelin Private Bank, in Switzerland, explains what it is like to operate under such rules.[26]

"Partners who have [joint and several] unlimited liability have a solidarity; the dynamic within the group is totally different," Hummler said. "On so many boards—and I have quite some experience of this—one doesn't dare to ask the right questions. This [unlimited liability] is the only way of doing business where you dare to ask the really difficult questions—mostly the simplest questions. I will say, 'Listen, Mr. Chairman, I still don't understand the case.' The chairman will say, 'You

obviously haven't read your papers properly.' At this point I don't stop the discussion, but I say again, 'Mr Chairman I still don't understand this bloody thing.' That's the difference. Because of your unlimited liability, you think twice."

Joint and several unlimited liability for partners in audit firms is clearly, given their special role in policing modern capitalism, a very good idea.

What was being proposed in Jersey, however, was different again: a law allowing limited liability partnerships (or LLPs.) An LLP for accountancy firms is an example of having your cake and eating it: An LLP partner not only gets the benefits of being in a partnership—less disclosure, lower taxes, and weaker regulation—but it gets the limited liability protection too. And if a partner commits wrongdoing or is negligent, other partners who are not involved aren't accountable for the consequences. This law was the product of what Professor Prem Sikka, of Essex University, calls auditors' ultimate aim "to use the state to shield it from the consequences of its own failures."[27] For those involved, it is the best of all worlds. For the rest of society, it is the worst of all worlds.

The draft Jersey LLP Act was worse still. LLPs would not need to have their own accounts audited or even to say on their invoices or letterheads that they were registered in Jersey. It had no provisions for regulating audit firms or investigating misdemeanors, and it offered other audit stakeholders—that is, the public—almost no rights. To get these astonishingly generous concessions from the public at large, these multibillion-dollar global corporations would have to pay a one-time fee of just ten thousand pounds at first, then five thousand pounds a year afterward.

As with the liberalization of usury provisions in Delaware, the Jersey proposal was a delayed reaction to the ideological revolution associated with Ronald Reagan and Margaret Thatcher: a shift away from the view that competitive markets need robust regulation to a childlike faith in self-regulation by market actors.

Big accountancy firms had already gotten LLPs in the United States after first influencing the Texas legislature in 1991; within four years nearly half of U.S. states had it. These limited liability provisions "took away the most powerful incentive for self- policing by the corporate professions of law and accounting," wrote the tax expert David Cay Johnston, and "help explain the

wave of corporate cheating that swept the country."[28] Already there was evidence from the United States that whenever these provisions are introduced, less time is allocated to each audit, and quality suffers. It is nearly impossible to provide a smoking gun in such cases, but these kinds of concessions were undoubtedly important factors in the Enron and WorldCom disasters and in the destruction of Enron's auditor, Arthur Andersen LLP.

In Britain, following high-profile audit failures such as BCCI, Polly Peck, and many others, auditors had already squeezed major concessions out of the government, having won the right in 1989 to be limited liability companies[29]—though few audit companies converted, since many did not want to have to publish their accounts. A British House of Lords decision in 1990 worsened matters, ruling that auditors owe no "duty of care" to any individual stakeholder injured by audit failures.

Still, the UK had been holding out against an LLP law and for once was doing the right thing. "The UK . . . wanted to tell the world, 'You can trust London,'" said Sikka, who researched the Jersey LLP affair. "If it is impossible to sue the auditors, that makes it harder to look clean." The accountants had other ideas. "I think the calculation was that if the UK fell, the rest of Europe would fall, and the former British Colonies would also fall into place. They thought: 'If the UK gets going, everything else is won.'"

The accountants' strategy was simple: find an easy-to-influence legislature offshore, win LLP concessions there, then threaten to relocate there if the UK refused to create its own LLP law. First they approached the Isle of Man, then Guernsey, for an LLP law, but they were turned down. Then they came to Jersey, which is, as Jersey senator Stuart Syvret put it, "a legislature for hire."

A month after that initial letter, Price Waterhouse and Ernst & Young publicly announced the proposed Jersey LLP legislation. Senior Jersey politicians had assured them that the bill would be "nodded through," as one insider notes.

Not everybody was happy. Jersey's senior law draftsman complained that the new law was like "getting a completed crossword and being asked to write the clues." Syvret remembers first coming across the proposed law. "I knew bugger-all about accountancy, and suddenly it was on our desks and we had to debate it in two weeks," he remembers. He and Gary Matthews, one of the only other dissidents in the legislature to smell a rat, set about educating themselves about LLP laws. Matthews contacted a British parliamentarian, Austin Mitchell,

who in turn called Sikka. They soon began to understand what this law meant. Matthews put it bluntly. “This law is poison.”

Sikka remembers Matthews and Syvret first contacting him as they scrambled to get up to speed. “Gary Matthews said, ‘They want to rush this through parliament and I don’t understand a word—and other people I’ve spoken to don’t understand it either.’” “I’d been there on holiday but had taken no interest in this funny little island, until that fateful call from Gary Matthews. The more we looked into it, the more rotten the place looked.”

Matthews and Syvret were up against a well-resourced and motivated establishment on an island whose very political structure makes dissent extremely hard. Jersey has no political parties. The 53 members of the States (or government) are directly elected, but in three separate groups: 12 senators, 29 deputies, and 12 parish constables (known as connétables). Elections are staggered over time, so there has never been a general election or a change of government. There is no tradition of “government” versus “opposition” but instead a permanent regime that evolves over time.

This dramatically weakens opponents of an establishment consensus. “When bad men combine,” the conservative thinker Edmund Burke wrote, “the good must associate; else they will fall, one by one, an unpitied sacrifice in a contemptible struggle.” Without political parties, good men and women are isolated, then picked off.

“Democracy doesn’t work here,” said Geoff Southern, one of few dissident deputies in the Jersey assembly. “There are 53 Members, but nobody can stand up and say, ‘Vote for us and we will do this as a bloc.’ Instead, it’s ‘I am a good bloke—vote for me.’ Manifestos are just candy floss.”[30] Jersey politics is about personalities, not issues; without shared platforms States Assembly members tend to look after themselves rather than embrace common agendas more likely to reflect the public interest. “For the last two hundred years the establishment has cultivated the notion that party politics is wicked, divisive, and harmful,” Southern said. “The media spreads it. If you did a survey, I expect two-thirds would say they think party politics is a bad idea. Propaganda is everywhere. The media here is like in Soviet Russia.”

Voter turnout reflects the absence of local democracy. The 33 percent turnout in the November 2005 election would have put Jersey in 165th position of 173 countries in a world ranking: marginally better than Sudan and far below the 77 percent European average since 1945.[31]

Poorer voters are especially disenfranchised, facing endless little hurdles that deter them from voting. Much of the Portuguese-origin working class subgroup that makes up nearly 10 percent of the population is unaware they even can vote, Southern said; voters must reregister every three years, and he has found dead people on his voters' rolls.

The connétables, by virtue of the parochial system through which they emerge, are intrinsically conservative and inexperienced, and make a powerful voting bloc—voting with the establishment every time. They tend to be small shopkeepers, farmers, guest house owners, and plumbers, and they get into major positions of power, and into the finance sector. When it comes to decisions on whether Jersey should adopt a global standard of banking regulation, they are unable to judge responsibly. A Wall Street Journal article in 1996 noticed, "Jersey is an island that until two decades ago lived off boat building, cod fishing, agriculture and tourism. It is run by a group who, although they form a social and political elite on Jersey, are mostly small-business owners and farmers who now find themselves overseeing an industry of global scope involving billions of dollars."[32] The article goes on to report the judgment of John Christensen, who was Jersey's economic adviser at the time: "By and large they are totally out of their depth."

Christensen remembers a legislature made up largely of small-town politicians with no understanding of the complex currents of international finance and who simply pass legislation through on the nod. "When I talked to the politicians on the Finance and Economics Committee," he said, "time and time again I talked about proposals coming forward. They said, 'I'm being honest John: I don't understand the detail, but I trust the lawyers and the bankers when they say it is necessary.'" The similarities with what members of the Delaware legislature were saying in 1980–81 are striking.

It is as if a vast global financial center had been tacked onto a couple of small-town parish councils in England or a smaller U.S. county. "They can argue at enormous length about the budget for the local pony club," said Christensen, "but a new limited liability law or a new trust law will go unchallenged. It's the captured state."

Syvret also noticed that Senator Reg Jeune, one of the most powerful politicians on the island and a major supporter of the LLP legislation, was simultaneously a consultant to Mourant du Feu & Jeune, the lawyers who had brought in the legislation in the first place: He had a direct

financial interest in supporting it. “I thought, ‘Whoa!’ This is extraordinarily brazen,” said Syvret. “When the States Assembly convened I stood up and said that Jeune has a conflict of interest—a financial interest. Jeune looked as though somebody had shot him. He staggered out of the chamber.”[33]

Syvret came under ferocious pressure from the Jersey establishment to apologize. He declined, was pressed again, and refused again. Another top politician threatened him with “serious implications” if he did not recant, adding, “which is a pity, since you had such a lot to offer.” The politician emphasized the word had, which Syvret took as a threat.

He stood his ground. “I just wasn’t going to take that crap,” he said. He was suspended from parliament, and in States Assembly deliberations in his absence he and Matthews were referred to as “The Enemy Within.” Sikka, for his part, was called “Enemy of the State.”

Senator John Rothwell, responding to Matthews’s concerns, pointed to the Jersey establishment’s approach to ethics. “The Island has done extremely well in projecting an image of low-profile respectability,” he said, “but people in the finance industry, having heard speeches in the House about ethics of government, are getting rather twitchy about what members might embrace.”[34] Rothwell, a public relations adviser by trade, knew exactly what he was saying. Oppose the LLP law and the financial services industries will see Jersey as unreliable—and the money will go elsewhere.

Matthews’s and Syvret’s robust challenges slowed the fast-track passage of the legislation but did not stop it: It was finally enacted in November.

In elections that year, well-financed candidates stood against Matthews under the banner “Don’t Rock the Boat,” and Matthews was vilified in public. He lost his seat and was unable to get a job afterward. He fled to England and his marriage fell apart. As Sikka put it, “They put that man through the mincer.”

On the surface Jersey feels terribly British, and the island’s rulers always say it is a well-regulated, transparent, and cooperative jurisdiction. The reality is shockingly different. It is a state whose leadership has essentially been captured by global finance and whose members will threaten and intimidate anyone who expresses dissenting views.

After the LLP law passed, the accounting firms next opened a new front in London. They publicly threatened to relocate to
Jersey if the UK did not create its own LLP law.

Sikka fought to stop it. “We told the politicians, ‘You can’t concede

this—these firms have held you to ransom,'" he said. He wrote in The Times of how harmful this legislation would be, and that the Jersey card was clearly a bluff. He noted that the big firms would never close up in London, sack their clients and staff, renegotiate contracts, and reopen in Jersey. "If the Government were to concede a liability cap to auditors, it would hardly be able to deny the same to producers of food, drink, medicine and cars. None of this would be welcomed by consumers."

The Financial Times saw the real agenda too. The accountants "want to keep the threat of moving 'off-shore' as a cosh with which to threaten the [UK] government if it fails to come up with a workable LLP law," it said.

But the accountants got most of the British financial press behind them, roundly criticized Sikka, and wielded the old favorite that Britain's government was "anti-business."

The campaign worked. Britain passed its LLP law in 2001. The accountants never did relocate to Jersey: They had simply used it as a crowbar. "It was the work that Ernst & Young and Price Waterhouse undertook with the Jersey government," an Ernst & Young partner crowed, "that first concentrated the mind of UK ministers…. I've no doubt whatsoever ourselves and Price Waterhouse drove it on to government's agenda because of the Jersey idea."[35]

As Sikka put it: "The Jersey sprat had served its purpose, now that the UK mackerel had been landed."[36]

The UK law was not quite as bad as the Jersey one—it involves more disclosure, for example—and perhaps Sikka's campaigning helped. Yet it still drastically diluted auditors' incentives to take care over their accounting. Ernst & Young became an LLP in 2001; KPMG went in May 2002; PricewaterhouseCoopers made the move in January 2003; Deloitte & Touche followed that August. A host of lawyers, architects, and others joined in, getting the tax perks and limited disclosure available to partnerships but with limited liability. Canada took on the LLP law in 1998; it has been followed by New Zealand, Australia, South Africa, Singapore, Japan, and India—to name a few. These different countries' LLP laws can only have contributed to the latest financial crisis. Had auditors faced getting personally into big trouble when they or their partners screwed up, they might not have been so hasty to sign off on all this off-balance-sheet financing.

The Jersey and Delaware episodes are stunningly similar despite happening fifteen years and an ocean apart and concerning entirely different subject matter. Deep truths about global finance are at work

here. Robert Kirkby, technical director for Jersey Finance, described the generic process. “Someone comes up with a new idea but onshore regulation blocks it,” he said. “You can lobby onshore but there are lots of stakeholders: you have to get past them all, and it takes a long time. In Jersey, you can bash this thing through fast. We got the leading edge years ago. We can change our company laws and our regulations so much faster than you can in, say, the UK, France or Germany.” Talking in March 2009, in the depths of the financial crisis provoked by reckless deregulation, Kirkby lauded Jersey’s new unregulated funds regime specializing in securitization—the pooling and repackaging of mortgages and other assets into securities to sell on to investors that has caused such mayhem.

Here in these deregulated offshore zones our democratic controls on finance and business are being hollowed out, year after year, around the world, out of sight.

I have no objection to deregulation in principle, as long as it is a process of genuine—and I mean genuine—democratic bargaining that considers the needs of all affected stakeholders, at home and overseas. What we have in Jersey and Delaware, by contrast, is rampant, uncontrolled deregulation, harnessed to the interests of a few insiders and large corporate players.

Just as European nobles used to consolidate their unaccountable powers in fortified castles, to better subjugate and extract tribute from the surrounding peasantry, so financial capital has coalesced in offshore’s fortified nodes of unaccountable political and economic power, capturing local politics in these jurisdictions and turning them into fast and flexible private law-making machines, defended against outside interference and protected by establishment consensus and the suppression of dissent.

Offshore is not just a place, an idea, a way of doing things, or even a weapon for the finance industries. It is also a process: a race to the bottom where regulations—laws and trappings of democracy—are steadily degraded, as one arrangement ricochets from these fortified redoubts of finance to the next jurisdiction, and the offshore system pushes steadily, further, deeper, onshore. The tax havens have become the battering rams of financial deregulation.

Most people have not yet understood these deep truths about offshore, because of two related confusions.

The first stems from efforts to use technical criteria to define secrecy jurisdictions: tax rates, forms of secrecy, and so on. But these are just

outcomes of the deeper truths. Our maps of offshore need to identify, first of all, these strongholds of financial

power. A definition like my loose one—that secrecy jurisdictions are places that seek to attract money by offering politically stable facilities to help people or entities get around the rules, laws, and regulations of jurisdictions elsewhere—helps us see what we are looking for.

A second confusion is to think that this is about physical geography, when it is really about political jurisdiction and trust- based networks. The future that the offshore system promises has a distinctly medieval quality: In a world still nominally run by democratic nation-states, the offshore system is more like a network of guilds in the service of unaccountable and often criminal elites.

These stories of Delaware and Jersey should serve as a warning to larger economies about what happens when the offshore ethic isn't challenged.

The Delaware story is one part of an explanation of how offshore contributed to the latest financial crisis, and the Jersey example helps explain why nobody saw it coming. Both of these jurisdictions got rich by eroding standards in the service of financial capital. The consequences are not just insidious but devastating.

In considering how the offshore system contributed to the financial and economic crisis, it's useful to look at the issue of debt. Why has so much debt built up in the world's richest economies? An article in the Financial Times in June 2009 ("Debt Is Capitalism's Dirty Little Secret") provides one answer. "The benefits of economic growth have gone into the pockets of plutocrats rather than the bulk of the population," the article reads. "So why has there been no revolution? Because there was a solution: debt. If you couldn't earn it, you could borrow it." As we have seen, the infrastructure was put in place to make this change happen. The tax havens were a big part of it.

As the 1990s progressed, occasional expert warnings about systemic, debt-related threats from offshore did emerge.

The IMF pointed squarely at the problem in 1999 when discussing the interbank market, where banks lend to each other. "A large part of the growth in OTC trading of derivative instruments may have involved offshore banks," the IMF said.[37] "The interbank nature of the offshore market implies that, in the event of financial distress, contagion is

likely…. Offshore banks are likely to be highly leveraged, that is less solvent, than onshore banks." The report, which contains plenty more along these lines, frets especially about lax offshore regulation. It was a direct warning, long before the crisis struck.

That report followed soon after the implosion of the hedge fund Long Term Capital Management (LTCM), a classic slice-and- dice offshore structure that nearly destroyed the U.S. banking system in 1998 after the fund took on massive risks, covered by near-paranoid secrecy. LTCM's managers were in Greenwich, Connecticut; the hedge fund was incorporated in Delaware; and the fund it managed was in the Cayman Islands. Yet none of the agonized analyses that followed took any serious interest in the offshore angle.[38] And the pattern just keeps being repeated.

The latest financial crisis was incubated in the so-called "shadow banking system"—a vast, unregulated economic terrain containing all manner of Special Purpose Entities (SPEs, also known as shadow banks) that borrowed money to lend out again at a profit but fall outside normal bank regulation, partly by separating themselves legally from the regulated institutions that sponsor them, off their balance sheets.

The shadow banking system is not traditionally described as either an "offshore" or "onshore" phenomenon, but an in-depth 2008 study on SPEs by the Swiss-based Bank for International Settlements is very clear about where the dangerous shadow banks were mainly located.[39] "The most common jurisdictions for US securitisations are the Cayman Islands and the state of Delaware," the BIS said. "The most common SPE jurisdictions for European securitisations are Ireland, Luxembourg, Jersey, and the UK." Every last one is a major secrecy jurisdiction that used a simple business model: ask the financial institutions exactly what they need, then shape the laws accordingly and without democratic debate.

The BIS report calls Cayman "offshore" and Delaware "onshore."[40] It is exactly this misunderstanding—confusing physical geography with political geography—that has led to widespread claims that the secrecy jurisdictions had nothing to do with this gigantic mess. The Bank for International Settlements, along with every other major international financial institution, needs to understand what offshore is and how it works.

Among the only academic experts to have seriously examined offshore's role in the financial crisis is Jim Stewart, senior lecturer in finance at Trinity College, Dublin.

In reports in July 2008 Stewart investigated the Dublin International Financial Services Centre (IFSC), a secrecy jurisdiction set up in 1987 under the corrupt Irish politician Charles Haughey with help primarily from City of London interests.[41] A showcase for high-risk, Wild West financial capitalism, the Dublin IFSC emerged the year after London's giant deregulatory Big Bang and now hosts over half the world's top 50 financial institutions. It became a big player in the shadow banking system and now hosts eight thousand funds with $1.5 trillion in assets. Perhaps most alluring of all Dublin's lures, Stewart said, is its "light touch regulation."[42]

In June 2007 two Bear Stearns hedge funds incorporated in the Cayman Islands announced huge losses, presaging its collapse. Bear Stearns had two investment funds and six debt securities listed on the Irish Stock Exchange and operated three subsidiaries in the Dublin IFSC through a holding company, Bear Stearns Ireland Ltd., for which every dollar of equity financed $119 of gross assets—an exceedingly high and dangerous ratio.

The accounts of Bear Stearns Ireland Ltd. state that it was regulated by the Irish Financial Services Regulatory Authority, and EU directives state that the host country—Ireland, in this case—is responsible for regulation. Yet in an interview, the Irish regulator said he considered his remit to extend to "Irish banks": It was effectively regulated nowhere. The Irish regulator did not feature in any media analysis of Bear Stearns's insolvency; Stewart cited nineteen funds in difficulties in the crisis and added that "almost always, the IFSC link is not discussed."

Several German banks that got into trouble also had funds quoted in Dublin. These included IKB, which got €7.8 billion in German state aid; and Sachsen, which got €17.8 billion of emergency funding and €2.8 billion in state aid. "And yet none of the accounts or prospectus for any of the years examined mentioned regulation or the Irish regulator," Stewart reported. "Within Ireland the Financial Regulator has been quoted as saying that they have no responsibility for entities whose main business is raising and investing in funds based on subprime lending." The Financial Times analysis of the episode laid the blame almost entirely on the structure of the German banking system.

In Ireland, Stewart noted, if the relevant documents are provided to the regulator by 3 P.M., the fund will be authorized the next day. Yet a prospectus for a quoted instrument is a complex legal and financial

document; a debt instrument issued by Sachsen

Bank ran to 245 pages. The regulator could not have assessed it in the two hours between 3 P.M. and the normal close of business. In Luxembourg, Stewart noted, a new law stated that a fund can enjoy preauthorization approval if the fund manager "notifies" the regulator within a month of launch.
It is the captured state, over again.

In April 2010 the U.S. Securities and Exchange Commission (SEC) opened a fraud probe into Goldman Sachs, alleging that it misled investors by misrepresenting the role of a CDO in a deal known as Abacus 2007-AC1. In July 2010 Goldman agreed to pay $550 million to settle the charge without admitting or denying the SEC's allegation. The deal's structure is notable[43]:

> Issuer: ABACUS 2007-AC1, Ltd., Incorporated with limited liability in the Cayman Islands.
> Co-Issuer: ABACUS 2007-AC1, Inc., a corporation organized under the laws of the state of Delaware.

McClatchy's, the only mainstream media organization to investigate the deal's offshore nature, found 148 such deals by Goldman Sachs in the Cayman Islands over a seven-year period.[44] In fact, every big Wall Street player used the Caymans for this business. These deals "became key links in a chain of exotic insurance-like bets called credit-default swaps that worsened the global economic collapse by enabling major financial institutions to take bigger and bigger risks without counting them on their balance sheets . . . sheltered by the Caymans' opaque regulatory apparatus."

It was not so much the Caymans' opacity that attracted these large players—though that helped—as its "flexibility." When tax haven supporters say they promote "efficiency" in global markets, this is the kind of thing they are talking about. At the heart of this efficiency is these jurisdictions' flexibility, which, as we have seen, is really about their political capture by financial capital. Whatever the banks want, they get. And from this flows power.

Rudolf Elmer, a senior accountant in a Swiss bank's Caymans office until 2003, takes the story further.[45]

Supervision in the Caymans was especially lax, he said. "Even if you have the right regulatory framework," he said, "you need the brainpower to audit the banks and companies. There is a general lack of this in the offshore world. You get a lot of high-risk issues running through the islands, being covered by junior auditors in CIMA [the Cayman Islands Monetary Authority]."

One of his office's functions was to take out cheap short-term loans and invest the proceeds in longer-term assets with higher rates of return. This is an easy way to make tax-free money—but it is dangerous too: You must "roll over" short-term loans every few days, replacing one loan with another. This is easy in the good times, but when lending dries up, as it did in 2007, you must still repay the short-term loans fast—but suddenly nobody will provide new loans to replace them. You can fall into default very quickly. This is exactly what brought down the British bank Northern Rock in 2007. Yet the Caymans regulator, Elmer said, took an extremist laissez-faire approach to these so-called maturity mismatches. "This is a short-term and long- term problem," said Elmer. "From a regulatory point of view we couldn't have done that in the UK or Switzerland. The Cayman Islands Monetary Authority (CIMA) should have picked that up."

Elmer was involved in two CIMA audits. In the first one, he and his local CEO talked for an hour or so with a CIMA official. "The CIMA person said, 'Is it the same as it used to be?' The CEO said, 'Yes, it is the same.' The CIMA guy said, 'No problem.' The Cayman regulator knew our CEO well, and he knew he would tell him the truth. Personal relationships were key." A subsequent, later audit was more extensive and lasted about a week. "You have to be very experienced in that sort of thing," said Elmer. "Two junior auditors came in and made a lengthy report, which had little content. I went through those audits, and from a regulatory point of view, they were not sufficient at all." No further action was taken.

"It was quite crucial for [our] group to use Cayman and BVI vehicles," he said. "It boils down to three things: tax, regulatory, and legal advantages. You have a lot of freedom."

This extreme freedom, turning the secrecy jurisdictions into hothouses for risky new banking products, contributed massively to the crisis of the world's major economies.

The rise of debt in our economies has yet more offshore fathers. There is only space here briefly to sketch a few important ones.

In 2009 the IMF published a detailed report explaining how tax havens, combined with distortions in onshore tax systems, cranked up the global debt engine by encouraging firms to borrow rather than finance themselves out of equity.[46] These effects, it said, "are pervasive, often large—and hard to justify given the potential impact on financial stability." Amid all the noise from G20 leaders about tax havens in 2008 and 2009, the IMF concluded, this dangerous offshore aspect went entirely unnoticed.

The core principles the IMF outlined are simple. A corporation borrows money from offshore, then pays interest on that loan back to the offshore financing company. It then uses the old transfer pricing trick: the profits are offshore, where they avoid tax, and the costs (the interest payments) are onshore, where they are deducted against tax.

This simple trick is central to the business model of private equity companies. They will buy a company that someone has sweated for years to create, then load it up with debt, cutting the tax bill and magnifying the returns.

Leveraged buyouts—always involving offshore leverage—accelerated fast ahead of the crisis: The amount raised by private equity funds rose more than sixfold from 2003 to over $300 billion in 2007, by which time their share of all U.S. merger and acquisition activity had risen to 30 percent.[47] Reports praise private equity companies for excellent "value creation." Sometimes private equity companies do create real value. But this core feature of their business model is not value creation but value skimming. A big tax bill is slashed, the company's shares or value rise, managers' remunerations become engorged, and wealth is shifted away from taxpayers to wealthy managers and stockholders. Nowhere in any of this did anyone produce a better or cheaper widget. And in the process, extra debt is injected into the financial system. Plenty of good firms have gone bust as a result of this offshore debt-loading, which the New York Times in 2009 described as "a Wall Street version of 'Flip This House.'"[48] More than half of the companies that defaulted on their debt that year were either previously or currently owned by private equity firms.

A lot of innovation that corporations do—I'm talking about useful innovations to make better and cheaper goods and services, not the

financial innovations that simply shift wealth upward and risks downward along the social scale—happen in small and medium enterprises. But the offshore system works directly against this.

First, it subsidizes multinationals by helping them cut their taxes and grow faster, making it harder for the innovative minnows to compete. And when small innovative firms do emerge they becomes targets for predators who seek to "unlock value" from "synergies" created by bringing the small firm into the bigger, more diversified one. Some synergies may be useful— economies of scale, for instance—but too often the predator can "unlock value" simply by being better at squeezing out these abusive, unproductive offshore tax privileges. Some make their best profits by seeking out and harvesting those small, genuinely innovative companies that haven't yet been abusive enough on offshore tax avoidance to "unlock" those abuses for themselves.

This harvesting then removes nimble, competitive, and innovative firms from the marketplace and relocates them inside large corporate bureaucracies, curbing competition and potentially raising prices. Debt rises, and ordinary people pay more tax, or see their schools and hospitals fall into disrepair. And if the predators leave their earnings offshore they can "defer" tax on them indefinitely. Deferred taxation is, as the accountant Richard Murphy puts it, "an interest-free loan from the government, with no repayment date." In other words, more debt.

Consider what happens when this multinational corporation is a bank. Like multinationals on steroids, banks have been particularly adept at going offshore to grow fast: by using it to escape tax, to dodge reserves requirements and other financial regulation, and to gear up their borrowings.

Banks achieved a staggering 16 percent annual return on equity between 1986 and 2006, according to Bank of England data,[49] and this offshore-enhanced growth means the banks are now big enough to hold us all ransom. Unless taxpayers give them what they want, financial calamity ensues. This is the "too big to fail" problem—courtesy of offshore.

But even that is still not all.

This one takes a little bit of explanation. Many blame the latest crisis not just on deregulation but also on global macroeconomic imbalances, as funds have flowed from countries with export surpluses, like China, India, Russia, and Saudi Arabia, and into deficit countries like the United States and Britain. This has led to overconsumption and borrowing in the deficit countries.

Now look at Global Financial Integrity's estimate that illicit financial flows

out of developing countries has been running at up to a trillion dollars each year. Most has flowed out of large developing countries like China and Russia and Saudi Arabia and into large OECD countries like Britain and the United States. Illicit flows in the other direction are much smaller, so the net result is a flow worth hundreds of billions of dollars each year into rich economies and secrecy jurisdictions.[50] The illicit flows, which are unrecorded and hardly noticed, add to those recorded imbalances.

Let's look quickly at what happens on the ground. Imagine a Mexican company orders construction equipment from the United States and agrees to a price of $10 million. But the Mexican company asks for the commercial invoice to be drawn to read $12 million. The buyer does this because when he pays his $12 million, $2 million of that is secretly deposited into his Miami bank account. The missing $2 million is invisible to the numbers crunchers who compile the trade statistics—though it represents a very real illicit financial flow from Mexico to the United States—and it has tangible effects: It will push up U.S. house prices, distort the U.S. housing market, and boosts bank profits from their mortgage operations. First-time buyers find it harder to get on the property ladder, a housing bubble inflates further, and debt builds up in the economy.

As if all this were not enough, there is yet more.

Trust is a central ingredient in any economy. Where participants in a market don't trust each other, expensive litigation substitutes for honest behavior. And there is nothing— nothing—like the offshore system to generate opacity and erode trust and the behavioral constraint. When nobody can find out what a company's true financial position is until after the money has evaporated, trickery and bamboozlement abound. Financial markets seized up in 2007 because nobody knew, or trusted, what the other players in the market were doing, or what they were worth, or what or where their risks were. It is no coincidence that so many of those involved in great financial trickery, like Enron, or the empire of the fraudster Bernie Madoff, or Sir Allen Stanford's Stanford Bank, or Long Term Capital Management, or Lehman Brothers, or AIG, were so thoroughly entrenched offshore.

The secrecy jurisdictions specialize in bamboozlement. Along with the secrecy, and a curmudgeonly reluctance to co- operate with foreign jurisdictions, the offshore system provides endless incentives for corporations—especially financial ones
—to festoon their affairs across jurisdictions, usually a complex mix of

onshore and offshore, to fox the regulators. These giant impenetrable offshore trails, sliced, diced, and trailed around the world, increased the distance between the lenders and their borrowers until bankers no longer knew who their ultimate clients were. It is hardly a surprise that the Royal Bank of Scotland in 2003 offered a gold credit card with a ten-thousand-pound spending limit to a Monty Slater in Manchester, England. Monty Slater was a Shih Tzu dog.[51]

John Maynard Keynes summed up the problem well. "Remoteness between ownership and operation is an evil in the relations among men, likely or certain in the long run to set up strains and enmities which will bring to nought the financial calculation."

With this observation, Keynes exposed the flaw in the grand bargain at the heart of the globalization project. In giving freedom to finance, people in democratic nation-states lost their freedom to choose and implement the laws and rules that they wanted. But they handed these freedoms to the world's financiers in exchange for a promise: that the efficiency gains from those free financial flows will be so great as to make that loss of freedom worthwhile.

The tax havens helped bring this calculation to naught.

CONCLUSION
Reclaiming Our Culture

JOHN MAYNARD KEYNES'S OBSERVATION IN THE AFTERMATH of the Wall Street Crash, which I cited in chapter 3, is as apt today as it was when first articulated: "We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand." But the financial system is vastly more dangerous and pervasive now. Changes to domestic banking regulations matter but will never suffice. Reform must be based on a thorough grasp of the new, globalized reality—and anyone who wants to understand the modern financial machine must understand what tax havens are and how they work.

We must tackle the offshore system. I will point to ten major areas for change, in no particular order and as briefly as I can. All overlap with each other—and the last ties them all together.

First, we can pursue transparency. Many and varied changes are needed; here are two.

About 60 percent of world trade happens inside multinational corporations, which cut taxes by shuffling money between jurisdictions to create artificial paper trails that shift their profits into zero-tax havens and their costs into high-tax countries. The complexity and cost of this system cause great harm.

But these maneuverings are invisible in corporations' annual reports. Under current accounting rules corporations can scoop up all their results—profits, borrowings, tax payments, and so on—from several countries and consolidate each into one figure, perhaps broken down by region. So a corporation may publish its profits from, say, Africa, but nobody can unpick those numbers to work out the profits in each country. You can't find the information anywhere. Trillions of dollars' worth of cross- border flows simply disappear from view. So a citizen in a country where a multinational operates cannot tell from these reports even whether that corporation operates there, let alone what it does, its level of activity, its profits, its local employment, or its tax payments. As multinationals become ever more complex, this problem just gets worse.

One might think that the main global rule-setter for international accounting standards would be a public international body accountable

to democratic governments. It is not. The International Accounting Standards Board (IASB) is a private company financed by the Big Four accountancy firms and global multinationals, headquartered in the City of London, and registered in Delaware.[1]

Richard Murphy, an accountant arguing for reform of international accounting standards, summarizes the problem as it stands. "A company gets its license to operate in any territory from the government that represents those people. It has a corporate duty to account in return. This is the essence of stewardship and accountability. Instead we have companies pretending they float above all these countries. They don't."

If multinationals had to break their financial information down by country and disclose what they do in each place, global markets would immediately become more transparent. A secret trove of information vital to citizens, investors, economists, and governments would come onshore and into view. Country-by-country reporting, as it is known, is already making progress in policymaking circles, particularly for the extractive industries.[2] It now needs major support and must be expanded to include all businesses—especially the banks.

Another essential step concerns how governments share information about the local incomes and assets of each others' citizens. If a person in one country owns an income-generating asset in another country, his or her tax authorities need to know about it. So governments need to share relevant information, subject to appropriate safeguards.

But the dominant standard for exchanging information is the OECD's "on request" standard: a cheats' charter whereby a country already has to know what it is looking for before it requests the information from another on a bilateral basis. Developing countries are particularly vulnerable here. The OECD's standard can be replaced by the far better alternative: automatic information exchange on a multilateral basis, where countries automatically tell each other what their respective taxpayers own and earn. Such a system exists in Europe: It works well and does not leak information (though major loopholes need plugging to defend against the Caymans trusts, Nevada corporations, Liechtenstein foundations, Austrian hidden Treuhands, and various other secrecy facilities that infest the offshore system). Momentum is just starting to build for change here[3]—and this can now be rolled out worldwide and vigorously supported. Sanctions and blacklists can spur the shift.

As a second major area for reform, we can prioritize the needs of developing countries.

The pattern always seems to be the same. A secrecy jurisdiction comes up with a new abusive offshore structure, and wealthy countries construct defenses against it as best they can. But poor countries, without the relevant expertise, are left wide open to the new drain. In February 2010 Misereor, a German development organization, researched the new information exchange agreements that had been signed between countries after world leaders promised to crack down on tax havens at a G20 meeting in Washington in 2008. Misereor found that just 6 percent of the tax treaties, and zero percent of the tax information exchange agreements, were signed with low- income countries. "While G20 and OECD are promoting DTTs and TIEAs as centre-pieces of a global standard on transparency and cooperation," Misereor concluded, "statistics show that poor developing countries are simply left out."[4]

Tax is the Cinderella in the debates about financing for development. Overshadowed for decades by its domineering sisters—aid and debt relief—tax is now, at last, starting to emerge from the shadows. Tax is the most sustainable, the most important, and the most beneficial form of finance for development. It makes rulers accountable to their citizens, not to donors, and the right kinds of taxes stimulate governments to create the strong institutions they need for getting their citizens and corporations to pay tax.

Three things can now happen. First, developing and middle-income countries can find a voice to articulate their concerns about this global system for transferring wealth from poor to rich and work together. A few countries like Brazil and India are beginning to construct serious offshore defenses, and the time is ripe for this to become a mass movement. Second, official development assistance in this area can rise dramatically: Less than one-thousandth of development aid is currently spent on helping countries improve their tax systems[5]—and much of that is spent on ideas that may make poverty worse, not better.

Third, if citizens and civil society organizations were to stop focusing so exclusively on aid, in order to help revitalize the debates about tax and its role in fostering accountability, things can change. Aid can help—but with ten dollars being drained out of the developing world for every dollar going in, we need new approaches. If there were ever a movement that could unite the citizens of developing and wealthy countries in one cause, this is it.

The third big change to make is to confront the British spiderweb, the most important and most aggressive single element in the global offshore system.

The City of London Corporation—the offshore island floating partly free from Britain's people and its democratic system— must be abolished and submerged into a unified and fully democratic London. The City's international offshore spider-web, the mechanism for harvesting and profiting from financial capital from around the globe, however dirty it may be, must be dismantled. It harms the people of Britain, and it harms the world at large. Britain is too thoroughly captured by the City and its offshore sector to do this alone: Pressure from outside is essential. Developing countries in particular need to appreciate how offshore is a somewhat imperial economic system, in which their own elites are deeply implicated. Alongside this new focus we need a greater understanding of the role of the United States as an offshore jurisdiction in its own right and the harm this causes, inside and outside the United States.

Onshore tax reform presents another arena where changes can be made. Endless possibilities exist, and I will focus on just two big, promising solutions that have been almost entirely overlooked.

The first is land value taxation.[6] This needs a very brief detour. A street musician who sets up his stall in the middle of the main street will earn far more than if he plays on the outskirts of town. The additional earnings on the best sites, over and above what he would earn on a just-worthwhile site, owe nothing at all to his skill or efforts[7]—they are pure, unearned "rental value." If a government builds a major new railway line, property owners near the new stations will see their properties rise in

value through no efforts of their own. It is pure windfall: unearned rental value. The correct approach to unearned natural rents like these is to tax them at high rates (and use the proceeds to either cut taxes elsewhere or spend more). This is not a tax on property ownership, but a tax on land: whether or not that piece of prime real estate is owned by a Russian oligarch hidden behind a Liechtenstein anstalt, the bricks of the building sited there are rooted firmly into the soil, and the tax can be levied. Because land cannot move, this tax is insulated against offshore escape. It encourages and rewards the best use of land and keeps rents lower than they would otherwise be.

Not only that, but a huge share of the profits of the financial sector derive ultimately from real estate business and land value. Tax land's rental value, and you capture a big slice of this financial business, however much it is reengineered offshore. When Pittsburgh became one of the few places in the world to adopt the tax in 1911, in the teeth of massive resistance from wealthy landowners, it had dramatic and positive effects: While the rest of America went on an orgy of land speculation ahead of the Crash of 1929, prices in Pittsburgh only rose 20 percent. Harrisburg's adoption of the tax in 1975 led to a dramatic inner-city regeneration. The tax is simple to administer and progressive (that is, the poor pay less)—and can be especially useful for promoting growth in developing countries.

Another promising, much-overlooked scheme concerns mineral-rich countries. Tides of looted or tainted oil money sluice constantly into the offshore system, distorting the global economy in the process. A radical and controversial proposal would upend this phenomenon by distributing a large share of a country's mineral windfalls directly, and without discrimination, to every inhabitant. This has only been implemented in a few places like Alaska, but in many other mineral-rich countries, even poor ones, it is feasible. Doing so could prevent hundreds of billions of dollars of stolen mineral-sourced loot from draining to offshore centers and deliver tremendous benefits for the populations concerned.

A corollary of onshore tax reform is leadership and unilateral action.

After the September 11, 2001, attacks, U.S. legislators tried to insert stronger anti-money-laundering provisions into the PATRIOT Act. In the halls of Congress, civility collapsed, and shouting matches erupted

between bank officials and congressional staffers.[8] Among other things, the bankers were defending offshore shell banks, which hide behind nominees and trustees so no one can know who their real owners and managers are. Senator Carl Levin who led the charge—after having had eleven transparency bills shot down by Senator Phil Gramm—stuck to his guns, and in the post-9/11 environment he at last got his way: remarkable provisions saying that no U.S. bank may receive a transfer from a foreign shell bank, and no foreign bank may transfer money to the United States that it has received from a foreign shell bank. The result, as Raymond Baker explains, is that "the thousands of shell banks that used to run loose have been reduced to perhaps a few dozen…. With a stroke of the legislative pen, a major threat to economic integrity has been almost completely removed from the global financial system." International agreement is generally a good thing, in cases like this. But leadership can work wonders too.

Too often, when corporations or individuals threaten to relocate offshore if they are taxed or regulated too highly, or asked to be too transparent, or to submit to criminal laws, government officials quail and give the wealthy owners of capital what they want. Not only that, but efforts to stop people from using abusive offshore loopholes are also greeted with the same cries of "Don't crack down on that loophole or we will go elsewhere!"

The latest crisis has made clear that much financial services activity is actually harmful. So if certain parts of the financial industry leave town—so much the better. Good projects will always find financing, whether or not your country is stuffed with foreign financiers, and local bankers are better placed to supply it because they know their customers. Tax and regulate the financial industries according to an economy's real needs, ignore the screams that capital and bankers will flit offshore, and you will tend to drive out the harmful parts, leaving the useful bits behind. The key is leadership. Unilateral action can work.

Another major task is to tackle the intermediaries and the private users of offshore.

Rudolf Strahm, a Swiss parliamentarian, studied every historical episode where Swiss bank secrecy has been loosened in response to foreign pressure and concluded that pressure only works when applied to Swiss banks. Every attempt to pressure the Swiss government was seen

as an attack on national pride—and failed.

When a kleptocrat loots his country and shifts the looted wealth offshore, the banks, accountants, and law firms that assist him are just as guilty as the kleptocrat. When a client gets caught and goes to jail, so should his or her relationship manager, accountant, trustee, lawyer, and corporate nominee. A few organizations like London-based Global Witness have sought to call these intermediaries to account—but we now need a sea change in the world's approach. Get serious with these people at last.

As regards the end users of offshore services, many strategies are needed. I will mention just one. Its awful-sounding name—Combined Reporting with Formula Apportionment and Unitary Taxation—masks a simple, powerful, and straightforward approach to tax, which California already uses successfully to confront transfer pricing abuses.

Instead of the current approach of trying to tax each separate bit of a multinational as if it were a free-floating entity, tax authorities could treat the multinational group as a single unit, then "apportion" its taxable income out to the different jurisdictions where it operates, under an agreed formula based on real things like sales, payrolls, and assets in each place. Each jurisdiction can tax its portion at whatever rate it wants. So consider a U.S. multinational with a one-man booking office in Bermuda, with no local sales. Current rules let it shift billions of dollars in profits there to skip tax. But under the alternative system based on sales and payroll, the formula would allocate only a minuscule portion of the income to Bermuda—so only a minuscule portion of its overall income would be subject to Bermuda's zero tax rate. The rest would get taxed properly based on the substance of what it does in the real world, rather than on the gymnastic legal form its accountants have created for it. Several U.S. states already use it quite successfully. Countries can do this unilaterally—and if this happened widely a vast part of the tax havens' business model would disappear. Again, developing countries could be particularly helped by this.

In this context, the financial sector needs special mention as a vast area to reform. Severe pundit fatigue has already set in on this topic, so I will just make two short recommendations that have not been a part of the general clamor.

First, policymakers, journalists, and many others can start to

understand and accept how tax havens have become the fortified refuges of financial capital, protecting it from tax and regulation and in the process contributing to the latest crisis in many and varied ways. The veil of silence and ignorance can be lifted and the message spread.

Second, countries worried about the safety of their financial systems could compile blacklists of financial regulatory havens based on the Jersey-Delaware notion of the captured state: a place that seeks to attract money by offering politically stable facilities to help people or entities get around the rules, laws, and regulations of jurisdictions elsewhere. This blacklisting will be easy enough, technically speaking, once we understand what we are looking for. With these blacklists, appropriate prohibitions and regulations—many of them very simple—can be put in place to help countries reclaim their sovereignty and respect voters' wishes once more. Along with this another benefit would flow: Once these berserkers in the international regulatory system are out of the picture, international cooperation on financial reform will become much easier. This proposal will also help us guard not only against repeating the errors that led to the latest crisis but also against those of the next one, whose causes we may not even be able to imagine yet.

Next, we should rethink corporate responsibility.

Societies grant corporations immense privileges, such as limited liability, which lets investors cap their losses and shift outstanding debts onto the rest of society when all goes wrong. They have also been granted the right to be treated as artificial legal entities that can relocate to different jurisdictions almost at will, irrespective of where they really do business. In exchange for these remarkable privileges, corporations were originally held to a set of obligations to the societies in which they are embedded: notably to be transparent about their affairs and to pay tax.

The offshore system has undermined all this. The privileges have been preserved and enhanced, but the obligations have withered. Tax must now be brought squarely into corporate responsibility debates. Corporate managers are taught to think that they are accountable only to shareholders. From this perspective, escaping tax seems to be their duty. But we have forgotten the fundamental truth that corporations get

their license to operate, and the tools and confidence to do so effectively, from society. Seen this way, tax is not a cost to shareholders, to be minimized, but a distribution to the stakeholders in the enterprise: a return on the investment societies and their governments make in infrastructure, education, law and order, and the other basic prerequisites for all corporate activity. The shareholders must get their due, but the societies they depend on must too. When we start to make corporations feel they are accountable not only to shareholders but to societies too, a whole new arena will have been created in which the offshore system can be questioned and challenged.

We can also reevaluate corruption. I have already indicated how predominant corruption rankings of countries rate many of the world's top tax havens—the repositories of trillions of dollars of corrupt, stolen loot—as the world's "cleanest" jurisdictions, and how a new Financial Secrecy Index, which I mentioned in chapter6, has started the process of setting the record straight.

But we can move beyond rearranging the geography of corruption and reassess what corruption is. At heart, corruption involves insiders abusing the common good, in secrecy and with impunity, undermining the rules and systems that promote the public interest, and undermining our faith in those rules and systems. In the process it worsens poverty and inequality and entrenches vested interests and unaccountable power.

Bribery does all these things. But many of the services tax havens provide also do these things. This close analogy between bribe-paying and the business of secret offshore escape is no coincidence: We are talking about similar underlying processes. Some people have praised bribery as a way of getting around bureaucratic obstacles: Without that bribe, that company won't get its container through the port. They are wrong, of course: Bribery may benefit the bribe-payer, but it damages the system as a whole. Similarly, the defenders of secrecy jurisdictions argue that their services help private actors get around "inefficiencies" in mainstream economies, smoothing the way for business to proceed. And they do. But what are those "inefficiencies"? They are, most importantly, tax, financial regulations, criminal laws, and transparency—all of which are there for good reason. To help someone get around the obstacle is to corrode the system and trust in the system. Bribery rots and corrupts governments, and tax havens rot and corrupt the global financial system.

Once we start seeing this we will no longer limit ourselves to pointing fingers at developing country kleptocrats and rogue officials but will begin to examine a much broader array of actors and their facilitating activities. And we will have found a rubric for the citizens of rich and poor countries to find common cause in fighting a global scourge.[9]

The final and most important thing is to change the culture. When pundits, journalists, and politicians fawn over people who get rich by abusing the system—getting around tax and regulation and forcing everyone else to shoulder the associated risks and taxes—then we have lost our way.

Language can change. When someone claims that tax havens make global finance more efficient, we can ask, "Efficient for whom?" When someone says countries should compete with each other on tax or financial regulation, or that policymakers should aim for a more competitive tax or regulatory system—one may ask: "What kind of competition are you talking about? A race to the bottom on tax, secrecy, or financial regulation? Or a race to the top, such as when corporations operate in competitive markets on a level playing field?" When we hear "privacy" or "asset protection" or "tax efficient" in the context of private banking, companies can be asked exactly what they mean. When a private equity company shows record profits, we can be told how much of that comes from genuine productive improvement, and how much comes from gaming the offshore system. When hearing a pillar of society say that they are a well-regulated, cooperative, and transparent jurisdiction, the investigator can assume the opposite and probe further. When magazines carry alluring advertisements from seedy offshore promoters who may be inciting clients to criminal behavior, we can complain. When corporations talk about social responsibility, we can ask if they mean tax. When journalists need expert commentators to advise them about that tax story they are writing, they must understand that their interviewee from the big accountancy firm works for a business that makes a living out of helping wealthy corporations and individuals get around paying tax, and that their opinions will reflect that corrupted worldview. They must find alternative opinions to balance those views.

The world's international institutions and responsible governments could create and promote new guidelines and codes of conduct outlining responsible and irresponsible behavior in the fields of international tax and regulation, with special focus on offshore abuse. They could introduce general antiavoidance principles into their tax laws so that complex and abusive trickery, while technically not breaking the details

of legislation, can be disallowed. Tax evasion can become a predicate crime for money laundering, and tax offenses, among others, could be included in international conventions such as the United Nations Convention Against Corruption. Professional associations of lawyers, accountants, and bankers could create codes of conduct stressing, among other things, that it is unacceptable for a member to help a client commit a financial crime, whether the crime occurs at home or overseas. The economics profession needs to reappraise its approach to understand the effects of things such as secrecy and regulatory arbitrage. It could start to measure illicit, secret things, difficult though that may be.

We can recapture our culture from the forces of unaccountable privilege that have taken it away from us.

At the time of writing, heavy government spending around the world has staved off outright economic collapse following the meltdown in global finance, but at huge costs to taxpayers. “Never in the field of financial endeavor has so much money been owed by so few to so many,” said Mervyn King, the governor of the Bank of England. “And, one might add, so far with little real reform.”

It is time for the great global debate about tax havens to begin in earnest. Whoever you are, wherever you live, and whatever you do, offshore is at work nearby. It affects you. It is undermining the government you elect, hollowing out its tax base and corrupting your elected politicians. It is sustaining a vast criminal economy and creating a new, unaccountable aristocracy of corporate and financial power. If we do not act together to contain, control, and eradicate financial secrecy, then the world I found in West Africa more than a decade ago, a world of suave insiders, criminal complicity, and desperate poverty, will become the world we leave to our children. A tiny few will have their boots washed in champagne, while the rest of us struggle to make our lives in conditions of steepening inequality. We must avert this future.

NOTES

PROLOGUE

1. US Energy Information Administration (EIA), "U.S. Imports by Country of Origin," http://tonto.eia.doe.gov/dnav/pet/pet_move_impcus_a2_nus_ep00_im0_mbbl_m.htm.
2. The episode is covered in detail in the author's book Poisoned Wells: The Dirty Politics of African Oil (New York: Palgrave, 2007), chapters 4 and 5.
3. Valerie Lecasble and Airy Routier, Forages en eau profonde (Paris: Grasset, 1998).
4. Ibid., p. 252.
5. Eva Joly, Est-ce dans de monde-là que nous voulons vivre? (Paris: Les Arènes, 2003).
6. "Scandale!: How Roland Dumas Got France Gossiping," The Independent, January 30, 2001.
7. See Jean-Marie Bockel, "Je veux signer l'acte de décès de la Françafrique," Le Monde, January 16, 2008. Omar Bongo is now dead; the palace is now inhabited by his son, President Ali Bongo.
8. "Rupert Laid Bare," The Economist, March 18, 1999.
9. John Lanchester, "Bravo l'artiste," review of Rupert Murdoch: The Untold Story of the World's Greatest Media Wizard, by Neil Chenoweth, London Review of Books, February 5, 2004.
10. Eva Joly, Notre affaire à tous (Paris: Les Arènes, 2000).
11. Eva Joly, in Norway's official aid newsletter, Development Today, March 7, 2007.
12. See Martin Woods, "Banks Financing Mexico Gangs Admitted in Wells Fargo Deal," Bloomberg, June 29, 2010.

CHAPTER 1
WELCOME TO NOWHERE

1. These figures should be taken as very rough estimates, not least because

there is no agreement as to what a tax haven is, and estimates can vary widely.

Once we understand that the United States and United Kingdom are major tax havens, the eye-catch figure is quite reasonable, if vague. This particular statistic is from French finance minister Dominique Strauss-Kahn in a speech to the Paris Group of Experts in March 1999; quoted in J. Christensen and M. Hampton, "All Good Things Come to an End," The World Today (Royal Institute of International Affairs) 55, nos. 8–9 (1999). The share has grown substantially since then, because offshore financial services have been growing at substantially faster rates than the growth in trade.

2. See Ronen Palan, Richard Murphy, and Christian Chavagneux, Tax Havens: How Globalization Really Works (Ithaca, NY: Cornell University Press, 2010), p. 51. This work uses BIS data to show offshore's share of banking assets and liabilities rising to around 65 percent in 1990, before falling to 51 percent in 2007. Other measures of offshore, in various tables in the book, show explosive recent growth (interrupted by the financial crisis). Also see Luca Errico and Alberto Musalem, "Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues," IMF, January 1999, pp. 17–19. This study cites a figure of 54 percent in 1999, which is based on a relatively restrictive definition of offshore; subsequent measurements are affected, according to the IMF, because "the distinction between onshore and offshore banking has become progressively blurred."

3. Data from Palan et al., Tax Havens; from "IMF Finds 'Trillions' in Undeclared Wealth," Wealth Bulletin, March 15, 2010; and from M. K. Lewis, "International Banking and Offshore Finance: London and the Major Centres," in Mark P. Hampton and Jason P. Abbott, eds., Offshore Finance Centres and Tax Havens: The Rise of Global Capital (London: Macmillan Business, 1999).

4. The U.S. Government Accountability Office (GAO) reported in 2008 that 83 of the nation's hundred biggest corporations had subsidiaries in tax havens; the following year the Tax Justice Network, an advocacy organization that criticizes tax havens, used a broader definition of a tax

haven and found that 99 of Europe's 100 largest companies used offshore subsidiaries.

5. This loose definition is the result of collegiate discussions among members of the Tax Justice Network and other contacts primarily in the United States. It is similar to a definition offered by Richard Murphy, of the tax consultancy and advocacy company Tax Research UK, who defines secrecy jurisdictions as "places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so."

6. See "The Cayman Islands as an Offshore Tax Haven," http://www.cayman-information.com/cayman-islands_offshore_tax_haven.php.

7. See Jesse Drucker, "Google 2.4 percent Rate Shows How $60 Billion Lost to Tax Loopholes," Bloomberg, October 21, 2010.

8. See Martin A. Sullivan, "Microsoft Moving Profits, Not Jobs, Out of the U.S.," Tax Notes, October 18, 2010; and Martin A. Sullivan, "Cisco CEO Seeks Relief for Profits Shifted Overseas," Tax Analysts, November 29, 2010.

9. John W. Diamond, "International Tax Avoidance and Evasion," National Tax Journal, December 1, 2009.

10. Form 10-Q for Chiquita Brands International Inc., Quarterly Report, May 5, 2009, http://biz.yahoo.com/e/090505/cqb10-q.html.

11. See Senator Carl Levin news release, "Dorgan and Levin Release Study Showing Majority of Corporations Pay No Federal Income Tax," August 12, 2008.

12. The problem is getting worse—it is estimated that by 2007 the United States was losing an additional $28 billion in annual revenue, over and above what it was already losing before 1999, due to the worsening offshore shenanigans by nonfinancial U.S. corporations. If you include financial corporations, the sum is far bigger. See Testimony of Martin A. Sullivan, contributing editor, Tax Analysts , Before the Committee on Ways and Means U.S. House of Representatives, July 22, 2010. As Sullivan reported, in 2007 a quarter of all foreign profits of U.S.-based multinationals outside the financial sector were realized in just five tax havens: Bermuda, Singapore, Ireland, Switzerland, and the Cayman Islands.

13. Media reports have claimed that Switzerland's banking secrecy laws were the product of efforts to protect German Jews from the Nazis. This story originated from a November 1966 bulletin from the Schweizerische Kreditanstalt (today's Credit Suisse), and it is false. See Bruno Gurtner, "Swiss Secrecy Had Nothing to Do with the Nazis," Financial Times letters, March 26, 2009; and Sebastién Guex, "The Origins of the Swiss Banking Secrecy Law and Its Repercussions for Swiss Federal Policy," Business History Review 74 (summer 2000): 237–266, http://www.jstor.org/pss/3116693. Note also that tiny Liechtenstein next door emerged as a kind of Swiss appendage after the First World War.

14. Luxembourg specializes in holding companies exempt from income taxes, introduced in 1929.

15. IMF data records Luxembourg's investment liabilities at $2.5 trillion and its assets at only $1.5 trillion, a discrepancy of a trillion dollars. And these are just portfolio investments: add cash deposits, and the sums are bigger still. See "IMF Finds 'Trillions' in Undeclared Wealth," Wealth Bulletin, March 15, 2010.

16. "Kim Jong-il Keeps $4bn 'Emergency Fund' in European Banks," Daily Telegraph, March 14, 2010.

17. See, for example, Akin Gump Strauss Hauer & Feld LLP news release, "Halliburton Co., KBR, Inc. and KBR LLC Agree to Largest Combined Settlement of FCPA Charges by U.S. Companies," February 13, 2009. Halliburton and KBR settled with the Department of Justice for $579 million in 2009.

18. It is no coincidence that London, the former capital of the greatest empire the world has known, is also the center of the most important part of the global offshore system. Until the early 1990s, economic historians had viewed the British empire in large part as a corollary of the industrial revolution, which had made the empire both necessary and possible; empire was, to a large degree, a story about industrial capitalism and trade. But in 1993 the economic historians P. J. Cain and A. G. Hopkins transformed this view with a two-volume book, British Imperialism: Innovation and Expansion 1688–1914 (London: Longman, 1993) and British Imperialism, Crisis and Deconstruction 1914–1990 (London: Longman, 1993), which recast the empire as something that was most fundamentally a story about financial capital, international credit, and the City of London, the governor of the imperial engine. This imperial connection, which will become clear as the book progresses, is of paramount importance to any understanding of the offshore system and of the City of London, the governor of a large part of the offshore engine.

19. Martin A. Sullivan, “Offshore Explorations: Jersey,” Tax Notes, October 23, 2007; “Offshore Explorations: Isle of Man,” Tax Notes, November 5, 2007; “Offshore Explorations: Guernsey,” Tax Notes, October 10, 2007. These are considered conservative estimates: Offshore bank deposits in Jersey alone were worth $800 billion in mid-2009; Colin Powell, chairman of the Jersey Financial Services Commission, estimated in 2009 that trusts in Jersey alone might involve another $300 to 400 billion.

20. Seven, including the Falkland Islands and the British Antarctic Territory, are not havens. Ascension Island, which houses highly secretive U.S. and British military bases, serves a quasi-imperial purpose as a base to help project British power overseas.

21. For example, 2003 saw the collapse of major money-laundering trials in which a key witness was forced to admit that he had been serving as an MI6 agent.

22. The Cayman Islands reported to the IMF $750 billion in portfolio assets (that is, loans, securities, and other profitable things) in 2008. This quantity of assets ought to be matched, more or less, by similarly sized liabilities (deposits and other obligations) on the other side of the balance sheet—yet these added up

to $2.2 trillion for the Cayman Islands, three times as much as the assets. See David Bain, "IMF Finds 'Trillions' in Undeclared Wealth," Wealth Bulletin, March 15, 2010. The IMF report is Philip R. Lane and Gian Maria Milesi-Ferretti, "Cross-Border Investment in Small International Financial Centers," IMF Working Paper 10/38, February 2010.

23. See Palan et al., Tax Havens, p. 11. The authors estimate that the Crown Dependencies and Overseas Territories, plus the former empire, account for 37 percent of all banking liabilities and 35 percent of all banking assets; the City of London accounts for 11 percent. Even back in 1996, the U.S. lawyer John Moscow estimated that apart from Switzerland and Liechtenstein, nearly every offshore dirty-money center was British run or controlled. See Chris Blackhurst and Clare Garner, "A Trillion Dollars in Dirty Money Keeps Island Tax Havens Afloat," The Independent, September 11, 1996.

24. The term "British Spiderweb" was coined, I believe, by Jim Henry, author of Blood Bankers.

25. See, for example, "Britain Imposes Direct Rule on Turks and Caicos," Associated Press, August 14, 2009. Plans are now afoot to prepare new elections for

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26. Although Ireland lies in the Eurozone, its emergence as a secrecy jurisdiction in the late 1980s was substantially linked to interests in the City of London, and its Wild West spirit of laissez-faire financial market regulation—the turning of a blind eye to nefarious activities and potential risks—was inspired by British, not continental European, models. It is also part of a British sphere of influence.

27. "Users of 'Tax Havens' Abroad Batten Down for Political Gale," New York Times, February 26, 1961.

28. Next came Bank of America, Lehman Brothers, and Wachovia Corp., with 115, 59, and 57 tax haven subsidiaries, respectively. See "Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions," U.S. Government Accountability Office, December 2008.

29. A conference in the City of London in 1995 was told that the industry objective was to shift offshore the majority of financial assets owned by the world's high- net-worth individuals by the end of the decade. See Steven Hiatt, ed., A Game as Old as Empire: The Secret World of Economic Hit Men and the Web of Global Corruption (San Francisco: Berrett Koehler,

2007), p. 55.

30. See Senator Levin, news release, "Senate, House Members Introduce Stop Tax Haven Abuse Act: Bill Targets $100 Billion in Lost Tax Each Year from Offshore Tax Dodges," March 2, 2009. This $100 billion has several components and is in the middle of a range of estimates: The U.S. Treasury in 2007 cited estimates ranging between $40 and $123 billion annually. See Treasury Inspector General for Tax Administration, Office of Inspections and Evaluations, "A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap," January 27, 2009.

Levin also states that "abusive domestic tax shelters cost tens of billions of dollars more." The United States has unusually sophisticated systems in place to stem offshore leakage; developing countries suffer far more in relation to the size of their economies. Education budget details from Office of Management and Budget, www.whitehouse.gov.

31. From the 2008 GAO report. Anumber of companies, including Delphi, Dow Chemical, MetLife, Pfizer, and Washington Mutual, referred to the "Virgin Islands"

but did not differentiate between the British Virgin Islands and the U.S. Virgin Islands.

32. The Deepwater Horizon switched from Panama to the Marshall Islands in 2004. Transocean, the owner of the Deepwater Horizon, has 35 vessels registered in the Marshall Islands. Transocean moved from the Cayman Islands to the Swiss canton of Zug in 2008. For Zeder and the Marshall Islands, see U.S. Office of Insular Affairs, "Fred Monroe Zeder: In Memoriam," http://www.doi.gov/oia/press/2004/fred_zeder.htm. While Bush's ambassador to the region, Zeder's private company, Island Development, became incorporated on October 14, 1986, four days before Zeder signed a treaty providing for $6 million in aid for the Marshall Islands, of which $1.2m was used to help set up the ship registry. Zeder died in 2008. See "Bush Friend, Former Ambassador: Company Wasn't Disclosed," Associated Press, reproduced in The Victoria Advocate, April 30, 1990. The United States is responsible for foreign affairs and defense, just as the UK is responsible for the foreign affairs and defense of its Overseas Territories. Khadija Sharife in the London Review of Books blog ("Offshore Exploitation," June 9, 2010) established that "During a joint hearing to investigate the explosion and sinking of the Deepwater Horizon, Hung Nguyen, a captain in the Coast Guard, was surprised to learn from the US Interior Department's Mineral Management

Service— the unit responsible for overseeing offshore exploitation—that 'there is no enforcement.' Each operator 'self-certifies and establishes what they think is adequate,' . . . This system of self-regulation was formulated by Dick Cheney's Energy Task Force."

33. Khadija Sharife, "Offshore Exploitation," London Review of Books blog, June 9, 2010.

34. About the Liberian Registry, see Liberian International Ship & Corporate Registry (LISCR, LLC), www.liscr.com, accessed September 30, 2010. For the Standard Oil link, see Andrew Leonard, "Big Oil's Slick Trick," Business Spectator, May 15, 2010.

35. Jeffrey Robinson, The Sink: How Banks, Lawyers and Accountants Finance Terrorism and Crime—and Why Governments Can't Stop Them (London: Constable & Robinson Ltd., 2003), p. 63.

36. Widely cited. See, for example, Simon Raftopolous, "Tax Havens: The Red Herring of the Global Financial Crisis," Appleby Global press release, May 2009, www.appleby-global.com.

37. The Economist, however, has called tax havens "good for the financial system" and routinely carries advertisements for offshore corporations on its back pages.

38. See "World Governments Chip Away at Bank Secrecy," German Press Agency, April 12, 2010.

39. Nicolas Sarkozy, "Just Ahead of the G20 Pittsburgh Summit," from "Paradis fiscaux: bilan du G20 en 12 questions," CCFD-Terre Solidaire, April 2010.

40. For a list of uncooperative tax havens, see OECD Center for Tax Policy and Administration, http://www.oecd.org/document/57/0,3343,en_2649_33745_30578809_1_1_1_1,00.html, accessed 2010. At the time of writing, countries could get off the blacklist by signing 12 "tax information exchange agreements" (TIEAs) with other jurisdictions—relying on extremely weak standards of information exchange. Many havens got off the blacklist by signing TIEAs with such global heavyweights as Greenland and San Marino.

41. E. G. Richard Salsman, "Treasury Secretary Paul O'Neil Confuses Tax Avoidance versus Tax Evasion," Capitalism Magazine, September 13, 2002.

42. That is a gross figure. See "The Dutch Trust Industry: Facts and Figures," International Management Services Association (VIMS) & Dutch Fiduciary Organization

(DFA), April 2008.

43. Author's interview with Morgenthau, New York, May 4, 2009.

44. Oliver Arlow, "Kim Jong-il Keeps 4bn Emergency Fund in European Banks," The Telegraph, March 14 2010.

45. Dev Kar and Devon Cartwright Smith, Illicit Financial Flows from Developing Countries, 2002–2006 (Washington, D.C.: Global Financial Integrity, 2008). The authors define illicit money as that which is "illegally earned, transferred or utilized." Economists from the Oxford Centre for Business Taxation have called these figures "drastically overstated." Dev Kar, the GFI economist (formerly an IMF Senior Economist), has in turn effectively countered their arguments, noting the blind spot in traditional estimates. Traditional models will estimate the magnitude of illicit outflows from a country, then estimate the magnitude of illicit inflows, and then subtract one from the other to achieve a net result. Kar explains, however, that the estimates should not be subtracted, but added. For further details, see "Time to Bury the Oxford Report," Tax Justice Network blog, July 16, 2009, plus associated links; and Dev Kar, "The Alpha, but Whither the Omega, of the Greek Crisis?" Task Force on Financial Integrity & Economic Development blog, May 11, 2010.

46. Raymond Baker, Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System (Hoboken, N.J.: Wiley, 2005). That book's headline $1–1.6 trillion figure was subsequently endorsed in "Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan," World Bank / UN Office on Drugs and Crime, June 2007.

47. A picture of the book may be found at "Illicit Flows: We Finally Reveal the Official Data," Tax Justice Network blog, July 23, 2009.

48. Josh Rogin, "Clinton Presses Pakistan to Raise Taxes on Wealthy," Foreign Policy, September 28, 2010.

49. Author's interviews with Blum, and "A Conversation with Jack Blum," The American Interest, November/December 2009.

50. Office of Management and Budget, "Budget of the U.S Government, Fiscal Year 2011, Historical Tables," February 2010 (calculations by Citizens for Tax Justice [CTJ], emailed to author by Bob Mcintyre, CTJ director). Also see Ben Bagdikian, "The 50-Year Swindle," The Progressive, April 31,

2002.

51. For instance, the share of total income going to the top 1 percent of earners rose from 8.9 percent in 1976 to 23.5 percent by 2007, while the average inflation-adjusted hourly wage declined by over 7 percent. See Robert H. Frank, "Income Inequality: Too Big to Ignore," New York Times, October 16, 2010.

52. Chuck Collins, Alison Goldberg, and Sam Pizzigati, "Shifting Responsibility: How 50 Years of Tax Cuts Benefited the Wealthiest Americans," report for Wealth for the Common Good, April 12, 2010.

53. KPMG press release, "Cyprus, Ireland and Switzerland Have Most Attractive Corporate Tax Regimes in Europe, Finds KPMG International Poll," December 17, 2007, http://www.kpmg.co.uk/news/detail.cfm?pr=3008. Cyprus achieved a score of 90 percent.

54. Anotable exception is "Business Unprepared as Fair Tax Follows Fair Trade into the Spotlight," SustainAbility, March 14, 2006, which examined the role of paying tax in the corporate responsibility debate.

55. See Hogan speaking on video, embedded in "Hogan Loses High Court Battle to Keep Financial Records Secret," Sydney Morning Herald, June 16, 2010.

CHAPTER 2
TECHNICALLY ABROAD

1. Philip Knightley, The Rise and Fall of the House of Vestey (London: Warner Books, 1993), p. 8.
2. Cain and Hopkins, pp. 150 and 157; statements in June 1929 and October 1929 by ambassador Robertson. The Argentine beef industry relied almost exclusively on the British market for its exports; by 1929 Argentina generated about 12 percent of Britain's income from overseas investments.
3. Charles Edward Russell, The Greatest Trust in the World (1905; reprint New York: Arno Press, 1975).
4. Rodolfo Roquel, Nosotros, los Peronistas (Buenos Aires: Dunken, 2005), p. 34.
5. Vestey Group History, Vestey Group website, http://www.vesteyfoods.com/en/vesteygroup/vestey-group-history.html.
6. Knightley, The Rise and Fall of the House of Vestey, p. 63.
7. Ibid., p. 27.
8. Leslie Bethell, ed., Cambridge History of Latin America, vol. 8 (Cambridge: Cambridge University Press, 1991).
9. "A: The Secretary of the Treasury," Washington, D.C., May 29, 1937, from Henry Morgenthau to FDR, from Franklin D. Roosevelt Presidential Library; given to author in 2008 by Morgenthau's son Robert Morgenthau, then Manhattan district attorney.
10. For instance, in 1899 the state allowed corporations to own equity in other corporations, setting the scene for the emergence of large, interlinked networks of companies, the multinational corporation, and transfer pricing activities.
11. Some of this analysis is derived from Ronen Palan, Richard Murphy, and Christian Chavagneux, Tax Havens: How Globalization Really Works (Ithaca, NY: Cornell University Press, 2010).
12. Most accounts say it was Bedford Gunning Jr. who made that statement at the constitutional convention.
13. When Britain decided to tax the worldwide profits of any person resident in the UK, the judges decided that in the case of corporations they should be treated as resident where the company's most important decisions were taken, at meetings of their boards of directors. This suited Britain, since thousands of firms with activities all over the world were financed through the City of London, and their boards were normally located there.

Germany, by contrast, placed more emphasis on the "seat of management"—that is, where the company's actual operations were managed—a subtly different definition. For more on this history, see Sol Picciotto, International Business Taxation (London: George Weidenfeld and Nicholson Ltd, 1992), pp. 4–13.

14. Until then, tax had not been a big issue for the Vesteys because Britain did not tax British-based companies on profits they made overseas—that is, unless they repatriated these profits. This had suited the brothers, who argued that most of their profits arose overseas.

15. Picciotto, International Business Taxation, pp. 1–37.

16. Knightley, The Rise and Fall of the House of Vestey, p. 34.

17. Some tax havens claim that trustees are required by law to know the identity of all beneficiaries. Contacts indicate, however, that generally offshore jurisdictions do not adequately police these laws, and trustees often do not know the real beneficiaries.

18. The U.S. Internal Revenue Service sums it up quite simply: "Although these schemes give the appearance of separating responsibility and control from the benefits of ownership, as would be the case with legitimate trusts, the taxpayer in fact controls them." See Internal Revenue Service, "Abusive Trust Tax Evasion Schemes—Facts (Section I)," June 12, 2008, http://www.irs.gov/businesses/small/article/0,id=106537,00.html.

19. Vestey's (Lord) Executors and another v. Inland Revenue Commissioners. Same v. Colquhoun (Inspector of Taxes.) Same v. Inland Revenue Commissioners, All England Law Reports, May 28, 1949, p. 1108.

20. Sol Picciotto also describes this in his "Offshore: The State as Legal Fiction," in Mark P. Hampton and Jason P. Abbott, eds., Offshore Finance Centres and Tax Havens: The Rise of Global Capital (New York: Macmillan, 1999), pp. 43–79.

21. Obituary: Edmund Hoyle Vestey, 1932–2007, Blue Star Line, http://www.bluestarline.org/edmund_vestey2.htm, accessed Sept 12, 2010.

22. See "Heirs and Disgraces," The Guardian, August 11, 1999.

CHAPTER 3 THE OPPOSITE OFOFFSHORE

1. Robert Skidelsky, John Maynard Keynes: Fighting for Freedom, 1937–1946

(New York: Penguin, 2000), p. xiv.

2. Ibid., p. xv.

3. Ibid., preface and p. 98.

4. See Thomas Friedman, “Foreign Affairs Big Mac I,” New York Times, December 8, 1996. The claim ended in March 1999 when NATO forces bombed Belgrade.

5. John Maynard Keynes, “National Self-Sufficiency,” The Yale Review 22, no. 4 (June 1933): 755–769.

6. Robert Skidelsky, John Maynard Keynes: Hopes Betrayed 1883–1920 (London: Macmillan, 1983), p. 220.

7. Robert Heilbroner, The Worldly Philosophers: The Lives, Times and Ideas of the Great Economic Thinkers (Austin, TX: Touchstone, 1999), p. 251.

8. Skidelsky, Fighting for Britain, p. 92.

9. Ibid., p. 112.

10. Ibid., p. 432.

11. Robert Skidelsky, John Maynard Keynes: Fighting for Freedom, 1937–1946 (New York: Penguin, 2000), p. xxii.

12. J. Bradford DeLong, review of Skidelsky, John Maynard Keynes: Fighting for Britain 1937–1946, July 2001, http://www.j-bradford-delong.net/Econ_Articles/Reviews/skidelsky_jel.html.

13. Helleiner, States and the Reemergence of Global Finance, p. 4.

14. Skidelsky, Fighting for Britain, pp. 340, 348.

15. Barry Eichengreen, ed., Europe’s Post-War Recovery (Cambridge: Cambridge University Press, 1995), p. 99.

16. Geoff Tily, the author of a book on Keynes, believes that the main reason Keynes supported capital controls was his belief that interest rates should be set and held low. This would place Keynes firmly on the side of the industrialist (for whom interest payments were a cost) against the financier (for whom interest payments were income). See Geoff Tily, “The Policy Implications of the General Theory,” Real-World Economics Review, no. 50 (2009): 16–33, http://www.paecon.net/PAEReview/issue50/Tily50.pdf.

17. Capital controls had emerged during the First World War as countries had sought to stop capital fleeing their countries in order to be able to tax capital income and keep interest rates low in order to finance their war efforts. Controls evaporated after the war, following lobbying by bankers, but then returned partially during the Great Depression and finally swept the world after the Second World War and the Bretton Woods arrangements. They slowly became leaky and then were progressively

dismantled around the world from around the 1970s. The United States got rid of its most important controls in 1974.

18. Eric Helleiner, "Regulating Capital Flight," in Gerald A. Epstein, ed., Capital Flight and Capital Controls in Developing Countries (Cheltenham: Edward Elgar, 2005), pp. 290–91.

19. Helleiner, States and the Reemergence of Global Finance, p. 58.

20. Ibid., p. 59.

21. Ha-Joon Chang, Bad Samaritans: The Guilty Secrets of Rich Nations and the Threat to Global Prosperity (London: Random House, 2007), p. 27.

22. Dani Rodrik and Arvind Subramanian, "Why Did Financial Globalization Disappoint?" IMF Staff Papers (2009), pp. 56, 112–138. They seek other explanations, especially exchange-rate factors, for the disappointing performance of liberalized economies, but they do note the close correlation. Also see Monique Morrissey and Dean Baker, "When Rivers Flow Upstream: International Capital Movements in the Era of Globalization," Center for Economic Policy Research Briefing Paper, March 2003. "A striking feature of the distribution of current account surpluses and deficits among developing countries is that most of the countries that are experiencing high GDP growth have surpluses, and often large surpluses…. The fact that most of these nations continue to experience rapid GDP growth, in spite of this large outflow of capital, suggests that the availability of capital has not been a major impediment to economic growth."

23. Martin Wolf, "This Time Will Never Be Different," Financial Times, September 28, 2009.

24. "Capital Inflows: The Role of Controls," IMF Staff Position Note, February 19, 2010.

CHAPTER 4
THE GREAT ESCAPE

1. Catherine R. Schenk, "The Origins of the Eurodollar Market in London: 1955–1963," Explorations in Economic History 35, no. 2 (1998): 221–238.

2. Ibid., p. 225.
3. Ibid., p. 227.
4. Anthony Sampson, Who Runs This Place?: The Anatomy of Britain in the 21st Century (London: John Murray, 2005), p. 246.
5. David Kynaston, The City of London Volume IV: A Club No More 1945–2000 (London: Pimlico, 2002), p. 54.
6. Ibid.
7. U.S. banks had started expanding overseas after the First World War but mostly in Latin America and Asia, and in the 1950s their presence was still hardly discernible in London.
8. E. A. McCreary, The Americanization of Europe: The Impact of Americans and American Business on the Uncommon Market (1964), quoted in Stefano Battilosi and Youssef Cassis, European Banks and the American Challenge: Competition and Cooperation in International Banking under Bretton Woods (Oxford: OUP, 2002).
9. Until then, London's role as a financial center had been based primarily on the British Imperial currency zone, whose member countries banked in London and whose nations used the pound sterling as their currency or pegged their currencies to the pound. Inside the zone trade and capital could flow quite freely, but flows in and out of the area were closely controlled. The pound sterling still financed about 40 percent of world trade, and the Bank of England wanted it to stay that way. See Gary Burn, The Reemergence of Global Finance (New York: Palgrave, 2006), p. 26.
10. These terms are a bit of a misnomer today: They are neither named after today's euro currency nor are they a creature only of American dollars. All the world's main currencies are traded in this stateless unregulated space today.
11. "With the creation of the Euromarket," wrote Helleiner, "bankers in both countries stumbled on a solution to the problem of how to reconstruct the London- New York financial axis that had been prominent in the 1920s." Helleiner, States and the Reemergence of Global Finance, p. 89.
12. P. J. Cain and A. G. Hopkins, British Imperialism: Crisis and Deconstruction 1914–1990 (London: Longman, 1993), p. 293.
13. Quoted in Kynaston, The City of London Volume IV, pp. 696–97.
14. Ibid., p. 697.
15. See "Linklaters Sees Fallout from Repo 105," Financial Times, March 13, 2010; and "Report of Anton R. Valukas, Examiner," Southern District Court, Jenner & Block LLP, vol. 3 of 9, March 11, 2010. The loophole was neither purely a UK matter nor a U.S. matter but derived from arbitrage between the two

jurisdictions. See "FSA on Defensive over Lehman Failings," Financial Times, March 18, 2010.

16. In this process an investment bank, say, lends money to a hedge fund, and the hedge fund posts collateral against that loan, but then the investment bank is allowed to reuse this collateral for its own business, as if it were its own collateral.

17. See Manmohan Singh and James Aitken, "The (Sizable) Role of Rehypothecation in the Shadow Banking System," IMF Working Paper WP/10/172, IMF, July 2010. See also Gillian Tett, "Web of Shadow Banking Must Be Unravelled," Financial Times, August 12, 2010. If you take this practice into account, the IMF reckoned, then the shadow banking system in the United States—the giant, unregulated financial marketplace that lay at the heart of the global financial catastrophes that erupted from 2007—was in fact a full 50 percent bigger than had previously been thought. The IMF concluded that "the United Kingdom provides a platform for higher leveraging not available in the United States."

18. "Energy Market Manipulation and Federal Enforcement Regimes," Michael Greenberger Testimony to U.S. Senate Committee, June 3, 2008, http://commerce.senate.gov/public/_files/IMGJune3Testimony0.pdf.

19. Michael Foot, "Final Report of the Independent Review of British Offshore Financial Centres," HMTreasury (UK), October 2009.

20. "Reaction to the Tax Gap Series," The Guardian, February 14, 2009.

21. Prem Sikka, "UK Company Law Is Terrorism's Friend," The Guardian, January 20, 2010.

22. Will Stewart, "Londongrad . . . Russia's Money Laundry," The Express (UK), February 27, 2010; and "Britain Called Crooks' Haven," Sydney Morning Herald, February 28, 2010.

23. See "Lloyds Forfeits $350m for Disguising Origin of Funds from Iran and Sudan," The Guardian, January 20, 2009; and "Lloyds TSB to Pay $350 Million to Settle Probe," Bloomberg, January 10, 2009.

24. Megan Murphy, "Banking: City Limits," Financial Times, December 13, 2009; and Richard Roberts, The City: A Guide to London's Global Financial Centre ,

2nd ed. (London: The Economist/Profile Books, 2008), pp. 261–73.

25. The voting is supposed to reflect the "composition" of the workforce but not the "wishes" of the workforce. It is done through voting appointments: Business managers appoint voters from the workforce, who must be UK or Commonwealth or European Union residents. Source: Corporation of London website.

26. City of London, City Livery Companies, www.cityoflondon.gov.uk, accessed August 2010.

27. The Corporation itself hints at this: "The right of the City to run its own affairs was gradually won as concessions were gained from the Crown. London's importance as a centre of trade, population and wealth secured it rights and liberties earlier than other towns and cities. From medieval to Stuart times the City was the major source of financial loans to monarchs, who sought funds to support their policies at home and abroad." Source: City of London, "Development of local government," www.cityoflondon.gov.uk, November 19, 2009, http://www.cityoflondon.gov.uk/Corporation/LGNL_Services/Leisure_and_culture/Local_history_and_heritage/development.htm.

28. Clement Attlee, The Labour Party in Perspective, first published in 1937.

29. John David, Reforming London: The London Government Problem, 1855–1900 (Oxford: OUP, 1988), p. 51.

30. Reginald R. Sharpe, London and the Kingdom, Volume 1 (Bibliobazaar LLC, 2008).

31. Ibid., p. 42. Winchester was left out of the original survey too, but was later surveyed; the City never was.

32. Which King James I had granted to the City of London.

33. While the 6,000 human residents would still get a vote each, the corporate vote was widened, increasing their votes from about 23,000 to 32,000. Voting rights would reflect the number of employees, but not the "wishes" of the workforce.

34. His role is, as the Remembrancer's Office puts it, to have "day to day contact with officials in Government departments responsible for developing government policy, the drafting and promotion of legislation and responsibility for relations with both Houses of Parliament and their Committees." City of London, City Remembrancer's Office, www.cityoflondon.gov.uk, accessed August 2009.

35. Aprevious Remembrancer boasted that his operating principle was to "oppose every bill which would interfere with the rights and privileges enjoyed by the

Corporation."

36. "House of Lords European Union Sub-committee A(Economic and Financial Affairs and International Trade): Inquiry into Directive on Alternative Investment Fund Managers," memorandum from the City of London Corporation, submitted by the Office of the City Remembrancer, September 2009.

37. "House of Lords European Union Sub-committee A: Inquiry into the Commission's Communications on Ensuring Efficient, Safe and Sound Derivatives Markets," memorandum from the City of London Corporation, submitted by the Office of the City Remembrancer, January 2010.

38. City of London, "City of London funds," www.cityoflondon.gov.uk, accessed August 2010.

39. Developments are described in the blog "Mammon. From Superhero to Subzero," Open Shoreditch, February 8, 2009.

40. City Cash funds offices in Brussels, Mumbai, Beijing, and Shanghai.

41. David Hencke and Rob Evans, "Medieval Powers in City Trial of Strength," The Guardian, October 5, 2002.

42. Jason Beattie, an experienced British political reporter, tried to dig into City Cash using Freedom of Information (FOI) requests—standard journalistic tools that force reluctant British government departments to yield information. He had no success, and the Corporation's website, in fact, reveals why. The FOI Act of 2000, it admits, "applies to the City of London as a local authority, police authority and port health authority only," and the last word is emphasized with boldface type. In other words, everything is open to examination, except the money, which is the part that matters. City of London, "Access to Information," www.cityoflondon.gov.uk, accessed August 2010.

43. Some of this sentence was drawn directly from Burn, The Reemergence of Global Finance, pp. 151 and 158.

44. Ibid., p. 160.

45. Schenk, "The Origins of the Eurodollar Market in London," p. 235.

46. "The Earl of Cromer Is Dead at Seventy-Two: Former Head of Bank of England," New York Times, March 19, 1991.

47. See Eddie George, "The Bank of England: How the Pieces Fit Together," Bank of England Lectures, 1996, p. 91, http://www.bankofengland.co.uk/publications/quarterlybulletin/qb960110.pdf.

48. Burn, The Reemergence of Global Finance, p. 142.

49. Ibid., p. 124.
50. Jeffrey Robinson, The Sink: How Banks, Lawyers and Accountants Finance Terrorism and Crime—and Why Governments Can't Stop Them (Robinson

Publishing, 2004), p. 57.
51. Burn, The Reemergence of Global Finance, p. 161.
52. Ibid., p. 164.
53. Richard Sylla, "United States Banks and Europe: Strategy and Attitudes," in Stefano Battilossi and Youssef Cassis, eds., European Banks and the American
Challenge (Oxford: OUP, 2002), p. 62.
54. Cited in Martin Mayer, The Bankers (London: W. H. Allen, 1976), quoted in Burn, The Reemergence of Global Finance, p. 165.
55. Burn, The Reemergence of Global Finance, p. 125.
56. Thomas A. Bass, "The Future of Money," Wired, October 1996, http://www.wired.com/wired/archive/4.10/wriston_pr.html.
57. Kynaston, The City of London Volume IV, p. 569.
58. Ibid., p. 442, quoting Janet Kelly, Bankers and Borders (Cambridge, MA: HarperBusiness, 1977).
59. Mostly this involved borrowing from the Euromarkets in London and its fast-growing tax haven satellites, then lending out to other parts of the world; and through investment banking activities that they were not allowed to do at home. See Ulrich Ramm, "German Banks and the American Challenge," in Battilossi and Cassis, eds., European Banks and the American Challenge, p. 182. According to Ramm, the share of U.S. banks' foreign balance sheet business handled via London fell from 50.6 percent to 37.5 percent from 1973–76, while the Bahamas and Caymans increased their shares from 19.5 to
30.6 percent.
60. Anthony Sampson, Who Runs This Place? The Anatomy of Britain in the 21st Century (New York: John Murray, 2005), p. 255.
61. See "The Economic Effects of Capital Controls," Congressional Budget Office, August 1985, http://www.cbo.gov/doc.cfm?index=5981&type=0.
62. Burn, The Reemergence of Global Finance, p. 146.
63. Bass, "The Future of Money."
64. Kynaston, The City of London Volume IV, p. 396; and Mark P. Hampton and Jason P. Abbott, Offshore Finance Centres and Tax Havens (London: Macmillan,
1999), p. 91.
65. Letter from HB Mynors of the Bank of England to Sir Charles J. Hambro of Hambro Bank, January 29, 1963. Cited in Schenk, "The Origins of the Eurodollar
Market in London."
66. In 1962 Time magazine concluded that "the Eurodollar, most experts

agree, will gradually disappear if U.S. interest rates rise to European levels, or the U.S. payments deficit ends." "Western Europe: Those Eurodollars," Time, July 27, 1962.

67. Burn, The Reemergence of Global Finance, pp. 36, 140.

68. These concerns would be echoed a generation later when the Bank for International Settlements asked in June 2008, as financial panic spread around the globe, "How could a huge shadow banking system emerge without provoking clear statements of official concern?"

69. But add "In private meetings and speeches," the Corporation notes, "the Lord Mayor expounds the values of liberalisation." See City of London, the Lord Mayor's International World, www.cityoflondon.gov.uk, accessed August 2010.

70. See, for example, "Ordinance 10 and Its Impacts on Chinese Companies London IPOs," Fasken Martineau Corporate e-bulletin, July 2009, http://www.fasken.com/china_equity/. The Lord Mayor was told that Ordinance 10 was designed to "prevent the illegal transfer of assets overseas."

71. "Report by the Rt Hon. the Lord Mayor (Alderman John Stuttard) on His Visit to China, Hong Kong and South Korea," City of London Corporation, November 8, 2007.

72. For example, David Kynaston's magnum opus of the modern City of London, subtitled "AClub No More," regarded by some as the definitive work on the City, hardly mentions the Corporation of London, and even then it hardly strays beyond discussing the Corporation's role in City construction projects.

73. All Glasman quotes are from the author's interviews with Glasman, 2009 and 2010.

CHAPTER 5
CONSTRUCTION OF A SPIDERWEB

1. See Tom Naylor, Hot Money and the Politics of Debt, 3rd ed. (McGill-Queen's University Press, 2004), pp. 20–22.

2. Jeffrey Robinson, The Sink: How Banks, Lawyers and Accountants Finance Terrorism and Crime—and Why Governments Can't Stop Them (Robinson Publishing, 2004), pp. 29–37.

3. E.g., Baron Grey of Naunton, 1964–1968; Francis Edward Hovell-Thurlow-Cumming-Bruce, 8th Baron Thurlow KCMG, 1968–1972; Sir John Warburton Paul, GCMG, OBE, MC.
4. The Bahamas became internally self-governing in 1964 and fully independent in 1973, though remaining a member of the British Commonwealth.
5. Memo V 122/2 to Rickett from M. H. Parsons, June 5, 1963.
6. See, for example, Lisa S. King, "Sir Stafford Sands' Legacy Reviewed," Freeport News, Nassau, August 31, 2005.
7. See Marvin Miller, compiler, "The Breaking of a President 1974—The Nixon Connection," http://www.mail-archive.com/ctrl@listserv.aol.com/msg11727.html.
8. See Tom Naylor, Hot Money and the Politics of Debt, 3rd ed., p. 40; also see Oswald Brown, "Restore Sir Stafford's Portrait to the $10 Bill," Freeport News (Bahamas), Feb. 13, 2009, http://freeport.nassauguardian.net/editorial/293789643182596.php; "The Bahamas: Bad News for the Boys," Time, Jan. 20, 1967, http://www.time.com/time/magazine/article/0,9171,843308,00.html.
9. Anthony Sampson, "Treasure Island," published in YellowBlackRed, 1999, www.reocities.com/blackyellowred/#top.
10. Report on a team visit to the Cayman Island, British Development Division in the Caribbean, April 14–17, 1969. From the British National Archives.
11. Paul Sagar, the primary researcher for this material, provides the essence of this summary.
12. DSC 203940.
13. Research conducted in British national archives by Paul Sagar on behalf of this book.
14. Thanks to Paul Sagar for this concise summary.
15. William Brittain-Catlin, Offshore: The Dark Side of the Global Economy (New York: Picador, 2005), p. 33.
16. In the interview, and J. A. Roy Bodden, The Cayman Islands in Transition (Kingston/Miami: Ian Randle Publishers, 2007), p. 105.
17. Robinson, The Sink, p. 48.
18. Widely cited. See, for example, "Bernard Cornfeld," www.includipedia.com, accessed August 2010.
19. Author's interview with Gill, George Town, Grand Cayman, May 2009.
20. Field refused to testify, pleading Fifth Amendment protection, but the U.S.

Court of Appeals rejected this plea.

21. The Confidential Relationships (Preservation) law was amended in 2009, making the law somewhat less hard-line, but the essential elements providing criminal sanctions against breaking secrecy remain in place.

22. Norman's Cay: Playground for Drug Smugglers, PBS Frontline, www.pbs.org.

23. Seamus Andrew and Niall Goodsir-Cullen, "Accountability of Cayman Islands Directors," published by SC Andrew LLP, London, 2008.

24. See "Companies and Partnerships," published by Cayman Islands Financial Services, Cayman Islands government, http://www.scandrew.com/publications/Accountability%20of%20Cayman%20Islands%20Directors.pdf, accessed August 27, 2010.

25. Letter to Benn from Michael Dun, one of Benn's constituents, "Ref. Tax Havens and the Bank of England," May 30, 1975. The letter was forwarded to the UK Chancellor, Dennis Healey.

26. Author's interview with Scriven, March 2009.

27. Michael Foot, "Final Report of the Independent Review of British Offshore Financial Centres," HM Treasury, October 2009, http://www.hm- treasury.gov.uk/d/foot_review_main.pdf.

28. "Jersey Banking: The International Finance Centre," Jersey Finance Ltd., Fact Sheet, August 2009, http://www.jerseyfinance.je/_bluebox/download.cfm?attachment=18FCF7CA.

29. Some illustrative comparative data is provided at Ann Hollingshead, "Bamboozled!," Task Force on Financial Integrity blog, October 16, 2009.

30. When Lee Kwan Yew approached the Bank of England for support in setting up an offshore market, it was less encouraging, saying that it supported Hong Kong as a financial center instead. See Lee Kwan Yew, From Third World to First: The Singapore Story, 1965–2000 (Singapore: Singapore Press Holdings, 2000), p. 90.

31. This was widely reported. E.g., Netty Ismail, "Morgan Stanley Fallout from Andy Xie Costs More Jobs," Bloomberg, October 12, 2006; and Netty Ismail,

"Morgan Stanley Fallout From Andy Xie Costs More Jobs (Update1)," Bloomberg, October 12, 2006.

CHAPTER 6 THE FALL OF AMERICA

1. From author's interview with Hudson, New York, 2008.
2. These days, it is intangibles like patents or brands that are most often abused: Transfer mispricing on oil is much harder because the market price of oil is widely known.
3. As told to author by Hudson in New York in 2008; the memo is reproduced on p. 33 of the 2004 paperback edition of Tom Naylor's Hot Money and the Politics of Debt, 3rd ed. (McGill-Queen's University Press).
4. Raymond Baker, Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System (Hoboken, NJ: John Wiley & Sons, 2005). Baker is a world authority on illicit cross-border financial flows. The chapter 4 table entitled "Specified Unlawful Activities under U.S. Anti-Money Laundering Laws" lists 65 crimes—aircraft piracy, human trafficking, alien smuggling, bank fraud, bribery, ocean dumping, and so on—that can be used as a basis for money- laundering charges under U.S. law. The table then cross-checks each crime against two columns: first, if the crime underlying the money flow is committed in the United States; and second, if the crime is committed overseas. The table shows all 65 crimes triggering U.S. money-laundering laws if the crime is committed in United States. But if the crime is committed overseas, three-quarters of them—including alien smuggling, racketeering, peonage, and slavery, and nearly all forms of tax evasion—are excluded from the "prohibited" list.
5. See, for example, "US Bankers Attack IRS Deposit Interest Reporting Requirement," Tax News, December 3, 2002.
6. "Miami: The Capital of Latin America," Time, December 2, 1993.
7. See Naylor, Hot Money and the Politics of Debt, p. 292.
8. Author's interviews with Blum.
9. Blum, by correspondence, and Naylor, Hot Money and the Politics of Debt, p. 293.
10. This was the Interest Equalization Tax. The Kennedy

speech on this subject is available at the American Presidency Project, http://www.presidency.ucsb.edu/ws/index.php?pid=9349.

11. The tax did not cover loans, so many corporations simply switched from bond financing to lending. To check bank loans to foreign countries, the U.S. Congress enacted the Voluntary Foreign Credit Restraint Program (VFCRP) in February 1965, broadening it in 1966. U.S. corporations were asked to voluntarily limit their direct foreign investment. The program was made mandatory in 1968. Capital controls were relaxed in 1969 and phased out in 1974, after the United States left the Bretton-Woods system of fixed-exchange rates. See, for example, "Introduction to Capital Controls," St. Louis Fed. Review, November/December 1999, p. 24.

12. This "deferral," as it is known, was not uniformly available. The Kennedy administration had enacted Subpart F of the Code in 1962, which defended against tax havens by curbing deferral of U.S. corporate taxes in certain situations, deeming the income of foreign subsidiaries and affiliates of U.S. corporations to have been distributed to the U.S. parent and taxed in the U.S. even though this income is not actually distributed.

13. Some countries have limited defenses against deferral; so-called "Subpart F" legislation in the United States (disallowing deferral on passive income) is an example. Even this defense is patchy, however, and developing nations usually find it impossible to construct meaningful defenses using this strategy.

14. David Cay Johnston, Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich—and Cheat Everybody Else (New York: Penguin, 2003).

15. Eric Helleiner, States and the Reemergence of Global Finance: From Bretton Woods to the 1990s (Ithaca, NY: Cornell University Press, 1996), pp. 135–6. "Ironically the triumph of 'monetarism' seemed to be occurring at just the time that international linkages were reducing the

Fed's ability to control the monetary base."

16. Ibid., p. 137.

17. Ronen Palan, The Offshore World: Sovereign Markets, Virtual Places, and Nomad Millionaires (Ithaca, NY: Cornell University Press, 2003), p. 134.

18. The Federal Reserve Bank of St. Louis, which studied the new offshore IBFs, noted that the decline in Caribbean business "suggests that the growth of business in this area was almost entirely intended to bypass U.S. monetary regulations." See K. Alec Chrystal, "International Banking Facilities," St. Louis Fed. Review, April 1984, https://research.stlouisfed.org/publications/review/84/04/International_Apr1984.pdf.

19. Mark Hampton, The Offshore Interface: Tax Havens in the Global Economy (London: Macmillan, 1996), p. 63.

20. Palan, The Offshore World, p. 135.

21. Author's interview with Rosenbloom, December 1, 2009.

22. The Portfolio Interest Exemption.

23. Author's interview; also see Testimony of Michael J. McIntyre and Robert S. McIntyre on Banking Secrecy Practices and WealthyAmerican Taxpayers before the U.S. House Committee on Ways and Means, Subcommittee on Select Revenue Measures, March 31, 2009.

24. Testimony of Michael J. McIntyre and Robert S. McIntyre on Banking Secrecy Practices and WealthyAmerican Taxpayers Before the U.S. House Committee on Ways and Means Subcommittee on Select Revenue Measures, March 31, 2009, http://www.ctj.org/pdf/mcintyresw&mtestimony20090331.pdf.

25. The U.S. Foreign Account Tax Compliance Act (FATCA) of 2010 tightens up some aspects of the QI rules, making it harder for U.S. tax cheats, but it leaves the secrecy for foreigners in place. See "FATCA: New Automatic Info Exchange Tool," Tax Justice Network, May 18, 2010.

26. See Michael J. McIntyre, "How to End the Charade of Information Exchange," Tax Notes International, October 26, 2009, p. 194.

27. Much of the information comes from "Failure to Identify Company Owners Impedes Law Enforcement," Hearing Senate Permanent Subcommittee, November 14, 2006. Also "U.S. Corporations Associated with Viktor Bout," Prepared by Senate Permanent Subcommittee on Investigations, November

2009, on Senator Carl Levin's webpage, levin.senate.gov.

28. "Failure to Identify Company Owners Impedes Law Enforcement," Hearing Senate Permanent Subcommittee, November 14, 2006, p. 3.

29. L.J. Davis, "Delaware Inc.," New York Times, June 5, 1988.

30. Corp 95, http://www.corp95.com/, accessed June 10, 2010.

31. The forms of secrecy are different: lack of corporate transparency in Delaware and lack of financial transparency in Switzerland.

32. "Failure to Identify Company Owners Impedes Law Enforcement," Hearing Senate Permanent Subcommittee, November 14, 2006. A new act was introduced in 2008, the Incorporation Transparency and Law Enforcement Assistance Act, aiming to beef up transparency in this area. At the time of writing, the bill was on the sidelines.

33. Jeff Gerth, "New York Banks Urged Delaware To Lure Bankers," New York Times, March 17, 1981.

34. Chancery courts emerged out of English ecclesiastical courts and trust laws, where concepts of legal guardianship and fiduciary duty were paramount, and this makes them useful for what Delaware's Court of Chancery does most of all: rule on the nitty-gritty of how corporations organize themselves internally, and what happens when things go awry: whether internal rules have been followed, whether management insiders are illegally abusing shareholders, and whether corporate statutes were applied fairly. The Chancery court has no close competitor in this arena.

35. Bernard S. Black, "Shareholder Activism and Corporate Governance in the United States," New Palgrave Dictionary of Economics and the Law 3 (1998): 459–465, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=45100.

36. Senate Bill No. 58, An Act to Amend Title 10 of the Delaware Code Relating to the Court of Chancery, State of Delaware Division of Corporations, http://corp.delaware.gov/sb58.shtml.

37. Matthew Goldstein, "Special Report: For Some People, CDOs Aren't a Four-Letter Word," Reuters, May 17, 2010.

38. Madhav Mehra, "Are We Making a Mockery of Independent Directors?"

World Council for Corporate Governance, http://www.wcfcg.net/ht130304.htm, accessed August 15, 2010. Dr. Madhav Mehra is president of the council.

39. There are salient differences with the Cayman Islands. For example, most Cayman companies (the "exempt" companies) are by Cayman law not permitted to do business in Cayman. Such is not the case in Delaware. Also: typically, in Delaware, federal but no state taxes are paid; in Cayman, no taxes are paid.

40. Twelve thousand was the figure cited; the true figure is closer to eighteen thousand.

41. List of Delaware Registered Agents, Delaware Department of State division of corporations, corp.delaware.gov, http://corp.delaware.gov/agents/agts.shtml, accessed August 15, 2010.

42. The 2008 and 2007 reports are available at the state of Delaware's official website, http://sos.delaware.gov/2008AnnualReport.pdf.

43. Transcript of interview with Mrs. Ngozi Okonjo-Iweala, Nigerian finance minister, interview by Paul Vallely, The Independent, May 16, 2006, http://www.independent.co.uk/news/world/africa/transcript-of-interview-with-mrs-ngozi-okonjoiweala-nigerian-finance-minister–478337.html.

44. Transparency International has started to embrace this issue and called in November 2008 for a "second wave" of corruption campaigning to tackle these and other matters. As I write this, it is in the process of reevaluating its stance.

CHAPTER 7 THE DRAIN

1. "Interview: John Moscow," Money Laundering Bulletin, April 1997.
2. A range of estimates for the size of the narcotics trade exists. This one comes from "The Global Narcotics Industry," Center for Strategic and International Studies, Washington, D.C., http://csis.org/programs/transnational-threats-project/past-task-forces/-global-narcotics-industry.
3. Based on the current price of $75 per barrel.
4. This section on BCCI is drawn mostly from Peter Truell and Larry Gurwin, False Profits: The Inside Story of BCCI, the World's Most Corrupt Financial Empire (New York: Houghton Mifflin, 1992); from Jeffrey Robinson, The Sink: How Banks, Lawyers and Accountants Finance Terrorism and Crime—and Why Governments Can't Stop Them (London: Robinson Publishing, 2004); as well as various newspaper and academic reports, plus author's interviews with Robert Morgenthau and Jack Blum in 2008 and 2009.
5. For most of its life, Ernst & Whinney (now Ernst & Young) audited BCCI Luxembourg, while Price Waterhouse (now PWC) audited BCCI Cayman.
6. See Peter Truell and Larry Gurwin, False Profits: The Inside Story of BCCI, the World's Most Corrupt Financial Empire (New York: Houghton Mifflin, 1992), p. 87.
7. Ibid., p. 189.
8. Ibid., pp. 193–97 and pp. 290–91; and Robinson, The Sink, pp. 79–81. Some of the capital was real money, but much of it was not.
9. Author's interview with Morgenthau, May 4, 2009. Morgenthau didn't name Scott, but he was the attorney general at the time.
10. Ibid.
11. Robinson, The Sink, pp. 318 and 357.
12. Ibid., p. 84.
13. In 2009, Britain's Information Commissioners refused a Freedom of Information request by Prem Sikka finally to publish PriceWaterhouse's

1991 "Sandstorm" report on BCCI, in an extraordinary and long-winded reply arguing that "it is very clearly in the public interest that the UK maintains strong and effective relations with its international partners"—a clear defense of tax haven London. See Freedom of Information Act 2000 (Section 50), Decision Notice, December 14, 2009, Information Commissioners (UK), http://www.ico.gov.uk/upload/documents/decisionnotices/2009/fs_50202116.pdf. In an email to the author on June 15, 2010, Sikka said he remained committed to securing publication of the report. Sikka also provides a useful in-depth examination of the BCCI affair in Austin Mitchell, Prem Sikka, Patricia Arnold, Christine Cooper, and Hugh Will-mott, "The BCCI Cover-Up," Association for Accountancy & Business Affairs, 2001, http://visar.csustan.edu/aaba/BCCICOVERUP.pdf.

14. Author's interview with Morgenthau, May 4, 2009; and "More Offshore Tax Probes in Works: NY's Morgenthau," Reuters, April 27, 2009.

15. See the author's Poisoned Wells: The Dirty Politics of African Oil (New York: Palgrave, 2007).

16. French magistrates issued an international arrest warrant for Gaydamak in January 2001, and he moved to Moscow; in October 2009 he was convicted in absentia for arms trafficking, fraud, and tax offenses. Gaydamak says the magistrates used forged documents and said he owed no French taxes because he had been resident in London at the time in question. Author's interview with Gaydamak, and Le Monde, December 8, 2000, cited in Global Witness, All the President's Men, 2002, p. 26.

17. The arms he helped finance did, it is true, hasten victory over UNITA, though not everyone would agree that helping supply arms constitutes "bringing peace." Gaydamak had recently bought the Israeli football team Hapoel and a basketball team, Betar Jerusalem, with, he said, political aims.

18. Russia agreed, with Gaydamak's help, to cut the debt down to just $1.5 billion, sliced into 31 promissory notes with a face value of $48.3 million each.

Angola would pay these off at face value in six monthly installments, after a five-year grace period, from 2001 to 2016. Gaydamak and his partner Pierre

Falcone then set up a private company, Abalone Investments, with an account at UBS in Geneva. Abalone bought the 31 notes from Russia for $750 million

—at a 50 percent discount—though Angola would pay Abalone the $1.5 billion in full. Angola's state oil company Sonangol started paying money

into the Abalone account via the controversial and secretive oil trader Glencore. In February 2001, after 16 of the 31 notes (or $774 million) had been paid off, the Swiss judge froze the remaining 15 notes.

19. Global Witness, Time for Transparency, March 2004, p. 44.

20. Over $160 million went to an account called "Treasury Ministry of Finance" in Moscow, though knowledgeable sources in Switzerland told me that despite its name, this account may have been a front, with other interests behind it.

21. Le Monde, April 3, 2002: "Le règlement de la dette angolaise aurait donné lieu à des détournements de fonds," quoted in Global Witness, Time for Transparency, March 2004. I asked Gaydamak if the money had simply disappeared into private pockets, offshore. No, he said: Instead of paying Russia in cash for the promissory notes, Abalone paid Russia in "Russian obligations"—Russian debts he bought on secondary markets via these mysterious offshore companies and then redeemed to Russia—and Abalone had legally profited on those debt trades too. It was a "huge stupidity," he said, to assume that he would pay Russia back directly, rather than via intermediary accounts.

22. Dev Kar and Devon Cartwright-Smith, "Illicit Financial Flows from Africa: Hidden Resource for Development," Global Financial Integrity, March 26, 2010. Dev Kar is a former senior IMF economist.

23. See "'Angolagate' Revisited," Global Financial Integrity, Task Force on Financial Integrity & Economic Development, April 7, 2010, http://www.financialtaskforce.org/2010/04/07/angolagate-revisited/.

24. IMF data, "Angola: Selected Issues and Statistical Annex," April 1999 and Sept. 2003, and "Angola, Recent Economic Developments," Dec. 1995, Dec. 1997, Sept. 2000; "IMF Executive Board Concludes 2004 Article IV Consultation with Angola," July 2005.

25. The Soyo-Palanca Trust and the Cabinda Trust were used as efficient mechanisms for routing Angola's oil money, enabling Angola to provide trustworthy collateral for oil-backed loans, ring-fenced from the inefficiencies of Angola's domestic financial system. The problem was, essentially, that this ring-fencing also meant it was off the Angolan state's balance sheet, and therefore outside any normal budgetary or political procedures, playing havoc with Angola's ability to run a coherent budget.

26. Some economists, many with ties to the financial services industry and

to tax havens, have tried to dispute these numbers—none successfully. In fact, the numbers are quite compatible with the only comparable official estimate available—a World Bank study from 1994, which estimated total capital flight from developing countries at $155–377 billion in 1992: Simply extrapolating this figure to 2006 dollars (using the IMF conversion rate of 287.2 percent) yields a figure of $443 billion to $1.1 trillion; evidence is, however, that the growth rate has significantly exceeded the inflation rate. For counterarguments and detailed discussions, see "Time to Bury the Oxford Report," Tax Justice Network, July 16, 2009.

27. Léonce Ndikumana and James Boyce, "New Estimates of Capital Flight from Sub-Saharan African Countries: Linkages with External Borrowing and Policy Options," Political Economy Research Institute, April 8, 2008.

28. Although one might argue that the problem of climate change is a bigger threat.

29. Letter to John Snow from Phil Gramm, February 19, 2003, republished by Center for Freedom and Prosperity, http://www.freedomandprosperity.org/ltr/gramm-irs/gramm-irs.shtml.

30. James S. Henry, The Blood Bankers: Tales from the Global Underground Economy (Thunder's Mouth Press, 2003), p. 73.

31. "The Future of Money," Wired News 4, no. 10 (October 1996), http://www.wired.com/wired/archive/4.10/wriston.html?topic=&topic_set=.

32. Eric Helleiner, States and the Reemergence of Global Finance: From Bretton Woods to the 1990s (Ithaca, NY: Cornell University Press, 1996), p. 177.

33. Michael Hudson quotes are a mix of the author's interview with Hudson and "An Interview with Michael Hudson: An Insider Spills the Beans on Offshore Banking Centers," Counterpunch, March 25, 2004, http://www.counterpunch.org/schaefer03252004.html.

34. Luca Errico and Alberto Musalem, "Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues," IMF, January 1999.

35. Todd Moss, Gunilla Pettersson, and Nicolas van de Walle, "An Aid-Institutions Paradox? A Review Essay on Aid Dependency and State Building in Sub- Saharan Africa," Center for Global Development, Working Paper 74, January 2006.

36. "Address by Trevor Manuel, MP Minister for Finance of the Republic of South Africa," 4th Meeting of the Forum on TaxAdministration Cape Town,

January 10, 2008.

37. Chinese ministry of commerce. Total for Hong Kong was $27.7 billion, BVI $16.6 billion; the next largest was South Korea, with $3.7 billion.

38. See, for example, “India Gets 43% FDI through Mauritius Route,” Press Trust of India, April 20, 2009.

39. It was a French colony until Britain invaded during the Napoleonic Wars.

40. Author’s interview with Elmer, 2009.

41. Telephone interview with Rosenbloom, December 1, 2009.

CHAPTER 8
RESISTANCE

1. "Harmful Tax Competition: An Emerging Global Issue," Organization for Economic and Cooperative Development, 1998, http://www.oecd.org/dataoecd/25/26/44430243.pdf.
2. The last major attempt at attacking the havens had been the so-called Gordon report published by the U.S. Internal Revenue Service in January 1981: "Tax Havens and Their Use by United States Taxpayers—An Overview," report to the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy), submitted by Richard A. Gordon, Special Counsel for International Taxation, January 12, 1981. This was almost entirely ignored.
3. Though the 1998 report did not list the havens, the content was clearly aimed at smaller island centers.
4. Author interview with Dan Mitchell, Washington, D.C., Jan. 16, 2009.
5. David Cay Johnston, "Behind the IRS Hearings, a GOP Plan to End Tax Code," New York Times, May 4, 1998, http://www.nytimes.com/1998/05/04/us/behind-irs-hearings-a-gop-plan-to-end-tax-code.html?pagewanted=1.
6. David Cay Johnston, Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich—and Cheat Everybody Else (New York: Penguin, 2003), p. 148.
7. See "The Liberalizing Impact of Tax Havens in a Globalized Economy," presentation by Dan Mitchell, Capitol Hill, March 23, 2009, http://www.youtube.com/watch?v=ISfsY1nqoaM&feature=related.
8. Ibid.
9. Paul de Grauwe and Magdalena Polan, "Globalisation and Social Spending," Cesifo Working Paper No. 885, March 2003, https://lirias.kuleuven.be/bitstream/123456789/119409/1/cesifo_wp885.pdf.
10. "Table A. Total Tax Revenue as Percentage of GDP," OECD, http://www.oecd.org/dataoecd/48/27/41498733.pdf.
11. "A Fair Share: Has the Tide Turned for Corporate Profits?" The Economist, August 27, 2009, http://www.economist.com/research/articlesBySubject/displaystory.cfm?sub

41. Telephone interview with Rosenbloom, December 1, 2009.

jectid=2512631&story_id=E1_TQPNSGGV. In 2006, for example, just ahead of the economic crisis, U.S. corporate profits were higher as a share of national income, and wages and salaries were lower, than at any time since the Second World War.

12. See David Cay Johnston, "Tax Rates for Top 400 Earners Fall as Income Soars, IRS Data," Tax Analysts , undated, 2010, http://www.tax.com/taxcom/features.nsf/Articles/0DEC0EAA7E4D7A2B852576CD00714692?OpenDocument.

13. Mitchell's own book quotes a seminal 2006 European study that baldly explains the problem: "The effect [of falling tax rates] on incorporation is significant and large. It implies that the revenue effects of lower corporate tax rates—possibly induced by tax competition—partly show up in lower personal tax revenues rather than lower corporate tax revenues…. There is reason (after all) to worry about tax competition." "Corporate Tax Policy, Entrepreneurship and Incorporation in the EU," CESifo Working Paper No. 1883, December 2006. Also see Lucas Bretschger and Frank Hettich, "Globalisation, Capital Mobility and Tax Competition: Theory and Evidence for OECD Countries," European Journal of Political Economy 18, no. 4 (November 2002); and S. Ganghof, The Politics of Income Taxation: A Comparative Analysis (European Consortium for Political Research Press, 2006).

14. Michael Keen and Alejandro Simone, "Is Tax Competition Harming Developing Countries More Than Developed?" Tax Notes International 1317, June 28, 2004.

15. Alexander Klemm and Stefan van Parys, "Empirical Evidence on the Effects of Tax Incentives," IMF Working Paper No. 09/136, July 1, 2009, http://www.imf.org/external/pubs/cat/longres.cfm?sk=23053.0.

16. One such incentive was the tax holiday, which the IMF economists said was "widely regarded as the most pernicious form of incentive." Britain had briefly tried this gimmick under Prime Minister Margaret Thatcher until it became clear they did not work: set up a ten-year tax holiday, and companies will pack up and leave after nine years and 11 months, or will transfer the business to another subsidiary and get another ten-year holiday. After these failures, however, Africa was still encouraged to embrace them: In 1990 only one sub-Saharan African country offered tax holidays, but a decade later they all did. Often these holidays are available in special export processing zones, which are a bit like small offshore

41. Telephone interview with Rosenbloom, December 1, 2009.

jurisdictions lodged inside the state. When these zones pop up, wealthy locals who want to invest at home inevitably send their money overseas, dress it up in an offshore secrecy structure, then return it, slashing their tax bill in the process.

17. Daniel J. Mitchell, The Moral Case for Tax Havens, video, Center for Freedom & Prosperity, October 2008.

18. This history is explored in more detail in the UK edition of this book, in chapter 3 on Switzerland. See also Sébastien Guex, "The Origins of the Swiss Banking Secrecy Loans and Its Repercussions for Swiss Federal Policy," Business History Review, Summer 2000, the President and Fellows of Harvard College, pp. 237–266.

19. "The Moral Case for Tax Havens," Center for Freedom and Prosperity Foundation video, http://www.youtube.com/watch?v=Xf14lkyH2dM; and "Tax Justice Network Sides with Europe's Tax Collectors, Ignores Critical Role of Low-Tax Jurisdiction in Protecting Human Rights and Promoting Pro-Growth Policy," Center for Freedom and Prosperity, April 7, 2005.

20. Joel Bakan, The Corporation (London: Constable & Robinson Ltd., 2005), p. 154.

21. "Why Do I Have to Deal with People Like Dan Mitchell?" J. Bradford DeLong, February 12, 2009, delong.typepad.com.

22. When the tax writer David Cay Johnston challenged Norquist, noting that his views were at odds with those of most economists, and taxes were needed to pay for civilization, Norquist responded that "we are not the successor of, we are not a continuation of, western civilisation. We are a unique and different civilisation." From David Cay Johnston, Perfectly Legal: The Covert Campaign to Rig our Tax System to Benefit the Super Rich—and Cheat Everybody Else (New York: Penguin, 2003), p. 3.

23. See, for example, "Historical Top Tax Rates," Tax Policy Center, October 26, 2009, http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=213.

24. Jason Sharman, Havens in a Storm: The Struggle for Global Tax Regulation (Ithaca, NY: Cornell University Press, 2006), p. 85.

25. "The Moral Case for Tax Havens," Center for Freedom and Prosperity Foundation video, http://www.youtube.com/watch?v=Xf14lkyH2dM.

26. David Cay Johnston, "Treasury Chief: Tax Evasion Is on the Rise," New York Times, July 19, 2001, http://www.nytimes.com/2001/07/19/business/treasury- chief-tax-evasion-ison-the-rise.html?pagewanted=1.

27. "OECD Tax Haven Crackdown Is Out of Line, O'Neill Says," Center for Freedom and Prosperity news summary, May 11, 2010, http://www.freedomandprosperity.org/Articles/sum05–11–

41. Telephone interview with Rosenbloom, December 1, 2009.

01/sum05–11–01.shtml.

28. Martin A. Sullivan, "Lessons From the Last War on Tax Havens," Tax Notes International, July 30, 2007.

29. David Cay Johnston, "Treasury Chief: Tax Evasion Is on the Rise," New York Times, July 19, 2001.

30. Sharman, Havens in a Storm.

31. Johnston, Perfectly Legal, p. 2. A new study in October 2008 based on unpublished IRS data found that the rich hide much more of their income than the poor do. Taxpayers earning true income between $500,000 and $1 million a year understated their adjusted gross incomes by 21 percent overall in 2001, compared to just 8 percent for those earning $50,000 to $100,000. For poorer people, cheating was even lower. See "Rich Cheat More on Taxes, New Study Shows," Forbes, October 21, 2008, http://www.forbes.com/2008/10/21/taxes-irs-wealth-biz-beltway-cz_jn_1021beltway.html.

32. Martin Wolf, Why Globalization Works (New Haven, CT: Yale University Press, 2005), p. 283.

33. For useful explorations of this topic, see Monique Morrissey and Dean Baker, "When Rivers Flow Upstream: International Capital Movements in the Era of Globalization," Center for Economic and Policy Research, March 22, 2003; or Dani Rodrik and Arvind Subramanian, "Why Did Financial Globalization Disappoint?" IMF staff papers, vol. 56, no. 1, 2009, pp. 112–138.

34. Ryszard Kapuscinski, Shah of Shahs (New York: Vintage Books, 1992).

35. Caymanian Compass, July 8, 1991.

36. "Framing Cayman," The Lawyer, March 29, 2004, http://www.thelawyer.com/framing-cayman/109308.article.

37. Anthony Travers, "An Open Letter to President Obama from the Cayman Islands Financial Services Association," OBE, May 5, 2009.

38. "Tax Havens Batten Down as the Hurricane Looms," The Observer, March 29, 2009.

39. The G20 declared this on April 2, 2009; the blacklist was empty by April 7. See "The Empty OECD Black List: Where Did All Tax Havens Go?" Eurodad press release, April 16, 2009; Richard Murphy, "The TIEA Programme Is Failing," Tax Research blog, November 27, 2009; and "A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard," OECD, May 10, 2010, http://www.oecd.org/dataoecd/50/0/43606256.pdf.

40. Michael J. McIntyre, "How to End the Charade of Information Exchange," Tax Notes International, October 26, 2009.

CHAPTER 9
THE LIFE OFFSHORE

1. Now known as the Big Four, following the demise of Arthur Andersen.
2. Michael Bronner, "Telling Swiss Secrets: 222 Billionaires," Global Post, August 5, 2010.
3. Michael Bronner, "Telling Swiss Secrets: The Golden Goose," Global Post, August 5, 2010.
4. "Doom-mongers Huddle over Island under Threat," Financial Times, November 11, 1998.
5. Patrick Muirhead, "Jersey's Culture of Concealment," The Times, April 24, 2008.
6. Author's interview with Syvret, 2009.
7. Stuart Syvret's blog, "Jersey's Media and Its Role in the Culture of Concealment," July 29, 2010, http://stuartsyvret.blogspot.com/2010_07_01_archive.html.
8. Austin Mitchell, Prem Sikka, John Christensen, Philip Morris, and Steven Filling, "No Accounting for Tax Havens," Association for Accountancy and Business Affairs (2002).
9. "Economics and Development in the Twenty-First Century," remarks by Kenneth Galbraith on the occasion of his receipt of the Leontief Prize at Tufts University, March 27, 2000.
10. Companies can, if they prefer, set their own rates of tax, with a minimum of 2 percent, if they want to climb over the bar of a minimum rate specified in their country of origin. At the time of writing, Jersey is considering changes to its tax system.
11. Author's interview with Elmer, 2009.

CHAPTER 10
RATCHET

1. The main research for this was undertaken by myself and Ken Silverstein of Harper's magazine in 2009.
2. Some interviewees said May 1980, but Henry Beckler's resume says June 11, 1980, http://www.wtcde.com/HenryBeckler.pdf.
3. According to the New York Times, "Others who might have raised

40. Michael J. McIntyre, "How to End the Charade of Information Exchange," Tax Notes International, October 26, 2009.

questions about the bill, including other state officials, the press and the public, were intentionally kept in the dark, according to bankers and state officials" ("New York Banks Urged Delaware to Lure Bankers," New York Times, March 17, 1981, http://www.nytimes.com/1981/03/17/business/19810317BANK.html?&pagewanted=1).

4. Biondi is a former president of the Delaware State Bar Association, a Democrat who served as an adviser to both Republican and Democrat governors, and an attorney for business interests, the Teamsters union, and many others. Delaware Grapevine, a local political website, called him "a tough-minded political operative capable of delivering corporate contributions or muscling up votes." Celia Cohen, "I Heard You Picket Newspapers," Delaware Grapevine, July 13, 2005, http://www.delawaregrapevine.com/7–05sheeran.asp.

5. Interview with Hayward and Hayward's comments in Larry Nagengast, Pierre S. Du Pont IV, Governor of Delaware, 1977–1985 (Delaware: Delaware Heritage Press, April 2007), p. 109.

6. "Birth of a Banking Bonanza," Delaware Lawyer (Fall 1982): 38.

7. David S. Swayze and Christine P. Schiltz, "Keeping the First State First: The Alternative Bank Franchise Tax as an Economic Development Tool," Delaware Banker (Fall 2006), http://www.pgslegal.com/CM/FirmNews/Fall%202006%20Delaware%20Banker%20Article.pdf.

8. Adrian Kinnane, Durable Legacy: A History of Morris, Nichols, Arsht & Tunnell (Morris, Nichols, Arsht & Tunnell, 2005), http://www.mnat.com/asse ts/attachments/MNAT_Book Web_Version.pdf.

9. "New York Banks Urged Delaware to Lure Bankers," New York Times, March 17, 1981, http://www.nytimes.com/1981/03/17/business/19810317BANK.html?&pagewanted=1.

10. Nagengast, Pierre S. Du Pont IV, Governor of Delaware, 1977–1985, p. 113.

11. In 2010 the so-called Whitehouse Interstate Lending Amendment was introduced in the U.S. Senate, cosponsored by Senators Cochran, Merkley,

40. Michael J. McIntyre, "How to End the Charade of Information Exchange," Tax Notes International, October 26, 2009.

Durbin, Sanders, Levin, Burris, Franken, Brown, Menendez, Leahy, Webb, Casey, Wyden, Reed, Udall, and Begich, aiming to restore to the states the ability to enforce interest rate caps against out-of-state lenders. At the time of writing, it had made no progress.

12. Nagengast, Pierre S. Du Pont IV, Governor of Delaware, 1977–1985, p. 114.

13. A description of the Bank Franchise Tax, Delaware Department of Finance, http://finance.delaware.gov/publications/fiscal_notebook_09/Section07/bank_franchise.pdf.

14. "New York Banks Urged Delaware to Lure Bankers," New York Times, March 17, 1981, http://www.nytimes.com/1981/03/17/business/19810317BANK.html?&pagewanted=1.

15. Nagengast, Pierre S. Du Pont IV, Governor of Delaware, 1977–1985, p. 110.

16. Author's interview with Swayze, Delaware, November 24, 2009.

17. See "Consumers Turn to Plastic as Home Loans Slow," Reuters, September 11, 2007. Credit card debt stood at $907 billion, and this would rise to $975 billion by December 2008. From "US Credit Card ABS: 2006 Outlook," Barclays Capital, January 26, 2006; and Mark Furletti, "An Overview of Credit Card Asset-Backed Securities," Philadelphia Federal Reserve, December 2002; and "Fed Report: Consumer Credit Card Balances Keep Plummeting," http://www.creditcards.com/credit-card-news/federal-reserve-g19-consumer-credit-december–09–1276.php.

18. This research was undertaken by myself and Ken Silverstein of Harper's magazine in Delaware in 2009. As far as I know, nobody has ever deeply explored this Delaware episode and linked it to its wider impacts, apart from the early New York Times article cited in this chapter. For Geogheghan quote see Thomas Geoghegan, "Infinite Debt: How Unlimited Interest Rates Destroyed the Economy," Harper's, April 2009.

19. Paul Tucker, "Shadow Banking, Financing Markets and Financial Stability," remarks by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of

40. Michael J. McIntyre, "How to End the Charade of Information Exchange," Tax Notes International, October 26, 2009.

England, at a Bernie Gerald Cantor (BGC) Partners Seminar, London, January 21, 2010, http://www.bis.org/review/r100126d.pdf.

20. From Biondi interview and David S. Swayze and Christine P. Schiltz, "Keeping the First State First: The Alternative Bank Franchise Tax as an Economic Development Tool," Delaware Banker (Fall 2006), http://www.pgslegal.com/CM/FirmNews/Fall%202006%20Delaware%20Banker%20Article.pdf.

21. See, for example, JP Morgan CDO Handbook, May 29, 2001, p. 31; and Scott E. Waxman, "Delaware Statutory Trusts," Potter Anderson & Corroon LLP, 2010, http://www.potteranderson.com/news-publications–0–127.html. Biondi did not say he was involved in the Delaware Statutory Trust Act.

22. Scott E. Waxman, Nicholas I. Froio, Eric N. Feldman, and Ross Antonacci, "Delaware: The Jurisdiction of Choice in Securitisation," Potter Anderson & Corroon LLP, May 19, 2004, http://library.findlaw.com/2004/May/19/133435.html.

23. David S. Swayze and Christine P. Schlitz, "The Evolution of Banking in Delaware," published by Parkowski, Guerki & Swayze, http://www.pgslegal.com/CM/FirmNews/evolution-of-banking-in-delaware.asp.

24. See John Dunn and Prem Sikka, "Keeping the Auditors in the Dark," Association for Accountancy & Business Affairs, 1999, http://visar.csustan.edu/aaba/dunn&sikka.pdf.

25. The UK Companies Act of 1948, for example, required this.

26. Author's interview with Konrad Hummler, November 4, 2009.

27. Jim Cousins, Austin Mitchell, and Prem Sikka, "Race to the Bottom: The Case of the Accountancy Firms," Association for Accountancy & Business Affairs, 2004.

28. David Cay Johnston, Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich—and Cheat Everybody Else (New York: Penguin, 2003), p. 15.

29. From the UK Companies Act of 1989.

30. From author's interview with Southern, March 13, 2009.

31. "Voter Turnout," International Institute for Democracy and Electoral Assistance, 2010,

40. Michael J. McIntyre, "How to End the Charade of Information Exchange," Tax Notes International, October 26, 2009.

http://www.idea.int/vt/survey/voter_turnout_pop2.cfm.

32. "Offshore Hazard: Isle of Jersey Proves Less Than a Haven to Currency Investors," Wall St. Journal, September 17, 1996.

33. Aletter in October 1996 from Colin Powell, Jersey's Chief Adviser, to Pierre Horsfall, President of Jersey's Finance and Economics Committee, suggests the uncertain official position at the time. "Some might hold the view that there is nothing wrong with States members being directors of local companies," the letter read. "Indeed, for as long as States members are not full-time and salaried it is almost inevitable." The answer that had been put forward, Powell said, was to set up a Jersey Financial Services Commission to supervise the finance industry—though that, he conceded, may not be very different. "The Commission will include those who have a direct interest in the finance industry." The answer, Powell said, was to make sure that those in the future

commission would not be involved in particular areas where they had a conflict of interest, and that the matter should be debated further. (Letter from Colin Powell, O.B.E, Chief Adviser to the States, to Senator P.F. Horsfall, President, Finance and Economics Committee, October 25, 1996.)

34. "Finance: Damage Might Be Done to Jersey's Reputation," Jersey Evening Post, February 15, 1996.

35. Accountancy Age, March 29, 2001, p. 22.

36. Prem Sikka and Hugh Willmott, "All Offshore—The Sprat, The Mackerel, Accounting Firms and the State in Globalization," Essex Business School Working Paper No. WP 09/05, February 2009.

37. Luca Errico and Alberto Musalem, "Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues," IMF, January 1999. Also: "Favourable regulatory treatment in OFCs increases the operational leeway of offshore banks for balance sheet management," the IMF said: "exemptions from reserve requirements on deposits; liquidity requirements; liability and asset concentration restrictions; capital adequacy thresholds; and stringent foreign exchange position limits, allow offshore banks to more freely manage their balance sheets."

38. For example, in When Genius Failed, Roger Lowenstein's otherwise excellent analysis of the episode, the offshore structure is almost ignored. Roger Lowenstein, When Genius Failed (New York: 4th Estate, 2002).

39. See, for example, "Report on Special Purpose Entities," the Bank for International Settlements, September 2009.

40. As the BIS report puts it: "The onshore (Delaware) versus offshore (Cayman) decision will generally be driven by factors outlined in the previous section (on tax considerations of SPEs), while other (non-taxation related) considerations (such as clarity of legal regime, ease of incorporation, etc) will generally be similar to those outlined for European SPEs immediately above." Note that "clarity of legal regime" and "ease of incorporation" stem specifically from these jurisdictions' offshore status, as defined in this book.

41. See Jim Stewart, "Shadow Regulation and the Shadow Banking System: The Role of the Dublin International Financial Services Centre," Tax Justice Focus 4, no. 2 (July 18, 2008); and Jim Stewart, "Low Tax Financial Centres and the Subprime Crisis: The IFSC in Ireland," presentation, Tax

Justice/AABA
research workshop, University of Essex, July 3–4, 2008. Also, draft version of Jim Stewart, "Low Tax Financial Centres and the Financial Crisis: The Case of
the IFSC in Ireland," May 15, 2010.

42. Dublin's lures for the shadow banks were not especially its low-tax regime—though that helped—but other features: Ireland's wide array of tax treaties, and the fact that it ticks certain boxes that fund regulators require in their home countries, including the fact that certain EU directives apply. Being within the Euro currency zone is also crucial.

43. See Goldman Sachs, "Abacus Prospectus and Abacus Indicative Terms," February 26, 2007, http://www.scribd.com/doc/30054003/Abacus–2007-AC1- INDICATIVE-TERMS.

44. Goldman's offshore deals deepened global financial crisis: "Goldman's Offshore Deals Deepened Global Financial Crisis," McClatchy's, December 30,
2009.

45. Author's interviews with Elmer, 2010.

46. "Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy," IMF Fiscal Affairs Department, June 12, 2009.

47. 2003–2007 data from the IMF and from "Private Equity Fund Raising up in 2007: Report," Reuters, January 8, 2008.

48. Julie Cresswell, "Profits for Buyout Firms as Company Debt Soared," New York Times, October 4, 2009.

49. Andrew G. Haldane, "Small Lessons from a Big Crisis," Bank of England, May 8, 2009. Haldane is executive director, financial stability. For some excellent examples of this, see Gretchen Morgenson, "Private Equity's Trojan Horse of Debt," New York Times, March 12, 2010; and Julie Cresswell, "Profits for Buyout Firms as Company Debt Soared," New York Times, October 4, 2009.

50. The GFI studies present a range of estimates, with net flows into deficit countries worth hundreds of billions of dollars. See chart 7 in Dev Kar and Devon Cartwright Smith, "Illicit Financial Flows from Developing Countries 2002–2006," Global Financial Integrity, Washington, D.C., 2008, http://www.gfip.org/storage/gfip/economist%20-%20final%20version%201–2–09.pdf.

51. See Rebecca Smith, "Monty's £10,000 Credit Limit," July 28, 2003, http://www.wilmslowexpress.co.uk/news/s/63/63903_montys_10000_credit_li

mit.html.

CONCLUSION

1. The IASB issues International Financial Reporting Standards, which are currently in a process of "convergence" with U.S. accounting standards under the U.S. Financial Accounting Standards Board (FASB), which has a complex, private-led ownership structure but also does not require country-by-country reporting.
2. The World Bank says it "meets the cost/benefit test"; see the World Bank submission to the IASB, June 28, 2010, http://www.ifrs.org/NR/rdonlyres/7FAC2D52-A064–41BD–8BA8–445245232E0B/0/CL55.pdf.
3. Currently the most comprehensive source of updated information available on the topic of information exchange is a section entitled "On Exchange of Information for Tax Purposes" on the website of the Tax Justice Network, http://www.taxjustice.net/cms/front_content.php?idcat=140.
4. "Double Tax Treaties and Tax Information Exchange Agreements: What Advantages for Developing Countries?" Misereor, February 2010.
5. "Tax for Development," OECD Observer, December 2009–January 2010.
6. Campaigns have been established to pursue this. See, for example, Tax Justice Focus 6, no. 1 (2010), which explores land value taxation.
7. This example of the street musician is borrowed from Henry Law, "A Tax That Is Not a Tax," Tax Justice Focus 6, no. 1 (2010), www.taxjustice.net.
8. Raymond Baker, "Transparency First," The American Interest, July–August 2010.
9. This last paragraph is taken from my article coauthored with Raymond Baker and John Christensen in the September–October 2008 edition of the American Interest, entitled "Catching Up with Corruption."

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The European Central Bank

The New European Leviathan?

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To Gilly, my lovely wife

To Belinda, Christian, Katarina, and Kyle, thank you for your unending support of 'Dad' – the teacher

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Preface The European Central Bank: the New European Leviathan?

> …the sovereign power, whether placed in one man, as in a monarchy, or in one assembly of men, as in popular, and aristocratical commonwealths, is as great, as possibly men can be imagined to make it. And though of so unlimited a power, men may fancy many evil consequences, yet the consequences of the want of it, which is perpetual war of every man against his neighbor, are much worse.
>
> Thomas Hobbes, *Leviathan* (XX, 136)[1]

Introduction: Hobbes and the European Central Bank

With the 1 January 2002 changeover to the euro complete, one could provocatively argue that the European Central Bank has become the most important institutional creation in Europe since the institutionalization of the nation state in the seventeenth century. While the European Union (EU) may be the larger institutional embodiment of the historical process of supranational governance and European integration in postwar Europe, it is the ECB that perhaps best defines the relinquishing of state sovereignty to an institution with powerful supranational mechanisms of decision-making and enforcement. And while some may contend that the ECB's range of activities are limited to one narrow policy-arena, namely monetary policy, its influence has already spread into other arenas of EU and national policy-making – tax policy, financial regulation, budgetary policy, and macroeconomic policy-making. Acting as a political lever for further European integration, the ECB may just form a core element of an embryonic European super-state.

Whether one agrees or disagrees with this proposition, the creation and operation of the ECB has unleashed a whole range of questions that remain largely unanswered and widely debated. For example, what are the political and economic consequences of the ECB? More importantly, is the ECB emerging as a new European 'Leviathan'?

Has Europe submitted itself, as some would argue, to the rule of a political monster? Are there, in the words of Thomas Hobbes, 'evil consequences' associated with the formation of the ECB? Does the ECB have too much power? If so, can the ECB be controlled? And controlled by whom: member states? Furthermore, within the bounds of a democratic order that must be the foundation of European integration, is the ECB accountable? What about the rights of citizens and national governments alike? Can they provide input into the ECB that adequately reflects the interests and concerns of the member states, interests associations, and the public? This study seeks to address these very difficult questions by providing a comprehensive analysis of the ECB's actions and operations.

It should be made clear that we do not contend that the ECB is a political monster – a Leviathan, in the language of Hobbes. Moreover, we argue that any comparison between the two should be seen as speculative and designed to arouse some hard thinking about the future of the European Union more broadly, and European Monetary Union, more specifically. At the same time, however, some intriguing comparisons between Hobbes' analysis of the Leviathan and the European Central Bank can be made. It is not too much of a stretch to suggest that the ECB looms powerfully large on the political and economic map of Europe – much like Hobbes' Leviathan would loom large on the political development of Europe. Finally, we do recognise the limitations of Hobbes' controversial theory – especially given the powerful critiques of Hobbes over the centuries. However, the dilemma Hobbes faced is similar to the dilemma faced by Europeans today – namely, how to reconcile individual freedom and political authority.

Let us then assume for analytical purposes that the world is comprised of monetary anarchy, currency against currency, and where rules and order – in other words governance – are in short supply. Moreover, let us assume that the people and nations of Europe have long struggled with the negative consequences of currency competition – from repeated postwar bouts of externally produced instability (largely as a result of US dollar politics), as well as internal (European) bouts of instability caused by asymmetry in governance, lack of common rules and institutions, national self-interest, and the inability to enforce common decision-making. While the European Monetary System sought to provide a safe harbour in a sea of monetary anarchy brought on by the powerful forces of globalization, individual members have frequently pursued their own monetary and economic

interests – most notably Germany, but also France and Great Britain. Much as Hobbes identified 'competition' as a source of conflict, monetary competition and conflict have defined nearly 40 years of European postwar monetary history.

Given this scenario, how might a modern day Hobbes respond to the current state of European monetary politics? First and foremost, Hobbes was concerned with the power to preserve order. In a world that is 'nasty, brutish, and short' the power of the regime – the Leviathan – to preserve order must be absolute.[2] Without a common power over individuals to settle disputes, human beings become hostile to one another largely because they compete for limited resources, because their mistrust of one another forces them to try to protect themselves by dominating others, and because some people seek the glory of appearing superior to others. Considering the selfish passions of people, their fear of the Leviathan is the only reliable way to keep peace among them. In the immortal words of Hobbes, 'Covenants without the sword are but words, and of no strength to secure a man at all' (Chapter XVII, p. 109). Thus, Hobbes insists on the need for a government powerful enough and feared enough to protect individual rights against the aggression of others.

In addition to the creation of a sovereign with absolute power, laws propagated by the sovereign can facilitate the exercise of individual freedom. The goal is:

> not to bind the people from all voluntary actions; but to direct and keep them in such a motion, as not to hurt themselves by their own impetuous desires, rashness or indiscretion; as hedges are set, not to stop travellers, but to keep them in their way (Chapter XXX, p. 227).

To avoid anarchy in which every individual would be a 'law unto himself', government must have the power to regulate all actions. Moreover, the laws are made to assist individuals, not to hurt each other, but rather to join them together against a common enemy. This image of laws as hedges conveys Hobbes' thought that within the boundaries set by the sovereign, individuals are free to live as they please. While Hobbes might not have meant the unalienable individual rights as put forth by John Locke, self preservation and security push individuals to give up some autonomy in return for protection and order. To achieve the peace that makes civilized life possible, individuals must agree to the restraints – the laws or hedges – on their selfish aggressiveness and desire for competition.

Binding Hobbes' analysis of political order and laws is the social contract. Hobbes' social contract covers not only the institution of a government by those who choose the sovereign, but also the submission of all to a conqueror and a set of rules or laws. When people are conquered and submit to the conqueror out of fear, they have thereby given their consent to that government to reign over them. Moreover, those that submit to the government do so out of mutual shared interest. In other words, governmental coercion is necessary to overcome the prisoner's dilemma; coercion is necessary to avoid the catastrophe that would result if every person (state) were free to pursue its own self-interest. Hobbes' notion of the social contract suggests that it is in the long-term interest of all to live in a society that allows people to enjoy the benefits of peaceful cooperation with each other. People know that to secure this beneficial outcome, they have to protect themselves from the temptation to cheat; and they do this by establishing a coercive government. In order to prevent imminent disaster – namely death – individuals give up some measure of autonomy to the sovereign in return for the protection the sovereign provides. Cheaters will be punished.

It is not too far a leap to take Hobbes' understanding of human nature, self interest, and competition and apply it to European monetary politics. The European Central Bank is first and foremost concerned with the power to preserve monetary order. For the European Central Bank, its power must also be near absolute – as denoted by its overriding preoccupation with political independence and autonomy. Furthermore, the ECB should strike fear into the hearts of member states – pursuing a tough monetary policy stance and demanding fiscal rectitude. Without the ECB's power to settle monetary disputes between Euro-Zone members, it is likely that we would see continued monetary conflict, competition for scarce resources (in monetary terms – ensuring price stability while avoiding the burdens of adjustment of a weak currency), general mistrust among European monetary powers, and the ongoing battle over monetary prestige (strong currency status). While the Euro-Zone members might contend that this prediction is too pessimistic, one could counter that we still see some of these activities even within the European Monetary Union and the ECB.

The Maastricht Treaty lays down the binding laws governing the fiscal and monetary behaviour of member states. Primarily, the monetary laws (Article 105) must be guided toward the goal of price stability, not so that low inflation hurts anyone's particular interest, but rather that society and the economy – and importantly individuals – can proceed along an uninterrupted path of stable steady growth. Given

the allusion to hedges in Hobbes' analysis of the necessity of laws, we can see price stability as a hedge against monetary turmoil and economic instability. Even further, particularly from the German perspective, the ECB's independence to pursue price stability can act as a foundation for a stable political order. The ECB acts as a guide, a protector, of European monetary stability, but also the overriding political stability that comes from economic growth and prosperity. In this analysis, the ECB can act as a solid foundation to political union in Europe.

Finally, the Euro-Zone members have given their consent to be governed by the ECB. And the members did so, entering into a binding treaty – the social contract – out of a mutual shared interest in monetary stability and economic growth. To cooperate monetarily required the relinquishing of monetary sovereignty to the ECB. Not surprisingly, European monetary cooperation among nation states has often been analysed in terms of the prisoner's dilemma. The powerful incentive of states to cheat and take advantage of other states is well known throughout Europe's monetary history. The solution, the creation of governance – rules and institutions – that can provide information, enforce decisions, punish cheaters, and demand repeated interaction are at the foundation of the decision to create the ECB. For the Europeans, they have been dealing with this dilemma for the last three decades. In part, they were able to alleviate some of the problems with the ill-fated snake, the more successful EMS, and finally with EMU and the creation of the ECB. It would seem that the ECB has permanently solved the prisoner's dilemma. Other than potential fiscal 'cheaters' (still possible but limited by the Stability and Growth Pact), member states have relinquished their individual right to coin money and regulate monetary policy to the ECB – an ECB sovereign, autonomous, and powerful and reigning in Frankfurt/Main.

It would seem that the ECB fulfills much of the Hobbesian approach to understanding the behaviour of humans – but applied to the behaviour of nation states in an anarchic monetary world. But this brings us back to the question of accountability and the protection of individual and member state interests. How can we reconcile member states' rights with the political authority and power granted to the ECB? We are not quite sure that a perfect balance between these competing goals can be found or that the EU or the ECB have found it either. What we can say is that European monetary policy-making and economic governance in Europe are in a state of transition, a fluid, dynamic situation that will confront policymakers and national governments with difficult choices

between the competing objectives of sovereignty and international (European) cooperation.

Objectives of the book

The principal objective of our study is to provide a detailed analysis of the institutional structure and operation of the ECB, and through this analysis reasonably speculate on the Bank's future operation. Our study seeks to understand why the ECB was designed the way it was, how it fits into the overall EU policy-making system, and the debates about its institutional structure. The book explores the history of European central bank cooperation and co-ordination in the context of European monetary integration. The book also examines the preferences of key national actors (in particular French, German and British) that determined both the organization and independence of the ECB as well as the on-going debates about the Bank's design and operation. The complex issues of legitimacy, accountability and transparency – all within the larger construct of political independence – are explored in the context of member state attitudes and the present and future operation of the ECB. By bringing together in a systematic and comprehensive way the various issues of ECB power and independence, we seek to provide academics, students, analysts and the wider public with an accessible overview. With euro coins at present firmly in the hands of nearly 300 million Europeans, it is now even more imperative that we have a broadly encompassing explanation of the powerful ECB.

The book does not claim to make a definitive theoretical statement about the determinants of European integration or the creation of the European Central Bank. While we feel that the ECB should be considered a major step in the emergence of some unique confederal entity still rooted in its member states, we do not seek to explore the contribution of the ECB and EMU more generally in terms of the progress of European integration: this must be the subject of a future study. However, we do argue that the ECB's structure and operation, its successes and potential weaknesses have had and will continue to have an impact upon the shape of future efforts to create new supranational institutions and policies within the European Union. While some may fear the ECB 'Leviathan', the book argues that the ECB can be held accountable – both through existing structures and policies and possible future developments in European policy-making and institutional change.

Outline of the book

The book is divided into seven chapters. Chapter 1 broadly outlines the theoretical and analytical approaches that can be applied to help explain the logic behind the creation of the ECB, its structure, independence and its current operation. Chapter 2 draws out the historical development of European monetary authority in terms of its development as an 'epistemic community'. Starting in the postwar period, through the debates on EMU in the early 1970s and in the period from 1988 to 1991, and the preparation for the launch of the single currency in January 1999, we provide a detailed analysis of the gradual construction of European monetary authority. In doing so, we seek to provide historically-informed insights into the ECB's structure and power. Chapter 3 explores the prevailing attitudes of the three leading member states of the European Union – Germany, France and Britain – towards European monetary authority and the EMU project more generally, in addition to the distinct national traditions of monetary policy-making that have largely shaped these attitudes.

Chapters 4 and 5 complement each other with a focus on the institutional structure of the ECB and an analysis of ECB independence. Chapter 4 describes the European System of Central Banks (ESCB) and the interaction of the ECB with other EU institutions – especially the Eurogroup, but also other institutions, for example, the European Parliament. Chapter 5 then evaluates the institutional structure of the ECB through the analytical lens of political independence. To what extent is the ECB independent from the influence of key political and policy-makers? Does this independence make the ECB unaccountable and illegitimate in the eyes of the public and politicians? Given the European Union's ongoing struggle with questions of transparency and the democratic deficit, can the ECB operate independently without causing further sacrifice on these concerns? While a great amount of literature has already explored this topic, we review the literature and bring it into the context of the overarching theme of the book.

Using the preceding chapters as a backdrop, Chapter 6 evaluates the ECB in action – the actual monetary policy during its first years in operation. Using the concept of credibility as a framework of analysis, this more journalistic chapter traces the monetary steps of the ECB from July 1998 through the official launch of the euro in 2002. Here we focus on the interest rate debates, exchange rate politics and the role of ECOFIN in more detail and evaluate the ECB's 'successes' and 'failures'. We suggest that the ECB – despite some problems in the area

of policy credibility – is establishing itself and exerting its power more effectively, especially since the introduction of euro notes and coins in 1 January 2002. Finally, Chapter 7 concludes with a summary of the key arguments of our analysis and the expectations of the future behaviour of the ECB. We also draw out some institutional issues related to the future operation of the ECB as well as the European Union.

Methodologically, this book relies on a variety of approaches – including interviews with officials of the European Central Bank and other leading monetary and political officials from a number of member states, reviews of secondary sources and journalistic accounts, and the employment of statistical data. Interviewees were given anonymity in order to encourage discussion and frankness. Although reliability remains a problem with any anonymous interview, the intent was not to pinpoint specific positions or catch an official slip-up, but rather to elicit open reflections on the role of the European Central Bank and other officials in the respective EU member states. The official positions of the ECB are also readily available from source material and published interviews in the press, and one can visit the Bank's web-site at www.ecb.int.

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1

Analytical and Theoretical Approaches to the Study of the European Central Bank

> Each (theory) begins [its] analysis from a particular assumption that determines the kind of question that they ask, and therefore the answer they find. They are like … toy trains on separate tracks, travelling from different starting points and ending at different (predetermined) destinations, never crossing each other's path.
>
> Susan Strange, 1994: 16

Introduction: theorizing the European Central Bank

As scholars of the process of European integration, we are aware of the limitations and deficiencies of the state of theory in international relations and comparative politics. Susan Strange's dissatisfaction with the state of theorizing should warn us of the dangers and pitfalls of employing too deterministic a mode of theoretical analysis. The diversity of theories and analytical approaches at our disposal makes the task even more problematic. Europeanist Gary Marks has noted that studying the European Union asks 'us to think anew about political science as a discipline and how its subfields fit together' (Marks 1997: 1). Scholars have been debating the validity of different theoretical approaches since the late 1950s (for a review of the international relations and comparative politics/political economy approaches see Bulmer and Scott (1995) and Rosamond (2000)). Notable works on European Monetary Union (for example, Overturf 1997; Kenan 1995; McNamara 1998; Frieden, Gros and Jones 2000; Eichengreen and Frieden 2001) provide a comprehensive review of various theoretical approaches to the study of monetary integration.

This chapter seeks to explain the strengths and inadequacies of several major theoretical approaches applied to explain the move to

and the operation of EMU and the interlinking question of the structure and operation of an independent ECB and ESCB. We explore both the more traditional European integration approaches – drawing upon international relations theory – which have been widely debunked, in addition to some of the newer approaches which draw on the tools of comparative politics and political economy. The former include neo-realism; a revised neo-realism emphasizing 'voice opportunities' and geo-political developments; liberal intergovernmentalism emphasizing margin of manoeuvre in macroeconomic policy-making and the role of powerful business interests; neo-functionalism; and liberal institutionalism and regime theory. These theories tend to focus on the logic of the move to EMU: the creation and design of the ECB is given less consideration. Nonetheless, traditional theories of European integration provide some insight into the logic behind the structure of the ECB and its operation. We also introduce a structural perspective of international political economy which explains both the move to EMU and central bank independence in term of changes in global capitalism. Comparative politics and political economy offer approaches which, while in some cases paralleling the international relations theories, provide potentially greater explanatory power as to the structure and operation of the ECB. These include historical institutionalism; an analysis of the role of 'epistemic communities'; a cognitivist approach emphasizing the importance of ideas; structuralist explanations focusing on features of the European Community and the European Monetary System (EMS); and rational/public choice explanations including rational institutions building, 'garbage can' models, the problems associated with free-riding and principal–agent theory. This chapter embraces the eclecticism adopted by Sandholtz (1993) which challenges the ability of any one theoretical approach to explain the move to EMU, its institutional design and the operation of the ECB. Our examination here is meant to be a brief overview: it is neither exhaustive nor does it fully capture all the subtleties of each approach. Furthermore, with a couple of exceptions, we do not cover the large amount of theoretically driven literature from the discipline of economics: readers are encouraged to consult Eichengreen and Frieden (2001) among other sources. The insights provided by the different theoretical approaches that we cover here reappear repeatedly in later chapters of this book: in our analysis of the historical development of European monetary authority, of national perspectives on monetary policy-making, the

operation of the ECB, its relations with other EU institutions and member state governments as well as its future. However, our study is not directed by any one theoretical approach.

International relations theories

Neo-realism and geo-politics

Central to the (neo-)realist analysis are the state, geo-political power and the calculations of states. The move to EMU and the transfer of monetary policy-making power to the ECB thus cannot be explained in (neo-)realist terms because the loss of permanent *de jure* national sovereignty. Grieco (1995) develops a 'voice opportunities' thesis as a problematic attempt to salvage (neo-)realism and explain the logic behind the decision of major EC member states to surrender their control over monetary policy (see also Sandholtz (1993) and Howarth (2002a)). Grieco (1995: 34) writes:

> if states share a common interest and undertake negotiations on rules constituting a collaborative arrangement, then the weaker but still influential partners will seek to ensure that the rules so constructed will provide sufficient opportunities for them to voice their concerns and interests and thereby prevent or at least ameliorate their domination by stronger partners.

Thus governments are willing to surrender their *de jure* control in order to regain a degree of *de facto* control in a policy area where they have little. Germany's EMS partners wanted EMU in order to increase their voice in the determination of monetary policy, given that the asymmetric operation of the EMS forced them to follow German policy. Grieco assumes that dissatisfaction with the operation of the EMS meant the necessary embrace of EMU. His explanation quite reasonably presents the imposition of the German design for the European System of Central Banks (ESCB) as the necessary *quid pro quo* for the surrender of the deutsche mark. A voice opportunities explanation might also emphasize the equal representation of all Euro-Zone central bank governors on the ECB Governing Council as a *sine qua non* in the design of the ECB.

Some neo-realists might now be tempted to insist upon the inherent fragility of the EMU project and the authority of the ECB. When – in the context of prolonged asymmetric shocks that affect the economies of particular Euro-Zone member states more than others – these

member states may come to perceive that their interests diverge excessively from the Euro-Zone mainstream and they may choose to leave the EMU. Neo-realists could also point to the continued divergence in national economic policies, regardless of the convergence criteria of the EMU project and the rules of the Stability and Growth Pact, and the difficulty of forcing member state governments such as Italy and Ireland to respect the criteria (see Appendix 2). The risk remains that member states, for purely domestic political reasons, will adopt economic policies which create inflationary pressures for the other members of the Euro-Zone and thus undermine confidence in the value of the euro and the EMU project more generally.

Neo-realism seeks to avoid theoretical complications by avoiding the use of any concepts from comparative or domestic level politics. The lack of attention to internal domestic dynamics of states raises serious concerns about the comprehensiveness or usefulness of neo-realism to understanding European integration and more specifically EMU. Moreover, neo-realism fails to address adequately the role performed by EU institutions such as the Commission, Parliament and the ECB – as supranational bodies with their own particular interests rather than as fora of intergovernmental relations – in the operation of EMU.

Regarding the move to EMU more generally, most theorists (for example, Sandholtz 1993; Moravcsik 1998; Grieco 1995) discount the geo-political changes in Central and Eastern Europe in 1989/90 as a reason for French and German support for EMU. Geo-political changes are entirely irrelevant if the 2 June 1988 agreement between the West German Chancellor, Helmut Kohl and the French President, François Mitterrand, to push ahead with EMU was truly definitive. However, it is important not to discount the significance of these changes. Baun (1995) demonstrates their importance in keeping the EMU negotiations on track. From the French perspective (Howarth 2001 and 2002a), geo-political changes helped to convince many leading politicians of the necessity of EMU to tie Germany to the EU in order to prevent it from turning to *Mitteleuropa* as its zone of influence. It is impossible to determine whether or not President Mitterrand's resolve on EMU would have been enough to force French acceptance without German reunification. However, it is clear that geo-strategic changes helped him to convince a French political class motivated by *realpolitik* and greatly preoccupied by German power (Garcin 1993). From the German perspective (Loedel 1999a) geopolitical changes encouraged Kohl to overcome strong domestic opposition to EMU and the loss of the deutsche mark, and sacrifice domestic monetary independence in

order to assuage the concerns of the European partners, in particular the French.

Another geo-political motive – challenging American monetary dominance – motivated French support for an expanded European currency from the creation of the ECU – the European Currency Unit, the precursor to the euro – in 1979 (Howarth 2001). In the 1970s, French interest in European monetary cooperation was initially sparked by the collapse of the Bretton Woods System and the inability of the French to convince the Americans to re-establish an International Monetary System (IMS) which maintained stability between the dollar and European currencies. The French and others sought intra-European monetary stability in order to diminish the impact of dollar fluctuations (and American interest rate policy) upon European currencies and economies. These international monetary power motives should be seen in the context of the larger French geo-political goal of diminishing American economic and political hegemony in the international system. The French also wanted to avoid the creation of a tri-polar monetary world between the dollar, the yen and the deutsche mark. They argued that the mark could never compete with the dollar as an international reserve currency whereas the ECU had more potential. This logic of monetary power and the use of the term 'écu' in France – always spelled inaccurately with an accented small 'e': the name of a mediaeval French currency – helped to make the expanded use of the European currency and the creation of a stronger European monetary authority to manage and promote it acceptable even to some of the most nationalist opponents of European integration. EMU and the creation of a single currency can also been seen from this perspective. Permanently fixed European parities ended the speculation created by dollar fluctuations. It is much more difficult to speculate against the euro given its size.

Liberal intergovernmentalism

Liberal intergovernmentalism – a recent incarnation of intergovernmentalism developed most famously by Moravscik (1993, 1998) – claims that state strategies are based upon power considerations and preferences. Power is dependent upon a number of factors which will determine whether bargaining and issue linkage strategies are successful for governments. Preferences are shaped by macroeconomic considerations focusing upon the competitivity of large national companies in the context of global capitalism, rather than the geo-political power considerations of governments emphasized by neo-realists. According to

Moravcsik (1998) EC member states, led by France, sought EMU in order to increase their 'margin of manoeuvre in macroeconomic policy-making'. He (1998: 412) argues that '[t]he central French economic goal – greater macroeconomic flexibility through restraints on the Bundesbank and multilateral financing of central bank intervention – remained the same regardless of whether the forum was regional, bilateral or multilateral'.

A major weakness of liberal intergovernmentalism in explaining the move to EMU concerns the formation of national preferences. Moravcsik places great emphasis on the role of large industrial interests in France and Germany and correctly challenges claims that business support did not exist (1998: 380). However, this should not lead to the conclusion that business interests created the momentum behind the project. In late 1986, former French President Giscard d'Estaing and former German Chancellor Schmidt established the Committee for the Monetary Union of Europe which included government officials, industrialists and bankers (Collingen and Schwarzer 2002). The directors of several large EC corporations also created the Association for Monetary Union in Europe in 1987. Both were established with the aim to lobby governments to support EMU. However, neither actually did very much prior to the Maastricht Summit. Moreover, pro-EMU ideas had been circulating in banking and business circles since 1969. Sandholtz (1993: 24–5) appears to be correct when he argues that the interest group approach fails to explain why these ideas were heard in 1988–91 and not previously (see also Eichengreen and Frieden 2001). In France, François Perigot, the president of the leading employers' peak association, the CNPF (*Conseil national du patronat français*), came out in support of EMU only in April 1989, and the CNPF did not produce any study on the impact of EMU until after the Maastricht Summit. UNICE, the EC-wide employers' association endorsed EMU only in December 1990 (*Agence Europe* 1.12.90, 5382). For large importers and exporters, EMU was seen as less important a development than the Single Market Programme.[3] In most EC countries, business opinion – as well as public opinion more generally – was positive, but not actively so, which gave governments room to manoeuvre on the matter. Policy was led by the political and technocratic elites, not societal actors. Nonetheless, consistently high levels of business support help to explain why the project was kept on track despite numerous negotiating obstacles. This support provided a useful justificatory weapon for those in favour of EMU which could be wielded against those who opposed the project. According to a January

1989 poll, 86 per cent of EC employers supported the EMU goal although the precise design of the project had yet to be determined (*Quotidien de Paris*, 20.1.89). Liberal intergovernmentalists also emphasize that the 'sound money' (low inflation) orientation of the EMU project corresponds to the preferences of most large European companies which approve the constraints imposed on national governments to maintain a stable macro-economic framework which would contribute to a more positive investment climate in most Euro-Zone member states – with lower real rates of interest.

With regard to the operation of the Euro-Zone, intergovernmentalists might emphasize the extent to which ECB policy-making reflects the struggle among NCB governors who, despite their legally guaranteed independence and obligation to consider the interests of the Euro-Zone in general, tend nonetheless to represent the economic and political concerns of their respective member states. Furthermore, the on-going battle for Executive Board positions for member state nationals clearly reflects the belief – whether valid or not – that obtaining these positions increases national influence or, that at the very least, membership should reflect the relative importance of the different member state economies. Thus, perhaps unsurprisingly, five of the first six Executive Board members (including the President) came from the five largest economies of the Euro-Zone. Likewise, the battle over the replacement of Christian Noyer as ECB Vice-President demonstrates the extent to which Executive Board positions are prized. By April 2002, all the member state governments accepted appointment of the qualified governor of the Greek central bank, Lucas Papademos, with the exception of the Belgians, who sought the appointment of the Belgian senator and monetary policy expert, Daniel Gros. The Belgians abstained on the final vote but also made it clear that they would block the appointment of a Frenchman – probably Jean-Claude Trichet – as the ECB President in 2003, if the next appointment to the Executive Board was not a Belgian (*Financial Times*, 13 April 2002). An even clearer example of the perceived importance of the placement of nationals was the fudged appointment of the first ECB President in 1998. President Chirac – in a minority of one opposing the appointment of Wim Duisenberg – insisted that the first ECB president be a French national and forced the highly unusual compromise that Trichet would replace Duisenberg half-way through the latter's eight year term. Chirac insisted upon Noyer's appointment as Vice-President as a compensatory stop-gap measure to ensure France's hold over a leading position prior to Duisenberg's replacement.

(Neo-)functionalism

The central prediction of functionalism and more modern reformulations known as neo-functionalism is that European integration would be self-sustaining. The theoretical basis for this prediction was the concept of 'spill-over', whereby initial steps towards integration trigger endogenous economic and political dynamics leading to further cooperation (Haas 1958; Lindberg and Scheingold 1970). Functionalism suggests two areas for spill-over: functional and political. Functional spill-over occurs when incomplete integration undermines the effectiveness of existing economic policies, thereby creating pressures for deepening and widening policy co-ordination. Political spill-over occurs when the existence of supranational organizations sets in motion a self-reinforcing process of institution-building. The regulation by such supranational institutions and authorities (notably the European Commission) of the integrative and interdependent European economy requires such oversight. Monetary integration seemed well-suited for functionalist theorizing. As Overturf (1997; 161) notes, integration:

> was more administrative than political in nature, with tasks being performed by groups better described as coordinating agencies than political governments. It would correspond best to a smooth running, rational technocracy, with experts coming together to solve international problems of co-ordination in specific task areas for the benefit of all.

Functional and political spill-over in the area of monetary policy was both eased and encouraged by national central bankers who played a crucial role in reinforcing monetary cooperation among EC member states from the 1960s. Without this cooperation the move to EMU and the reinforcement of European monetary authority would likely have been impossible.

Monetary integration also represents a logical economic spill-over from the trade liberalization of the 1992 single market programme (initiated by the 1986 Single European Act (SEA)) and the massive increase in international/intra-EC capital flows. By the mid-1980s, several monetary economists – led by the Italian Tommaso Padoa-Schioppa (1994; 2000) – popularized the neo-functionalist 'inconsistent quartet' or 'triangle of incompatibility'.[4] According to the 'quartet', a state cannot enjoy monetary autonomy, free trade, free capital flows and fixed exchange rates at the same time. One must be surrendered. With the

Single European Act (SEA) of 1986, the EC member states had committed themselves to freer trade and capital flows, while the objective of the EMS was to minimize exchange rate fluctuations, thus facing participating states with the 'inconsistent quartet'. Only the country with the strongest currency (West Germany) retained its monetary autonomy. As a justification for EMU, the 'quartet' also assumed that, even though the operation of the asymmetric EMS left member state policy-makers little room to manoeuvre and that interest rate decisions followed those of the Bundesbank, the liberalization of capital meant that even tighter convergence in the EMS was not enough to ensure stable parities.

Several theorists, including Sandholtz (1993), Grieco (1995), Moravcsik (1998) and Østrup (1995), challenge functionalist claims of spill-over from capital liberalization to EMU.[5] First, they argue that the 1992 process strengthened the logic behind monetary integration but did not make EMU necessary. These authors argue that decisions about EMU took place prior to the removal of capital controls in 1990. In fact, the decision on capital liberalization was made at the same 2 June 1988 Franco-German summit when President Mitterrand and Chancellor Kohl reportedly agreed to proceed with discussions on EMU. There was no necessary spill-over. However, it might be possible to argue that there was a *perception* of necessary spill-over from the SEA to EMU via capital liberalization. Revisionist neo-functionalists place increased emphasis upon the role of ideas and actors: spill-over is not only about what is necessary but what people believe is necessary. In this way, neo-functionalism can be partially salvaged if 1) the decision on capital liberalization was *seen* as absolutely necessary following the SEA and 2) French and other EC policy-makers *anticipated* spill-over when they agreed to accept capital liberalization. EC governments most likely thought that capital liberalization created an economic dynamic encouraging EMU, in addition to it being the German precondition for starting the EMU negotiations. However, it is unlikely that they agreed to start the negotiating process on EMU *because* they accepted the need for capital liberalization and saw a necessary link between the two. Still, neo-functionalism at the level of perception remains a possibility. Moreover, the recognition of EMU as a long-term objective in the SEA encouraged this perception.

Prior to the Maastricht Treaty, political spill-over involved measures to reinforce cooperation among EC central bank governors. The EMU project through the convergence criteria, embodied further spill-over, restricting the economic policy-making of national governments. This

was further reinforced by the Stability Pact, which specified fines for countries which failed to respect the 3 per cent public deficit criterion and forced member state governments to prepare medium term economic guidelines to demonstrate the sustainability of national efforts to maintain low deficits – developments made possible by general provisions in the Maastricht Treaty. In the context of the EMS, economic policy co-ordination among national governments and a degree of economic policy convergence was accepted as a necessary pre-condition for exchange rate stabilization in the ERM. Since the start of the EMU project, the issue of spill-over has been linked closely to the construction of 'economic government' (or 'governance') at the EU level. From the late 1980s, European politicians and economists have disagreed as to the extent to which national economic policies must be harmonized – for example, should there be tax harmonization? – the precise nature of economic policy co-ordination, the profile of the Eurogroup, the rigour with which the Stability Pact fines should be imposed and the relationship between the ECB and other EU institutions. The pressure for further political spill-over has been great, held back by certain member states which seek to retain as much margin of manoeuvre in macroeconomic policy-making as possible despite the constraints of the Single Market and the operation of the Euro-Zone.

Liberal institutionalism/regime theory

Liberal institutionalism – often combined with some form of regime theory – explains the EU, and more specifically EMU, as an international regime. Regimes – defined as the principles, norms, rules, and decision-making procedures around which actor expectations converge on a given issue (Krasner 1983) – can help structure an analysis of the operation of EMU and the role of the ECB. Understanding the regime of European monetary and economic integration involves emphasizing the institutional components of joint-decision-making and the design and enforcement of Euro-Zone rules. Moreover, norms of behaviour can be identified with regard to EMU: the necessity of compromise, the transparency and close co-ordination of economic policy and a careful public discourse to avoid undermining the credibility of EMU.

Thus liberal institutionalism emphasizes the importance attached to the role of institutions and norms in the process of European integration. This approach suggests that institutions 'matter' (Keohane 1989) by affecting the interests of member states and mitigating the relative gains of states (Baldwin 1993). Joint or absolute gains from agreements, the development of long term relationships engendering trust among

actors, and expectations of reciprocal behaviour can be achieved through the development of common interests built on institutions. Such approaches also highlight the importance of domestic politics to understanding how choices and preferences are constructed and how common interests can be identified. In short, EU decision-making institutions and the norms and expectations of behaviour within the EU, have produced a sustained pattern of cooperation and integration based on the choices and preferences of state actors.

Liberal institutionalist theory (for example, Axelrod (1984) and Keohane (1984)) would explain the design of EMU in terms of the 'constitutionalisation' of 'sound money' ideas in participating member states through the convergence criteria, the principle of independent central banks and the primary goal of the ECB: the pursuit of price stability. A 'stabilization' regime is created at the EU level in which the ECB plays a core role as policeman. If individual Euro-Zone member states fail to pursue policies that contribute to price stability in the Euro-Zone, the ECB can criticize them publicly (while the Commission can recommend that the Eurogroup do so). Most importantly, the ECB possesses its interest rate weapon to encourage member states to modify their economic polices, to ensure the maintenance of low inflation. However, the ECB must seek to perform its policeman role in an unobtrusive manner which does not damage its relationship with the member states and seek to build a good relationship with them in its presence in the Economics and Financial Committee (with EU treasury and central bank officials), at Eurogroup meetings (with Euro-Zone ministers of finance) and in international fora. Liberal institutionalists examine the current development of EMU in terms of these pre-existing norms: the development of economic policy co-ordination at the European level, the macroeconomic policies adopted in the participating member states, the role of the ECB in relation to political authorities (the Eurogroup, the Commission and the European Parliament) and the ECB's own policy-making are all seen in terms of how they reinforce or undermine the stabilization goals of EMU, the credibility of ECB monetary policy-making and even the legitimacy of the stabilization goals and ECB control. The role of the ECB in the 'international regime' of EMU is discussed further in Chapters 4 (organization and powers) and 5 (legitimacy and accountability). Some member state governments – notably the French – have sought to challenge the norms underpinning EMU and the role of the ECB. France's position on the need to qualify both the stabilization bias of the EMU project and the central bank independence and convergence rules

which ensure this bias is explored in the chapter on national perspectives.

Structural changes in global capitalism

Dyson *et al*. (1995), amongst others, argue that EMU and the creation of an independent ESCB should be seen in terms of national central bankers seeking to reassert their control in the context of major structural changes in the global economy which weakened their policy autonomy during the two decades prior to EMU. Thus the interests of central bankers as actors are of explanatory importance – as argued by some applications of rational/public choice theories (see below) – but only secondary as they have been very much shaped, and their influence very much determined, by larger structural factors. Referring to Moran (1991), Dyson *et al*. (1995: 473) argue that the proliferation of institutional investors (particularly from overseas) weakened European central bankers because it undermined their traditional social and cultural cohesion ('cosy networks') with narrow and exclusive domestic financial communities. Furthermore, the rapid increase in international capital flows overwhelmed national capital controls and the domestic reserves that national central bankers could wield in managing exchange rate policies within the ERM, and considerably weakened the effectiveness of traditional monetary targeting (O'Brien 1992 and Porter 1993). In the EMS, the 'inconsistent quartet'/'triangle of incompatibility' set in: participating treasuries and central banks gradually lost their monetary policy autonomy as they sought to limit exchange rate fluctuations, while following Bundesbank interest rate decisions, in the context of increasing financial integration. However, at the same time, the need for increased co-ordination within the EMS and the need to follow the German lead on price stability increased the power of participating central banks in relation to treasuries and governments and increased the importance of price and exchange rate stability and credibility building. The influence of central bankers was reinforced by the market penalties – thus structural factors – imposed on countries that inadequately toed the line. Market penalties helped reinforce convergence towards 'sound money' and support for central bank independence, which could be presented as a low-cost reform to combating the high inflation of the 1970s and 1980s. Globalization and the deregulation of the financial markets increased convergence in national financial structures in West European countries, which contributed to the acceptability of monetary integration. Central bankers also argued that influence over monetary policy could be regained

from the financial markets by acting collectively, creating a single European currency managed by a credible independent European central bank.

Comparative political science approaches

Historical institutionalism and epistemic communities

Liberal institutionalism is mirrored in comparative political science by historical institutionalism, which emphasizes path dependency in the construction of EMU: that is, the determination of institutional and policy-making outcomes by the sequence of decisions made over time (Pierson 1996). A path dependency approach to understand the operation of ECB monetary policy since 1999 would emphasize the rules established in the Treaty on European Union and reinforced by subsequent decisions which ensure the continued pursuit of low inflationary policies (Campanella 1995). Policies are thus not the result of ideas, *per se*, or the calculation of the interests of individual members of the ECB Governing Council. Moreover, path dependency leads to the continuity of policy-making which is unlikely to change given the risks this would pose to the credibility of the ECB.

Those academics who emphasize the role of 'transgovernmental relations' in the creation of the EMU project argue that the officials with most influence over monetary policy – notably, central bankers and treasury officials – had become used to working with each other and shared more in common than with their respective national colleagues. The fora for this cooperation were the meetings of EMS central bank governors following those of the International Bank for Settlements in Basle, ECOFIN (ministers of finance), the EC Monetary Committee (becoming the Economics and Financial Committee in 1999, consisting of treasury and central bank officials) and from 1987 the Franco-German economic council (treasury and central bank officials from the two countries). Verdun (1998b and 1999) examines the role of the central bank governors in these various fora as well as the Delors Committee as an 'epistemic community'.[6]

The following chapter of this volume examines the history of European monetary authority in terms of the construction of a powerful epistemic community. The fora listed above were not only additional mechanisms for intergovernmental bargaining (see Rosenthal 1975) but also involved policy learning and socialization which were an important driving force for improved policy co-ordination and monetary integration. Given the central importance of the

governors to the success of the EMU negotiations, this would also suggest the importance of this epistemic community to understanding the process leading to the Maastricht Summit. (Verdun (1999) lists four ways – discussed *inter alia* in the next chapter – in which the Delors Committee played an important role in the EMU negotiation process). Applying a structuralist approach (see below) Dyson *et al*. (1995) argue that the development of financial markets into the 1980s facilitated the growing dominance of the monetary experts, who set the agenda of acceptable monetary policy-making and monetary cooperation which governments accepted. Their success owed to their uniform insistence on coherent ideas about monetary policy (low inflation and currency stability). Any government that opted to deviate from these goals faced the sanction of the financial markets which could undermine the stability of the national currency. Verdun (1998b: 190) argues that the integration process could only move forward if conducted along the lines of what monetary authorities had decided as the common line. The interests of the various national monetary authorities were not completely dissimilar from their national governments (as monetary authorities also included finance ministers), but they did not simply fight over perceived 'national' interests. Nor did they come up with a 'lowest common denominator' solution as neo-realists predict which would have been the case with intergovernmental bargaining. The process of policy learning and socialization moulded these monetary authorities. Working within a European institutional framework, they began to look at their interests somewhat differently and sought acceptable European solutions to the problems.

It should be noted that some scholars question the usefulness of the epistemic community approach to explain the move to EMU. Dyson (1994) for one questions the importance of an epistemic community to the spread of 'sound money' ideas across several countries, concluding that this approach to policy-making fails to explain the decision by key member state governments to support the EMU project. Rather 'the national basis for economic policy ideas remained solidly entrenched' (1994: 251). Other scholars focus upon the importance of a domestically based epistemic community which helped to enforce 'sound money' attitudes in several EC member states which in turn made it possible for governments to accept the imposition of the German standard on inflation, the EMU project and specifically the appropriate model for central banks.[7]

The debatable importance of an epistemic community in the move to EMU also raises the problem that the major building blocks of EMU –

'sound money', neo-liberal reform and the independent ECB – were all pursued at an elite level. Prior to the December 1991 Maastricht Summit, these issues were not the subject of widespread political debate or interest group mobilization. In this sense, the move to EMU and its institutional design correspond to much of European integration which is marked by elite driven developments and technocratic policy-making rather than efforts to galvanize democratic participation. McNamara (1998: 174) also points out that 'all this could change … for EMU both exacerbates and makes visible what was previously obscured, that is, the social costs of neo-liberal reforms and the democratic deficit inherent in European integration more generally'. Thus the influence of central bankers in the lead up to EMU and the reinforcement of their power in the Maastricht project point to concerns regarding the democratic deficit which are discussed in Chapter 5.

The cognitivist approach: the importance of 'sound money' ideas

The prevalence of 'sound money' ideas made EMU possible (Dyson 1994; McNamara 1998; Sandholtz 1993; Verdun 1996; 2000b), notably because the acceptance of these ideas enabled the French and other member state governments to accept the institutional design – independent central banks – and rules that entrenched 'sound money' – the convergence criteria and the primacy of price stability – whereas prior to the 1980s most were not willing to do so. Lessons of policy failure in France and other countries (Howarth 2001), the ill-effects of macro-economic and monetary policies that resulted in relatively high inflation, increased the attraction of 'sound money'. Likewise, policy-learning from the success of the German model of independent central banking encouraged governments to accept independence as the best way to reinforce the credibility for tackling inflation and the need to transpose the German model to the European level. 'Sound money' has been embedded in a competitive neo-liberal policy consensus 'based on a pragmatic version of monetarist theory, one that advocates a monetarist emphasis on price stability while departing from monetarism in advocating fixed exchange rates' (McNamara 1998: 173). 'Sound money' is rooted in the rise of neo-classical economics which upholds the neutrality of monetary policy in the long run, the view that the reduction of unemployment depends principally upon supply-side policies and the importance of agents' expectations and thus credibility building for the effectiveness of monetary policy. As the principal measure for building credibility, neo-classical economics advocates the isolation of monetary policy from political influence – which risks sacrificing 'sound money' for other short-term political and

economic goals – and independent central banks with the legal obligation to pursue price stability.

Neo-liberal views were shared by the economists working on the Commission's *One Market, One Money* study of EMU. The first ECB president, Wim Duisenberg is a monetarist who has long been known for his emphasis on monetary rigour as Dutch central bank governor. Verdun (1996) looks at how the rise in popularity of neo-liberalism in the 1980s proved conducive to monetarist policy-making, while Gill (1997) shows the strength of neo-liberal ideas in EC institutions, as does Hall (1986) in other international organizations. The economic slow-down and rise in unemployment in the early to mid-1990s in several West European economies, and the demands – coming principally from French governments – for a greater 'balance' in EU economic policies (see Chapter 3) have only moderately threatened the existing consensus. If the move to EMU relied upon the neo-liberal consensus, the successful operation of the Euro-Zone will rely upon the continuation of this consensus.

Marcussen (1998, 2000) examines the important role of three ideational mechanisms in the development of support for central bank independence: central bankers as 'ideational entrepreneurs', Germany as the ideational model and – an idea introduced by DiMaggio and Powell (1991) – ideational coercion. Marcussen seeks to explain why the EU member states not participating in EMU – Britain, Denmark and Sweden – all, nonetheless, opted for central bank independence, even though this was contrary to their monetary policy-making traditions, and why the French chose to do so right at the start of Stage Two of EMU in 1994 rather than wait until 1998. His core argument, however, can be applied to several of the other EU member states and helps to explain the logic behind the independence of the ECB. Marcussen (2000: 23) argues that much of the pressure behind reform was neither economic nor legal but was rather ideational: 'once a causal idea about the positive relationship between central bank independence and low inflation performance has become safely institutionalized in formal treaties, it starts to become difficult to avoid its constraining impact because any deviance from this norm will be considered to be illegitimate'. Ideational coercion – indeed a form of 'peer pressure' – played a role in that if reform was not undertaken, the national policy elites risked being excluded from the EU policy elite. Finally, a cognitivist approach to ECB monetary policy-making since 1999 would insist upon the continued importance of sound money ideas and the peer pressure of central bankers which would have much

greater influence over interest rate decisions than national bias. However, unlike path dependency approaches, a cognitivist approach would also accept the possibility of ideational shift in the central banking community and the influence of ideas about effective monetary policy coming from international organizations and academic communities. While the Treaty on European Union mandates the ECB to maintain low inflation, the bank's Governing Council retains the power to determine its own inflation target.

Other theories of central bank behaviour

Before proceeding to structural explanations of EMU and the ECB, we should also mention a couple of the traditional theories of central bank behaviour which fit uneasily into the three categories of comparative political theory (see Dyson *et al*. 1995: 476). Public-interest theories assume some broad consensus amongst central bankers and economists as to what is 'appropriate' policy and thus can be linked to ideational explanations. Public-interest theories attempt to explain the behaviour of central bankers as an exercise in applied welfare economics: avoiding inflation and stabilizing financial markets in the interests of the population (as opposed to the selfish, short-term behaviour of politicians and market operators).[8] Personality theories focus on the influence of important individual central bank governors (Boyle 1967; Friedman and Schwartz 1963: 411). It is clear, that the most powerful central banker of the period during which the discussions and negotiations on EMU took place, Bundesbank President Karl Otto Pöhl was a more conciliatory president than either his immediate predecessors or his immediate successor. Likewise, Pöhl's French counterpart, de Larosière, enjoyed considerable prestige as the former head of the International Monetary Fund (IMF). However, personality theories fail to demonstrate any correlation between the start of negotiations and the arrival of new influential central bank governors or their relations with powerful political figures. The press coverage of the ECB since the start of EMU and the drop in the value of the euro has frequently – but problematically – turned to commentary on the ECB president, Wim Duisenberg's, managerial and communications competence, and has even occasionally entered into the realm of personality analysis.

Structuralist explanations

In addition to changes in global capitalism, Dyson *et al*. (1995: 479–81) point to three structural factors that help to explain the influence of central bankers in relation to governments in the 1980s and the struc-

ture of the ESCB agreed upon by member state governments. First, the Bundesbank both had a great deal of influence in the EMU discussions and became the model for the future ECB principally because of its impressive and long-standing record fighting inflation, and the role of the deutsche mark as the most credible EU currency and the ERM's anchor. The Bundesbank also enjoyed a domestic support base and legitimacy denied most other central banks. This enabled the Bundesbank to insist upon the 'economist's' approach to EMU, which involved gradualism, economic convergence and the indivisibility of monetary policy (Smaghi *et al.* 1994). A second structural factor was the powerful position of leading national central bankers in relation to national governments and national bureaucracies. The power of bankers was due either to a tradition of distance and respect (as in Germany and Italy) or close ties and elite networks in the operation of policy (as in Britain and France). Their influence ensured the success of EC central bankers in dominating the formulation of the ESCB's institutional design.

A third structural factor was the limited resources that the EC had at its disposal. The European Commission and other EC institutions were thus relatively weak in relation central bankers during the discussions and negotiations on the ESCB design. Modest EC resources also ensured the unbalanced institutional organization of EMU in favour of the ECB and monetary policy, with the limited construction of the economic policy side of EMU and a political counterweight ('economic government') with which the ECB could enter into dialogue. The small size of the EC budget dictated the construction of EMU which focused on the rules-based approach of monetary policy involving the convergence criteria, a ban on 'bail-outs' for governments, and the development of monetary instruments to achieve price stability. Furthermore, Dyson *et al.* (1995: 480) argue that the in-built regulatory approach of the EC to policy (see Dehousse 1992; Majone 1996, 1999) placed the burden of work for developing EMU on to the Committee of Central Bank Governors and, from 1994, the European Monetary Institute (EMI), where the central bankers designed a project to their liking.

Rational/public choice theories

Some rational/public choice theories of central bank independence which emphasize the aims of politicians seem to have some potential validity, especially given the centrality of political actors in the decision to move to EMU. These include scapegoat theories (Kane

1980) which emphasize the desire of national governments to pass on monetary policy to independent central banks so that blame for policy failures can also be shifted. Another variation on rational choice places emphasis on the desire to eliminate the domestic political difficulties associated with exchange rate adjustments (Bean 1992; Østrup 1995). According to this approach, EMU became necessary when – in the context of liberalized capital flows – the EMS demonstrated its failure to maintain stability despite considerable economic convergence. March's (1986) 'garbage can' model of policy-making applies: national governments sought to transfer responsibility in a policy area that had become too politically difficult to manage. This claim has a certain intuitive appeal: none of those countries most in favour of EMU in the late 1980s – France, Italy, Spain and Belgium – had distinguished themselves over the previous decades by their exchange rate policy successes.

The application of a rational choice approach to weak currency country policies on European monetary *cooperation* – notably the creation of the EMS – makes sense. As these countries (France, Italy, etc.) tended to suffer from speculation, and devaluations were normally perceived to be a sign of managerial inadequacy, governments had a certain political interest in constraining their margin of manoeuvre in economic and monetary policy-making within European exchange rate mechanisms in order to ensure greater monetary stability. However, in the French case at least, the application of the 'garbage can' model to policy-making on EMU and the decision to transfer powers to an independent Bank of France and the ECB is problematic. French policy-makers did seek to transfer control over monetary policy to European institutions because it was politically difficult to manage. However, they blamed this difficulty upon the asymmetric functioning of the ERM in the context of increased capital mobility – which considerably narrowed their margin of manoeuvre in monetary policy-making – not upon their control *per se*. Indeed, the French sought to maximize their *de facto* control as much as possible through the creation of a more symmetric EMS (Howarth 2001).

Opposition to central bank independence was well-entrenched in several EC member states, including the most influential country in favour of EMU: France. Despite ideational pressures pushing in the direction of independence and a relatively recent record of devaluations, in the late 1980s few French politicians and officials in the powerful Treasury division of the Ministry of Finance which con-

trolled monetary policy, considered independence to be either desirable or necessary to enhance the credibility of French policy-making (Howarth 2001; see also the section on France in Chapter 3). Politicians thus did not transfer monetary policy because they felt that it was too politically difficult to manage. Rather, President Mitterrand accepted – in the face of considerable domestic opposition – German conditions on the institutional design of EMU regardless French policy-making tradition. The opposition of most leading French politicians to central bank independence and the attempt to establish a powerful political counterweight to the ECB at the European level, indicates their preference to maintain *as much* political control over monetary policy-making as possible.[9] What the French sought to end were, first and foremost, the politically embarrassing difficulties and economic costs involved in dealing with speculative attacks against the franc, not their *de jure* control over monetary policy. Mitterrand agreed to surrender control over most aspects of monetary policy to an independent Bank of France and ECB *only* when further EMS reform to create a more symmetric system proved highly unlikely and when the Germans refused to modify their position on independence. French efforts to qualify ECB independence since the Maastricht Treaty further demonstrate the problematic nature of claims of 'garbage can' policy-making. Thus the application of a rational choice model to explain the logic behind the support of national policymakers for the transfer of monetary policy-making power to an independent ECB appears problematic. Nonetheless, the attacks by some national governments on the ECB for its policy-making – explored in Chapter 6 – suggest that claims of scapegoating appear to have some limited validity.

The application of public choice theory to the behaviour of national central bankers (including their choice of monetary instruments and how to use them) focuses on how they are driven by the private self-interests of central bankers acting as rational maximizers seeking their own prestige and self-preservation (Toma and Toma 1986). Public choice theory clearly fails to explain the timing of the move to EMU and central bank independence in that central bankers were compelled – in some cases reluctantly – to act by politicians. However, the theory can provide useful explanations (in terms of control maximization) of the strong influence of EC/Euro-Zone central bankers in the discussions and negotiations leading to the agreements on EMU, the role of the EMI in the preparations for the start of EMU, as well as the operation of the ECB in the Euro-Zone.

Campanella (2000) and Elgie (2001) convincingly draw on versions of rational choice theory in order to explore the inter-institutional dynamics of European monetary policy-making in terms of a principal–agent relationship (see Calvert, McCubbins and Weingast 1989 and Pollack 1997): the ECOFIN/Eurogroup (member state governments) as the principal and the ECB as the agent. Campanella (*ibid*.) applies a version of game theory – a variation on the strategic interaction approach (Fratianni and Hagen 1990) – to explain the conflict between the ECB and ECOFIN in the 1998–99 period and the likelihood of continued conflict: 'The strategic interaction approach would predict the emergence of a battle for political dominance, where the fiscal authorities are likely to want the bank to subscribe to their own preferences, while the bank resists these pressures [asserts its independence] and sticks to its own prerogatives' (Campanella *ibid*.: 111). However, Campanella argues that the triangular relationship of principal–agent and a third actor, namely the market constituency, to which the agent (the ECB) is accountable, establishes what she labels – drawing on Axelrod (1984) – an 'iterated strategic interaction'. A standard game-theoretic approach – a one-time game of chicken – does not apply.

> [The actors] belong to the same EMU environment, and are expected to play this game over and over again. This signals that they are bound sooner or later to learn to calculate, before any move is made, the likely consequences of the other group's move on its own payoff. … [ECOFIN/the Eurogroup] must recognize the ECB's motives in resisting political pressures. … This iterated game also explains why the ECB does not always engage in bitter confrontation with [ECOFIN/the Eurogroup]. Indeed, when direct governmental pressures are removed, the bank will eventually review its resistance, settling for an accommodation with political authorities (Campanella 2000: 112).

The details of this triangular inter-institutional relationship are further explored in Chapter 6 of this volume.

Elgie (2001) applies principal–agent theory to understand better the nature of the democratic deficit created by the ECB's control over European monetary policy. First, the theory can be applied to demonstrate that the agent (the ECB) is 'shirking' from the delegation of power as set up by the principal (the member states collectively) in the TEU – principally by insufficiently taking into consideration its

secondary goals of supporting the economic policies of the Euro-Zone member state governments – and thus acting in an undemocratic manner. Second, the principal–agent theory can also be applied to explain the underlying logic of criticism of the ECB along the lines that the preferences of the principal have changed since the Maastricht Summit – notably in terms of French government demands for an 'economic government' – thus resulting in a divergence with the preferences of the ECB. Elgie also applies the agent–principal theory to demonstrate ways to diminish the deficit – what he labels as standard and non-standard solutions – in the event that it is deemed to be unacceptable. This application is further explored in the final chapter of this volume.

Rational choice theories can also be applied to explain and attempt to resolve the free-rider problem. In the context of EMU, the risk is strong that individual member states will, for domestic political reasons, not obey the rules of the Stability and Growth Pact and run excessive public spending deficits and/or permit excessive inflation. Although there are penalties – fines can be imposed on countries that fail to respect the deficit criterion – many observers believe that these would not be imposed for political reasons. The February 2002 decision of the Eurogroup not to sanction officially Germany and Portugal for running deficits approaching the 3 per cent figure – as recommended by the European Commission and the ECB – provides a good example. The other Euro-Zone member states would thus pay the price of higher ECB interest rates. This has implications for the ECB which plays the delicate role of policeman, delivering its very public warning to recalcitrant member states, as well as judge, delivering its verdict through its interest rate weapon.

Finally, a rational choice approach – focusing upon cost and benefit incentive structures – can be applied to the decision-making process of the ECB itself. According to this approach, the individual members of the ECB's Governing Council have potentially divided loyalties. NCB governors sitting on the Governing Council are, according to the mandate of the ECB, expected to consider the interests of the entire Euro-Zone when they make policy proposals. However, the governors, while officially independent from political influence at the national level, are prone to represent the economic interests of their own member state. Thus ECB monetary policy-making should – according to this approach – be seen as a reflection of a balance among the differing perspectives of the NCB governors competing to shape policy in a way most suited to the needs of their national economies and even political circumstances.

Conclusion

Several of the theoretical perspectives drawn from comparative politics emphasize the important role of central bankers in the move to EMU and the determination of its rules and institutional design: in historical institutionalist, cognitivist, structural and rational choice terms. However, it is important to note that, although the central bankers clearly played an important role, politicians played *the* crucial role in the move to EMU. Politicians initiated the project and overcame the caution of the central bankers as demonstrated most clearly in the bankers' view that the need for previous economic convergence meant that there should be no fixed dates for stages two and three of the project (Delors 1989: 28). Had the central bankers had their way, EMU may never have come about. Moreover, the bankers failed to convince EC governments of the need for an independent EMI in Stage Two – due principally to German refusal. Nonetheless, despite the clear limits to the influence of central bankers in designing the transition, the EMU project corresponded very much to their preferences: with the convergence criteria, including strictly interpreted rules on deficits, the abolition of government bail-outs, the absence of a counterbalancing EU-level macroeconomic policy ('economic government') and, above all, central bank independence.

In order to appreciate the contribution of different theoretical approaches from international relations and comparative politics to understanding the creation and operation of EMU and the ECB, this chapter has embraced the eclecticism adopted by Sandholtz (1993) in his study of the move to EMU. We argue that only a combination of different theoretical and analytical approaches provides a thorough explanation of the creation of the ECB, but also that the tools of comparative politics are more useful to our study of the operation of the ECB than those of international relations. The creation and operational principles of the ECB must be understood in structural and ideational terms – the development of global and European capitalism and the proliferation of 'sound money' ideas in particular – while the motives of the most powerful member states and central bankers – themselves structured by EC institutions, the operation of the EMS and increasing international economic interdependence – should also be taken into consideration. Chapter 2 examines the history of European monetary authority in terms of the development of an 'epistemic community', while 'cognitive' factors inspire our study of national perspectives on the ECB and central bank independence (Chapter 3). The role of the ECB in the 'international

regime' of EMU is explored in Chapters 4 (organization and powers) and 5 (legitimacy and accountability issues), while theories of comparative politics, notably rational choice, inspire much of our analysis of the ECB in operation (Chapter 6).

2

The Long and Winding Road to the ECB: European Monetary Authority in the Prehistory of EMU

Table 2.1 Chronological development of European monetary authority

Date	*Event*
1964	First regular meetings of the Committee of Governors of the Central Banks of EEC member states.
1970	(October) The Werner Report recommends the creation of an ECB and an EC organization of national central banks.
1973	Creation of the European Monetary Cooperation Fund (EMCF / FECOM).
1979	Creation of European Monetary System (EMS) which involves the possible creation of a European Monetary Fund (EMF).
1987	(September) Basle-Nyborg Agreements reinforce inter-NCB coordination and increase EMS support mechanisms.
1988	(26 February) Genscher, the West German Minister of Foreign Affairs, submits a memorandum on the creation of the ESCB including an independent ECB.
1989	(April) Submission of the Report of the Delors Committee recommending the institutional design for EMU including the ESCB and an independent ECB.
1990	(July) Start of Stage One of the EMU project, Committee of central bank governors given additional responsibilities.
1990	At the October Rome (I) European Council, the Heads of State or Government agree to the principle of independent European central banks.
1991	At the December Maastricht European Council, the Heads of State or Government agree to a timetable and conditions for the move to EMU, the creation and powers of the EMI and of the ECB.
1993	(August) The EC ministers of finance agree to widen the fluctuation margins of the ERM to ±15% resulting in a dramatic shift in the co-ordination activities of the Committee of Governors / EMI.
1993	(October) At the extraordinary Brussels European Council, the Heads of State or Government agree to place the EMI (and future ECB) in Frankfurt.
1994	(1 January) Start of Stage Two of EMU. Replacement of the Committee of Governors by the EMI.

Table 2.1 Chronological development of European monetary authority

Date	*Event*
1995	(December) The European Council meeting in Madrid adopts the 'changeover scenario' to the single currency drafted by the EMI.
1998	(March) EMI publishes its *Convergence Report*, recommending that all those member states wanting to proceed with EMU were in a position to do so, with the exception of Greece.
1998	(2 May) On the basis of March 1998 EMI Convergence report and Commission recommendations, agreement by the European Council on the member states to participate in Stage Three of EMU.
1998	(25 May) Compromise in the European Council on the members of ECB Executive Board.
1998	(1 June) Creation of the European Central Bank. Start of term of Executive Board (end of EMI).
1998	(December) Agreement at Vienna European Council to allow ECB President to attend G7 meetings and grant the ECB observer status at the IMF board.
1999	(1 January) Start of Stage Three of EMU. ECB starts to manage the euro.

Introduction

The ECB has had a relatively short history (discussed in Chapter 6) but its antecedents, the Committee of Governors of the Central Banks of the EEC and the European Monetary Institute (EMI) played an important role in the management and development of European monetary policy from the early days of European monetary cooperation to the move to EMU. The history of European monetary authority is, of course, tightly intertwined with the history of monetary integration. Nonetheless, this chapter will not enter into the details regarding the progress of the discussions and negotiations on monetary integration. Readers should refer to the numerous studies of the move to EMU written by political scientists and historians (including, most notably, Dyson 1994; Ludlow 1982; Tsoukalis 1977) and economists and central bankers (including ECB Executive Board member Padoa-Schioppa 1994, 2000; Grahl 1997; Gros and Thygesen 1992, 1998; Kenen 1995; Steinherr 1994; Ungerer 1997). This chapter focuses on the role of EC/EU central bankers in the development of European monetary cooperation and integration. It also examines the debates since the late 1960s regarding the responsibilities of the central bankers in the context of monetary cooperation and more specifically, the responsibilities and powers of a

European monetary authority in the transition period leading to EMU and the design of the ESCB.

The early years of central bank cooperation

EEC central bank governors – notably in the Delors Committee but also in the EMI of the second stage of the EMU project – formed part of an 'epistemic community' which provided the intellectual and institutional backing to the underlying principles of EMU (sound money and finance and central bank independence) (Dyson 1994; Verdun 1999, 2000a).[10] This 'epistemic community' was long in the making. The Managing Board of the European Payments Union (EPU) (established in 1950 and ended in 1958) included central bank governors and national finance ministry officials, who also met regularly at IMF and Organization of European Economic Cooperation/Organization of Economic Cooperation and Development (OEEC/OECD) meetings. The EPU was the most efficient vehicle for West European economic policy co-ordination until the mid-1980s due principally to the temporary payments situation existing in the postwar period. The 1957 Treaty of Rome included provisions for the creation of the Monetary Committee, which comprised one representative from the ministry of finance and one from the central bank of each member state in addition to two representatives from the Commission. This group was to provide a forum for exchange of information and for preparing the meetings of the Council of Ministers of Economics and Finance (ECOFIN). Subsequently, it played a crucial role in the management of European monetary mechanisms (the Snake and the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS)) in particular with regard to co-ordinating system realignments. EEC central bankers also met regularly in international fora, notably the Bank for International Settlements (BIS) (consisting of central bank governors from the Group of Ten).

In 1964, Ecofin mandated the EEC central bankers to meet separately in the Committee of Governors of the Central Banks of the EEC following monthly BIS meetings in Basle. A Commission representative attended Committee meetings as an observer. The Committee's mandate was limited principally to the exchange of information and the resolution of technical issues of mutual concern. The Committee of Governors was one of a series of economic policy committees to develop economic policy co-ordination among the EC Six, to help ensure the smooth operation of the

Common Market. However, it lacked an operational role until the 1970s. In March 1975, the Committee decided – during a period of dollar weakness and volatility – to limit, on an experimental basis, the daily movements in the dollar rates of all EC currencies (not just the Snake currencies). However, this agreement was widely ignored and was not subsequently invoked. In March 1977, the Ecofin Council encouraged the Committee of Governors and the Monetary Committee to extend their consultations on exchange-rate matters. From the summer of 1977, these consultations were aided by the European Commission which submitted at regular intervals analytical papers on recent trends and prospects in exchange markets. The central bank governors also played an important role in both their Committee and the Monetary Committee transforming the often ambiguous Bremen European Council conclusions on the EMS into a workable system.

The idea of a European central bank pre-dates the discussions of the early 1970s in the Werner Committee. In October 1949, the Planning Group of the European Cooperation Administration of the European Recovery Programme presented a timetable for a European monetary union and European central bank, modelled on the American Federal Reserve, as a means to encourage European integration and trade liberalization. The Americans dropped the idea of monetary union when it became clear that several European governments, notably the British, found the resulting loss of sovereignty unacceptable. EMU was not an explicit goal in the Treaty of Rome of 1957 and only limited monetary co-ordination was called for through the EEC Monetary Committee. This Committee and its senior national finance and central bank officials actively called for closer co-ordination of monetary policies, notably to avoid unilateral revaluations. This encouraged the Commission to propose its 1962 *Action Programme for the Second Stage* which involved the creation of a Committee of Central Bank Governors which would manage a system of fixed exchange rates and a European reserve currency, en route to monetary union. French reluctance blocked the implementation of the Programme. However, its publication did stimulate discussions between national ministers of finance – also concerned about the effect of currency instability on the CAP – which led to the agreement on the need for consultations within the Monetary Committee prior to any currency revaluation; an agreement subsequently ignored. Moreover, the ministers of finance created the Committee of Central Bank Governors. The Barre Plan of 1969 was less ambitious than the *Action Programme* and focused on

improving monetary cooperation, including the creation of a Community mechanism of monetary cooperation which would be managed by the Committee of Governors. The discussions surrounding the Barre Plan led to a July 1969 Ecofin agreement on prior consultation on all economic policy measures that would have effect on other member states, including monetary policy decisions. However, the unilateral float and revaluation of the deutsche mark in August 1969 demonstrated yet again the weakness of such agreements. The growing instability in the Bretton Woods System and its perceived damaging impact on the operation of the Common Agricultural Policy (CAP) encouraged further discussions.

The Werner Committee and the European Monetary Cooperation Fund

The EC Heads of State or Government meeting in the Hague in December 1969 affirmed the desire to move forward to EMU. Unlike the Delors Committee of 1988–89 which consisted principally of central bank governors, the Werner Committee – set up in March 1970 to examine the practical steps to EMU – comprised only one central banker, the chairman of the Committee of Governors (in addition to the chairmen of the Monetary Committee and other EC economic policy committees, a representative of the Commission, and the chair Pierre Werner, the Luxembourg Prime Minister). The October 1970 Werner Report recommended the creation of an ECB and an EC organisation of national central banks, based on the US Federal Reserve System, which would conduct the principal elements of internal monetary policy and exchange-rate policy in relation to third countries. However, the Report makes only a relatively brief reference to the necessary institutional framework and was vague as to its establishment and its relationship to political authorities. The Werner Committee's proposals on the move to EMU failed because of the fundamental divergence between the 'economists' (led by the Germans) and 'monetarists' (led by the French). The former saw institutional construction and the establishment of a 'single' currency as following after a necessary economic convergence. The latter saw a 'single' currency and monetary institutions as an initial step required to help achieve economic policy convergence (Tsoukalis 1977). Most members of the French neo-Gaullist government also saw the loss of sovereignty as unacceptable and French President Pompidou, who had first called for EMU, was forced to retreat to a more negative position. At the same

time, many Germans saw the transfer of monetary power from the Bundesbank and the eventual loss of the mark – both important symbols of postwar German economic prosperity – as equally unacceptable. The immediate French concern in the EMU discussions was to improve European support mechanisms to support weaker currencies (notably the French franc) and maintain stability in inter-European parities.

The creation of the European Monetary Cooperation Fund (EMCF/FECOM, the Fund's French acronym) in April 1973 was the major institutional legacy of the EMU discussions. The Fund – legally based temporarily in Luxembourg – was responsible for monitoring the 'Community's exchange rate system', even though only five of the nine EC member states participated in the Snake. Each EC member state governor on the Fund's governing board had one vote. It was expected to provide the central bank governors their first substantive collective task since the European Payments Union (EPU) of the late 1940s: the management of a small percentage of European reserves pooled to help maintain stability in the balance of payments of countries participating in the Snake monetary mechanism established in April 1971. The Fund assumed responsibility for the existing currency support mechanisms (very-short-term and short-term facilities) – which had been developed through agreements by the central bank governors during the EMU negotiations – although the BIS was appointed the executing agent. It should be stressed that there was little substance to these agreements and the creation of the EMCF was of little actual significance to the operation of European monetary policy co-ordination: the Fund's board met formally for a few minutes each month after the Committee of Governors meeting where all the important issues were discussed. The Fund employed no one. Moreover, the separate central banks continued to hold and manage, on behalf of the EMCF, the pooled reserves and receive interest on them, which effectively limited the role of the EMCF to that of a bookkeeper. This limited role was due in part to the Fund's formal subordination to ECOFIN. The EC ministers of finance had rejected the Werner Committee's proposal that the Committee of Governors control the Fund. Several bank governors – notably the president of the independent Bundesbank – found this political yolk unacceptable and insisted that the substantive work on monetary policy co-ordination remain in their Committee.[11] This issue of autonomy would reappear in subsequent discussions on the reinforcement of the Fund.

Reinforced monetary co-ordination

A second product of the EMU discussions of the early 1970s were new provisions for reinforced short-term economic policy co-ordination, including monetary co-ordination (22 March 1971 ECOFIN Decisions). The Committee of Governors was asked to establish general – non-binding – guidelines for the trend of bank liquidity, the terms for supply of credit and the level of interest rates. However, no policy co-ordination resulted beyond the day-to-day concertation in the foreign exchange market. The Committee of Governors established a Committee of Alternates and expert groups, with small staffs, to monitor exchange market developments and trends in national money supplies and their determinants. The Committee also established (with the Monetary Committee) a Working Group on harmonization of Monetary Policy Instruments to follow up on the March 1971 decision. However, this group failed to contribute significantly to improved co-ordination: it only published a series of detailed surveys prepared by the individual central banks on national monetary policy instruments and their use. Although there was a gradual and significant increase in the exchange of information about domestic aspects of monetary policy, the money supply projections continued to be prepared separately on a national basis. The IMF remained the principal source of objective information for assessing the general monetary situation in the EC member states. Discussion in the various EC monetary committees proceeded predominantly on information volunteered by national policy-makers (often only orally for current issues) and no major initiatives were produced to improve the coordination (Gros and Thygesen 1992: 22).

Policy co-ordination – or more often *attempts* at policy co-ordination – was intensified in the context of the tighter fluctuation margins of the ERM of the EMS, which increased the significance of central bank governor discussions. This was in part due to the creation of a new credit mechanism, the extension of the repayment period of credit supplied under the short-term monetary support mechanism and the enlargement of medium-term financial assistance for this repayment. Moreover, the governors were given additional powers: by unanimous vote, they could decide on the use of 'debtor rallonges' to extend additional credit beyond the automatic extension of repayment allowed to debtor countries. During the 1980s, these facilities were gradually extended. However, it is important to stress that these support mechanisms were never very significant to the operation of the EMS because

they formed only a small percentage of the reserves used by NCBs in their interventions. A central issue in the negotiations leading to the creation of the EMS had been establishment of some objective indicator or threshold (the 'divergence indicator' calculated in terms of ECUs) to trigger automatically policy co-ordination discussions. Had the indicator actually been used – it was not – this would have increased the role of the central bank governors even more. Overall, co-ordination remained limited because the EMS was principally a 'limited, defensive mechanism to improve monetary stability' (Gros and Thygesen 1992; 52). Moreover, even though the EMS involved increasing the common pool of European reserves as well as a system of compensation for holders of ECU, it did not involve transferring control over these reserves and this system – managed by the BIS – to the EMCF, which remained limited to its bookkeeping function.

In their April 1978 initiative on the EMS, French President Giscard d'Estaing and German Chancellor Schmidt called for the EMCF to be transformed into a European Monetary Fund (EMF) within two years of the start of the EMS: to manage pooled exchange reserves in accordance with a joint exchange-rate policy and offer balance of payments assistance. However, in the ensuing negotiations the Germans and French failed to agree upon what the EMF should do and plans for it were quietly shelved in December 1980. In 1982, the Commission produced a note listing ten possible tasks for the EMF, ranging from the relatively insignificant assumption of the accounting functions of the EMCF to responsibility over realignments in the EMS and for formulation of a joint monetary policy. The French had wanted the EMF to manage exchange reserves and promote the use of the fledgling European currency unit, the ECU, as a reserve currency and a repayment instrument. Crucially, the Germans (the Bundesbank) had feared that with more power to manage the ECU, the creation of the EMF would have inflationary consequences, especially given that it would be under the formal control of ECOFIN (Emminger 1986). Also, as with the Werner Plan, the EMF was overtaken by events: the international economic downturn of the late 1970s and early 1980s and the continued divergence in inflation performance among EC countries. The EMF saga suggests unmitigated failure. However, it also provided a useful lesson for EC governments, encouraging them to embrace a different approach to institutional matters in the late 1980s: the strengthening of a European monetary authority could only be achieved in the context of a larger project of monetary integration which satisfied German concerns on inflation and the authority's independence.

Furthermore, the opposition of the Bundesbank to the EMF demonstrated that future institutional reform ideas should first be vetted by the central bankers in their Committee rather than presented as a virtual *fait accompli* by political leaders.

The increased subtleties of co-ordination in the context of the EMS and difficult realignment negotiations increased the reliance of governments on the Committee of Governors and the Monetary Commitee. Gradual capital liberalization in the 1980s would impose even greater demands on monetary co-ordination. Moreover, the governors played a central role in EMS reform, sought above all by the French: the details of the September 1987 Basle-Nyborg agreements were prepared and first approved by the Committee of Governors in Basle (and subsequently by ECOFIN in Nyborg). The reforms involved measures to strengthen the operating mechanisms of the EMS including interest rate co-ordination among participating finance ministries and NCBs and the promotion of the more effective use of the credit support mechanisms.[12] However, these reforms did not reinforce institutional structures *per se*. Most central bankers were interested in discussing further monetary union. However, they were generally pragmatic about it. They preferred to develop the full potential of the Basle-Nyborg agreements within a system of voluntary co-ordination (Gros and Thygesen 1992). The Committee of Governors sought to 'strengthen the procedure for joint monitoring of economic and monetary developments and policies with the aim of arriving at common assessments of both the prevailing conjuncture and appropriate policy responses.' (Committee of Governors 'Press Communiqué' 18 September 1987), which remained a core objective right up to the start of Stage Three of EMU in 1999. The governors sought a better balance between exchange-rate movements within the fluctuation margins, changes in interest-rate differentials and interventions.

The French drive for EMS reform and the Genscher initiative

Mitterrand's March 1983 decision to keep the franc in the ERM made possible future developments in monetary integration. In 1985, Jacques Delors, as Commission president, (supported by the French) sought unsuccessfully to include mention of a European monetary authority in the Single European Act (SEA) (1986), although the goal of eventual EMU was incorporated into the Act's preamble and the EMS and the ECU (described as the 'European currency') were brought into

the scope of the treaties. Of potential significance for the future development of European monetary authority, the SEA applied the unanimity rule of Article 236a to any institutional development in the field of economic and monetary policy – which meant that it could be vetoed by the British government. The new French neo-Gaullist-led government of Jacques Chirac (1986–88) began actively pushing for a reinforced EMCF to promote the use of the ECU which was seen as a way to challenge the supremacy of the German mark (Balleix-Banerjee 1999; Howarth 2001). This was part of renewed French efforts to achieve greater symmetry within the EMS: to increase strong currency central bank support for weak currencies (notably increased and obligatory Bundesbank support for the franc, through increased interventions and co-ordinated interest rate changes). On a few occasions in 1987, in newspaper interviews and speeches in France, the neo-Gaullist finance minister, Edouard Balladur speculated on the possible eventual creation of a new European monetary authority, anticipating the most important issues discussed in the Delors Committee and during the intergovernmental negotiations on EMU in 1990 and 1991.[13] The questions that he posed – in place of specific proposals for the establishment of a new European monetary authority – suggest that he, or at least his advisers, had actively considered the transformation of the EMCF, but that this was not a high priority for the moment.

Balladur reintroduced major institutional reform to the debate on the EMS in his memorandum of 8 January 1988. The French finance minister commented on the need for 'the rapid pursuit of the monetary construction' as a logical follow up to the Single Market programme and speculated on the creation of a 'common central institution'. Domestically, he and Chirac presented a far more gradualist vision and insisted that the creation of a reinforced European monetary institution was a long term issue, not of immediate importance, and refused to give details of their vision (Balleix-Banerjee, 1993, 1997 and 1999). However, the creation of some form of European monetary institution became an issue of debate – albeit a minor one – during the 1988 French presidential election campaign. Acting independently of the French government, the 'fathers' of the EMS, former President Giscard d'Estaing former West German Chancellor Schmidt joined forces again to lead the campaign for the establishment of an ECB. In late 1986 they set up the Committee for the Monetary Union in Europe which included former politicians, central and private bankers and academics as members (Dyson 1994).

In 1987, they also encouraged the establishment of the Association for Monetary Union in Europe (AMUE) which included several European large industrial companies as members. The Association published statements and the results of surveys demonstrating the largely favourable attitudes of company bosses to EMU. On 24 February 1988, Giscard and Schmidt presented a statute for an independent central bank (*Le Monde*, 25.2.88). Likewise, leading members of the Bank of France called for a hard European currency and European central bank to manage it.[14]

On 26 February 1988, to the surprise of most observers, the German Minister of Foreign Affairs Hans-Dietrich Genscher submitted a memorandum with the title 'A European Currency Area and a European Central Bank' which presented both as an 'economically necessary completion of the European Internal Market' (Genscher, 1988). Genscher had seized the opportunity to forward his federalist agenda and presented what was in fact a conciliatory position between the old 'economist' and 'monetarist' positions in order to forward discussions on EMU (Genscher 1995, 1998). On the one hand he argued that a 'common' currency and a federal European system of central banks was crucial to help build economic convergence necessary to make monetary union work. In his effort to make his project appealing to the French and Italians, Genscher emphasized that the ECB should be set up in order to promote the use of the ECU as a general means of payments in Europe and reduce European dependence on the dollar. His project was criticized both by the German Ministry of Finance and, more publicly, by the Bundesbank. However, Genscher's insistence on the autonomy of the ECB and NCBs from political instruction and the sole goal of price stability reflected one of the core German demands during the ensuing discussion: that the ESCB would have to follow a German institutional design or EMU would not proceed. The ESCB must not be obliged to finance public sector deficits. Likewise, the ESCB would mirror the federal organization of the German system of central banks with an appropriate balance between central and federative elements in its decision-making. Drawing on the German Stability Act of 1967 and the Amato memorandum of 23 February 1988, governments would also be expected legally to commit themselves to price stability. These formed the core elements of the institutional design for EMU subsequently agreed upon. Finally, Genscher called for a small group to be created at the June 1988 Hanover European Council to draw up a more precise project for EMU in order to forward the project rapidly.

The Delors Committee and the ECB

At the Hanover Summit, it was agreed to create a committee consisting mainly of central bank governors, chaired by the Commission president Jacques Delors, to examine the practical steps leading to EMU. The decision by Chancellor Kohl, President Mitterrand and Delors to leave the matter initially to the central bankers (in addition to three independent persons, Delors and the European Commissioner Frans Andriessen) acting in a personal capacity, reflected the recognition that German (Bundesbank) demands on central bank independence were a *sine qua non* of the project. National treasury officials from several countries balked at German demands on autonomy and focused a great deal more on the economic side of EMU and the matter of the dialogue between economic and monetary policies – as demonstrated by the recommendations of the High Level (Guigou) Group which, during the 1989 French Council presidency, was in charge of preparations for the Intergovernmental Conference (IGC) on EMU. Moreover, the difficulties created by the exclusion of the Committee of Governors in the initial preparation of the EMS and the relative success of the discussions leading to the Basle-Nyborg agreements served as useful reminders that central bankers should be placed at the centre of discussions. The Delors Committee was charged with the responsibility of examining both the economic and monetary aspects of unification, the transition and above all the requirements for achieving EMU. Although the Committee outlined provisions for the ESCB, it was not mandated to propose a draft statute for a European central bank. This was to be left to the Committee of Governors after the publication of the Delors Report, although an unofficial group chaired by an academic Jean-Victor Louis and consisting of central bank officials (notably those with legal expertise) worked on the ESCB design. The central bank governors agreed unanimously on the Delors Report, released in April 1989, and the work of the Louis group was published shortly afterwards.[15] Both provided a blueprint for the draft statute of the ESCB and of the ECB which was subsequently adopted by the Committee of Governors in November 1990.[16] Only minor modifications were subsequently made to the institutional structure of EMU. However, several matters eluded agreement in the committees and could only be resolved in the following IGC.

The Delors Report embraced and clarified the conditions outlined by Genscher in his memorandum and by Bundesbank President, Karl-Otto Pöhl in his own paper presented to Committee members at the start of

their work in September 1988.[17] The German inspiration is very clear: the 'epistemic community' of central bank governors and other experts all shared the Bundesbank's predilection for guarantees on price stability and autonomy from political authorities and several had been struggling for years to increase their autonomy (Verdun 1999; for the French example, see Prate 1987). The bank governors accepted, however, the need for accountability and called for reporting requirements in relation to the European Parliament and the European Council. What is perhaps surprising is that the alternative major model for an independent federal system of central banks – the American Federal Reserve – was not seriously considered by the governors as it had been by the Werner Committee. Moreover, the European Council and ECOFIN's acceptance of the Report without serious disagreement is perhaps also surprising especially given that several national finance ministries and governments had a long tradition of opposition to increased NCB autonomy. Most of the governors subsequently campaigned publicly for independent central banks, both prior to and after the agreement by the Heads of State or Government in principle to accept independence at the October 1990 Rome I European Council.

The major issues of disagreement among the central bank governors and member state governments concerned the timetable to move to EMU, the role of the ECU and that of European monetary authority during the transition period from Stage One (the full liberalisation of capital movements) to the start of Stage Three, the irrevocable fixing of parities and the transfer of monetary power to the ECB. Due to this disagreement, the Delors Report's description of the two transition stages is brief and vague. Notably, an important paragraph in the Report in chapter III, section 1 ('gradualism and indivisibility') was left out. Pöhl was very critical of the sharing of monetary power during the transition period given the confusing signals that this could send to the financial markets. Monetary power had to be indivisible. Other Committee members agreed but felt that this did not prevent some functions from being transferred to the ESCB. The Report recommended only minor reinforcement of the powers of the Committee of Governors and its secretariat to improve the co-ordination of independent national monetary policies. In Stage Two, the ESCB would be set up and begin the transition from this co-ordination to its control over the formulation and implementation of the common monetary policy in Stage Three. While the central bank governors established the date of 1 July 1990 for the start of Stage One (the date by which capital liberalization in the EMS member states was to be completed), the

starting date of the second stage, when they thought the ESCB would begin operating, eluded agreement. Moreover, the Delors Report was very vague on the institutional developments and nature of co-ordination of Stage Two, in part because the central bank governors argued that 'this [transition] would depend on the effectiveness of the policy co-ordination achieved during the first stage, on the provisions of the Treaty, and on the decisions to be taken by the new institutions' (para. 57).

Verdun (1999: 185) sums up the importance of the Delors Committee in the move to EMU as fourfold (see also Dyson 1994). First, the Committee accepted the German model of central banking for the ESCB (independent central banks and price stability) whereas politicians may not have done so. Second, the central bankers and other monetary experts had the technical expertise to suggest a credible blueprint for the EMU project. Third, all the member states were 'represented' by their NCB governors which eased the acceptance of most of the member states. Finally, the Delors Committee can be seen as having drafted the 'right kind' of EMU: one that contained the 'necessary ingredients' for success yet went beyond the 'lowest common denominator approach. In this sense, the Committee fulfilled some of the core characteristics of an 'epistemic community'.

It should also be noted that in addition to this debate on the role of European monetary authority in Stage Two, there were alternative approaches to the move to EMU – forwarded principally by the British government but also several leading political parties and economists in all the member states – than that recommended by the Delors Committee. The adopted approach was 'institutional' in the sense that it accepted that some form of new monetary institution was required to manage the transition to Stage Three and that a full blown ECB would eventually be created. The two major market-led approaches – explicitly rejected by the Delors Committee – involved considerably less institutional implications. The competing currency approach (Gros and Thygesen 1992: 329–32) rejected altogether the need for institutional developments: market forces would determine the success of the various existing national European currencies and the best would win and become the single European currency and, presumably, that currency's central bank would become the European Central Bank (with subsequent institutional modifications). All legal restrictions on the use of currencies, exchange-rate fixing and the co-ordination of national policies would cease to be necessary. The parallel currency approach – an EC currency circulating in parallel with the member state currencies

(Gros and Thygesen 1992: 332–8) – also relied principally upon market mechanisms. However, this approach involved an institution to manage the new currency in order to promote its use by the private sector.

The draft submitted by finance ministers to the Maastricht European Council in December 1991 was nearly the same as the one prepared by the Committee of Central Bank Governors. However, there were two major differences in the tasks of the ESCB. First, the governors sought to give the ECB full power over exchange rate policy whereas the finance ministers decided to divide responsibility between the Council of Ministers and the ECB. Second, the finance ministers agreed to give the ECB a lot less power over prudential supervision of the banking system. The Governors had recommended that the ECB 'would participate as necessary in the formulation, coordination and execution of policies relating to prudential supervision and the stability of the financial system' and be 'entitled to offer advice and to be consulted' on the interpretation and implementation of EC legislation concerning prudential supervision. The finance ministers decided that the ECB should merely 'contribute to the smooth conduct' of policies designed and pursued by others. There were also several minor differences in the two drafts. One example had potential implications for the ECB's pursuit of price stability. The Committee of Governors' draft read that the 'ESCB shall support the general economic policies *of* the Community' (italics added) whereas the finance ministers final draft read 'the general economic policies *in* the Community'. According to Kenen (1995: 30) the word 'of' was apparently 'seen to invite the ESCB to disregard the policies of the individual EC countries and seemed also to invite the Community to adopt a wide range of common policies'.

The Committee of Governors in Stage One of EMU

Following the recommendation of the Delors Report (April 1989), the June 1989 Madrid European Council agreed to start Stage One of EMU on 1 July 1990. Based on the recommendations of the Delors Report (paras. 50–2) ECOFIN granted the Committee of Governors additional responsibilities from the start of Stage One (Council Decisions dated 12 March 1990 to replace the Council Decision of 1964). A responsibility assigned to the Committee of Governors was to start preparations for Stage Three of EMU by identifying the major issues and establishing a work programme by the end of 1993. Stage One was also supposed to be about tighter *voluntary* co-ordination of monetary policies made

necessary by the greater degree of exchange-rate fixity combined with financial market integration. The Committee of Governors was given new means to achieve this co-ordination. First, the new Council Decisions implied that the Committee of Governors could develop a more visible public profile, with the publication of an annual report and appearances of the Committee Chairman before the Economic and Monetary Committee of the European Parliament. Increased visibility was important in the context of the gradual construction of the future European monetary authority's credibility and legitimacy through demonstration of its accountability. The first report of the Committee (covering the first 18 months of Stage One to the end of the 1991) was published in April 1992. Moreover, the Decisions allowed the Committee of Governors' Chairman to decide to make public the deliberations of the Committee at any point in time.

Second, the Committee was encouraged to make critical reflections on the economic and monetary policies of individual member states and the EMS participants as whole. These critical reflections could appear in the Committee's reports to the European Council and Parliament or in the deliberations made public by the Committee Chairman. In theory, the Committee of Governors already possessed the power to make critical comments, although this power was severely curtailed by the control exercised by national ministries of finance over most of the NCBs. Moreover, the Committee had avoided criticism in the past because of considerations of collegiality and concerns about upsetting financial markets. It continued to do so, with a few notable exceptions. Most significantly, on 12 December 1990, the Committee of Governors agreed to ask publicly the German government to reduce its budget deficit, noting that it weighed too heavily on monetary policy and created tensions within the EMS (*Agence Europe*, 13.12.90, 5390).

Third, the ministers of finance hoped that the Committee would strengthen its analytical capacity (and its sub-committee structure) in order to develop an *ex ante* approach to, rather than an *ex post* analysis of, monetary co-ordination. The central bankers from the smaller member states were particularly keen to push ahead: they had few illusions about their remaining monetary autonomy. However, there were several obstacles to *ex ante* co-ordination, in addition to different monetary policy instruments and the reluctance of some of the larger member state central banks to change their ways. In several systems – including the UK and France – monetary authority was divided and ministries of finance (and governments) were unwilling to delegate

some of their powers to an unspecified process of central bank co-ordination. Moreover, in some systems – notably, the German federal system – the organization of the central bank's decision-making structure made difficult the delegation of any power through its president (or other representatives) to a European monetary authority.

The failure of the Committee of Governors to establish co-ordinated intermediate monetary targets for 1991 was the first demonstration of the weakness of Stage One procedures to build voluntary co-ordination. The establishment of these targets for 1991 was arguably too ambitious. However, the governors also failed to achieve a less ambitious goal: an agreement of a quantitative assessment of the monetary objectives of the participating countries. This failure was due to three problems (Gros and Thygesen 1992; 347): first, the difficulty of agreeing to joint assumptions about external shocks (due to temporary uncertainty about oil prices and the dollar); second, the differences in monetary or credit aggregates used by the participants; and third, the disagreements as to the role that such aggregates could play in fostering co-ordination. In order to overcome the second problem, in 1991, the Committee of Governors set up an Economic Unit to work on building statistical compatibility and harmonizing concepts of the aggregates used by the different member states. However, progress in Stage One was slow.

The Committee of Governors failed to improve co-ordination sufficiently to challenge speculation against most EMS currencies in 1992 and 1993. The efforts undertaken in Stage One did not compensate for the underlying change in the EMS which undermined stability: notably rising German inflation; lower French (and other country) inflation; the corresponding weakening of the position of the German mark as the ERM anchor currency; the record high interest rates in France and other EU countries; economic recession and rising unemployment in most participating countries. The most effective co-ordination during this period was bilateral, notably 'the sweetheart deal' between the French and German ministries of finance and central banks, first arranged to keep the franc in the ERM in September 1992, and then repeatedly referred to as a weapon to stem the periodic bouts of speculation over the next ten and a half months. This deal amounted to the public engagement of the Bundesbank to provide unlimited support to the franc to defend it against devaluation. However, given the Bundesbank's refusal to provide this unlimited support in late July 1993 – given the potential inflationary effects – the franc was forced to devalue. In order to the save the ERM and ease speculation, participat-

ing ministers of finance (with central bank governors in attendance) reached a deal at the 1–2 August Brussels Extraordinary ECOFIN to widen the mechanism's margins of fluctuation from ±2.25 to ±15 per cent. The widening of the ERM margins nullified the practice of monetary cooperation built up over the preceding 14 years of EMS operation and dramatically diminished the role of the Committee of Governors. It became superfluous to monitor the operation of the EMS and manage its credit facilities because interventions in the foreign exchange markets were minimal. Following the experience of July 1993, the French sought to strengthen their convergence programme with the Germans: starting in August, the two countries' programmes were planned in 'tight concertation' and presented to the press simultaneously (Howarth 2001). However, this did not involve reinforced co-ordination on the part of central bank governors.

The European Monetary Institute in Stage Two of EMU

The date for the start of Stage Two, 1 January 1994, was agreed at the October 1990 Rome (I) European Council (and confirmed subsequently by the October 1993 Brussels extraordinary European Council). However, the actual powers of European monetary authority remained a subject of considerable debate throughout much of the IGC and subsequently. The opposing sides corresponded to the traditional 'monetarist' versus 'economist' divide. The French had – as demonstrated in their January 1991 Draft Treaty – a maximalist interpretation of the role of the EMI to promote actively the ECU. The Germans, however, sought a minimal EMI – indeed, with virtually no powers beyond those already granted to the existing Committee of Governors. The Delors Committee had clearly leaned towards the German vision: '[Stage Two] must be seen as a period of transition to the final stage and would thus constitute a training process leading to collective decision-making, while the ultimate responsibility for policy decisions would remain at this stage with national authorities' (para. 55). As in Stage One, monetary authority was seen as indivisible. Nonetheless, all the national governments recognised the complexity of managing the EMS – with the ultimate responsibility for monetary policy remaining in national hands – while preparing for EMU and the transfer of power to the ECB in Stage Three. At the ECOFIN Apeldoorn meeting on 23 September 1991, EC ministers of finance agreed to French demands on the automaticity of Stage Two but they only allowed the creation of an EMI with minimal powers: the German vision had prevailed. Meeting in

Basle on 29 October, the governors left open certain aspects of the statutes of the EMI – including the structure of the direction; the voting procedures within the Institute; the constitution of its capital and its location – on which agreement eluded them. The final provisions of the Maastricht Treaty ensured the creation of an institute with a legal personality, to be directed and managed by a Council, consisting of a President and NCB governors (article 109f.1). Control over monetary policy would be transferred to the European level only with the creation of the single currency at the start of Stage Three. The Treaty on European Union included the protocols on the Statute of the ESCB and of the ECB (see Appendix 1) and the Protocol on the Statute of the EMI.

The EMI Executive Board consisted of 13 members (16 following the 1995 enlargement) including the president and all EU central bank governors. All the EU member states participated in Stage Two of EMU, including Britain, Denmark and Sweden. Thus, perhaps oddly, the central bank governors from the three countries which did not intend to join the first wave of countries moving to Stage Three, nonetheless participated in all the discussions and preparations for the move to EMU. The Institute was assigned the responsibility to strengthen cooperation and co-ordination between the member state central banks with the aim of ensuring price stability, to assume the responsibilities previously assigned to the EMCF and the Committee of Governors, and to facilitate the use of the ECU and oversee its development (including the smooth functioning of the ECU clearing system) (article 109, TEU and article 2, EMI Statute). By the end of 1996, the EMI was to specify the 'regulatory, organizational and logistical framework necessary for the ESCB to perform its tasks' (article 4, EMI Statute). Specifically, the EMI was to:

- prepare the instruments and the procedures necessary for carrying out a single monetary policy in the third stage;
- promote the harmonization, where necessary, of the rules and practices governing the collection, compilation and distribution of statistics in the areas within its field of competence;
- prepare the rules for operations to be undertaken by the national central banks in the framework of the ESCB;
- develop the framework for conducting foreign exchange operations as well as for holding and managing the official foreign exchange reserves of the member states participating in the Euro-Zone;
- promote the efficiency of cross-border payments; and

- supervise the technical preparation of ECU bank notes (article 4, EMI Statute);

The EMI Council was granted minimal powers to formulate – by a two-thirds majority of its members[18] – and submit opinions and recommendations to the Council on the orientation of monetary policy and the functioning of the EMS as well as the monetary and exchange rate policies in individual member states (article 109f; protocol article 5). Article 6 of the Protocol allowed the EMI to hold and manage foreign exchange reserves as an agent for and at the request of national central banks. However, the pooling of reserves remained voluntary and as no NCB asked the EMI to manage its reserves prior to the start of Stage Three, the Institute effectively assumed the bookkeeping responsibilities of the EMCF. At the 1991 Maastricht European Council, the Heads of State or Government finally reached a compromise on one of the most difficult issues during IGC: the timetable to move to Stage Three, either in 1997 or automatically (for qualifying member states) in 1999.

The move to Stage Two and the creation of the EMI proceeded on schedule. At the December 1993 Brussels European Council, Alexandre Lamfalussy, the Belgian former head of the BIS, was selected as the first president of the EMI. He was seen as a safe pair of hands: the decision was uncontroversial, acceptable to all the member state governments, including the Germans.[19] One potential obstacle – regarding location – was overcome at the October 1993 extraordinary European Council, where the European partners agreed to place the EMI and thus the future ECB in Frankfurt. The French had favoured Lyon. However, Chancellor Kohl insisted upon Frankfurt on the grounds that a German location was needed in order to assuage the large number of Germans hostile to the loss of the mark and the transfer of monetary power to the European level and to address, symbolically, the fear that the ECU (as it was then called) would be much weaker than mark and that the ECB would have difficulty maintaining low inflation.[20] The selection of Frankfurt likewise had another symbolic purpose: to signal to the financial markets that the ECB would be as diligent as the Bundesbank in the maintenance of price stability.

In terms of real policy co-ordination, it turned out that Stage Two amounted to an extended Stage One. The French saw the co-ordination difficulties and EMS instability in 1992 and 1993 as an important reason to expand and clarify the co-ordination role of the EMI (Jaillet 1994). The Maystadt Plan, presented by the Belgian minister of finance to his European colleagues unsuccessfully pursued this objective. The

co-ordination difficulties and the stability created by widening the fluctuation margins convinced the Germans that reinforced co-ordination in Stage Two was unnecessary. The EMI also chose largely to ignore the option of re-narrowing the EMS margins – which would have increased its co-ordination role – and focused most of its time and attention to its preparation tasks.

The EMI was much better equipped than the Committee of Governors to reinforce monetary policy co-ordination. First, the EMI Council was granted a strong degree of autonomy (EMI Protocol, article 8) – a foretaste of the ECB Governing Council's independence: members could not seek or take any instructions from EU institutions or bodies or member state governments. This autonomy was reinforced by the early move to NCB independence in several of the member states early in Stage Two. This autonomy increased the chance of criticism of the economic policies pursued by member state governments. Second, the EMI became a relatively large institution with a highly competent professional staff of over 200 by 1996, which could undertake independently some analytical functions, whereas the Committee of Governors had relied entirely on the NCBs. The Council and the Alternates Group were chaired respectively by the President and the Director-General of the EMI, who both devoted all their activity to the EMI, hence assuring the effective use of staff analyses. Third, the EMI's power to submit opinions and recommendations became more significant given the increasing independence of NCBs and the institute's greater professional analysis.

Some observers and participants (for example, Gros and Thygesen 1998) criticized the EMI for being insufficiently active in promoting co-ordination and collective evaluation of monetary developments, such as the significant movements in EU and other major currencies in 1995 and the strengthening of the Irish punt and British pound from 1997. However, the co-ordination role had become less relevant for reasons noted above – the wider fluctuation margins – because there were no crises in the EMS during Stage Two and most of the EU member states succeeded in maintaining price stability. Arguably a collective and public evaluation would have been more useful in the two years prior to the start of Stage Three. Policies pursued in this period would have a greater effect on inflation in the first years of EMU, and national and EMI inflation forecasts were of particular interest given that inflation targets would likely become an important factor shaping policy. Moreover, there remained the possibility of turbulence in the run-up to the selection of participating member states in the spring of 1998 and

the move to Stage Three. Gros and Thygesen (1992 and 1998) argue that the EMI could have played a more active coordinating role without undermining the 'ultimate responsibility' of national authorities' (1998: 426). In their opinion, the EMI should have prepared three elements as part of a 'useful learning process' to smooth the transition to EMU (as recommended in the Delors Report): 'a consensus on the specific formulation of the ultimate objective(s); a common analytical framework for intermediate objectives and for the design of monetary policy; and a sufficient degree of experience with common operations.' In particular, the expert authors bemoan the lack of experimentation in genuine joint decision making. In their individual papers appended to the Delors Report, Committee members made some suggestions as to the non-institutional steps in the transition period which could help build common policy-making. However, these were ignored during the IGC. Gros and Thygesen (1992) examine several possibilities for building common decision making with regard to adjustment of short term interest differentials, intervention policy vis-à-vis third currencies, the development of a Community-wide reserve requirement, realignments, and on the issue of a parallel currency (the ECU).

EMI documents focused instead on analysing the progress of the member states in meeting the Maastricht convergence criteria. With the criteria and the 1999 deadline in place, the EMI Board's monthly debates and regular reports on monetary policy and economic performance and convergence (summarised in the EMI's annual reports) assumed greater importance than those of the former Committee of Governors and helped nudge member states toward compliance.[21] Throughout Stage Two, the EMI gently chided the member states which were making inadequate progress. It also frequently criticised member states for 'one off' deficit cutting measures that did not ensure sustainable low deficits. In its 25 March 1998 convergence report, the EMI drew attention to the large debts and inadequately low deficits of several member states, recalled the medium-term aim of budget surplus established in the Stability and Growth Pact, and encouraged accelerated economic reform and 'decisive and sustained corrective policies of a structural nature' (EMI 1998). Although the final decision on which member states adequately met the convergence criteria and thus could join EMU remained the responsibility of the European Council and was announced by the Heads of State or Government on 2 May 1998, the EMI's March 1998 report was considered the more objective and authoritative statement on the suitability of member state participation.[22] The report stated that Greece was not prepared to participate in

Stage Three. By supporting Italy's participation in Stage Three – opposed previously by the German and Dutch governments – the EMI made its inclusion in the eleven first members more politically manageable.

The Institute also played a more active role in the preparations for EMU. The EMI successfully completed all the essential tasks outlined in the EMI Protocol article 4 (mentioned above) and published numerous documents approved at its 45 meetings between 1994 and the end of May 1998. The Institute:

- closely followed the development of the use of the private ECU/euro with annual reports.
- prepared the chronological sequence of events for the changeover to the euro (November 1995) (adopted by the December 1995 Madrid European Council). The EMI outlined differences between national changeover scenarios and the potential need for harmonized actions in a March 1997 document and submitted its own scenario.
- outlined the operation framework of the single monetary policy in a January 1997 document (which the TEU required by the end of 1996), the single monetary policy strategy of the ESCB (February 1997) and produced general documentation on ESCB monetary policy instruments and procedures and documents on several more specific points.
- set up the future monetary and exchange rate relationships between the Euro-Zone and other EU countries (the ERM-II).
- published its money and banking statistics compilation guide (April 1998): guidance provided to all EU NCBs for the compilation of money and banking statistics for submission to the ECB.
- clarified the rules for NCB operations: The EMI achieved several specific goals, outlined in the Statute of the ESCB and of the ECB.

1. It elaborated harmonized accounting rules and standards to make it possible to construct a consolidated balance sheet of the ESCB;
2. it put in place the necessary information and communications systems support for the operation and policy functions to be undertaken within the ESCB; and
3. it identified the possible ways in which the ESCB would contribute to the policies conducted by the competent supervisory authorities to foster the stability of credit institutions and the financial system.

- helped prepare necessary national and EU monetary and financial legislation, including the statute of the NCBs. It followed up on NCB reform in its annual reports.
- established foreign exchange rules (July 1997 common market standards for money market and foreign exchange transactions).
- developed the TARGET cross-border payment system (introduced in May 1995) and produced regular reports from August 1996 on the system's progress.
- organized a competition for the design of the new banknotes and selected a winner (approved by the December 1996 Dublin European Council).

As one of its final tasks, the EMI examined the irrevocable conversion rates for the euro. At a 2 May 1998 meeting, it agreed with the member state finance ministers and Commission representatives to use the existing ERM bilateral central rates of the participating currencies to determine the irrevocable rates.

The major final controversy in the lead up to EMU concerned the selection of the first ECB President. In May 1996, the NCB governors – with the approval of the Heads of State or Government – selected Wim Duisenberg, the experienced governor of the Bank of Netherlands, as the final president of the EMI. He was generally expected to become the first president of the ECB. However, the TEU granted the European Council the power to select the ECB president. At the December 1997 Luxembourg European Council, the political leaders failed to agree upon Duisenberg because the French President, Jacques Chirac, insisted upon the appointment of the Governor of the Bank of France, Jean-Claude Trichet. The French saw the presidency is an important symbol of monetary power: both the public and international face of the ECB. Placing Trichet in this position was thus of considerable importance to the French. It was also seen as an appropriate compromise given the decisions to establish the ECB in Frankfurt and to replace the ECU with the euro – both loaded with symbolic significance. Moreover, the French disclosed publicly that a secret agreement on Trichet's appointment had been reached with the Germans in October 1993 when Frankfurt was selected over Lyon. Owing to the important role of the future ECB president, the power motive went beyond the purely symbolic. The assumption was – regardless the autonomy of the Bank of France in relation to the French government – that Trichet's appointment would enhance French influence within the ECB during its crucial formative years and at the international level.

A lengthy and very public battle ensued. French stubbornness on this issue consumed most of the 25 May 1998 extraordinary Brussels European Council, where a compromise was reached. Duisenberg would stay on. However, to meet Chirac half way, the Dutchman agreed – supposedly 'of [his] own free will … and not under pressure from anyone' – to step down after mid-2003 to make way for Trichet.[23] In the meantime, the French would be adequately represented in the Executive Board, with the appointment of Christian Noyer, the former head of the French Treasury, as ECB Vice-President.[24] The compromise was made even more palatable for the French by the strategic appointment of another recent head of the Treasury, Jean Lemierre, as the first president of the Economic and Financial Committee, the rebaptized Monetary Committee. The incident increased the perception that the ECB's independence would be difficult to safeguard from the influence of member states. Moreover, the compromise was almost certainly illegal when viewed against TEU provisions because Article 112(2)(b) EC (ex 109a(2)(b)) requires that the term of the President's office last eight years (Craig 1999).

On 1 June, in accordance with Article 123 EC (ex 109L), the EMI was replaced by the ECB and the Executive Board began its term. With most of the preparatory work successfully completed prior to June 1998, the ECB devoted the remaining seven months of the year to the final testing of systems and procedures and establishing the rules of procedure of the General Council. There remained a few issues to resolve. One concerned the Euro-Zone's monetary policy strategy which was adopted by the ECB's Governing Council on 13 October (see Chapter 4). A second outstanding issue concerned the external representation of the euro. At the December European Council in Vienna, it was formally agreed to allow the ECB President to attend G7 meetings for discussions relating to EMU (for example, multilateral surveillance and exchange rate issues) and at the time of the agreement on the relevant sections of the meetings' published statements. The ECB was also previously granted observer status on the IMF Executive board.

On 1 January 1999, EMU was officially launched. Control over European monetary policy, including interest rates and monetary mass, was transferred to the ECB. The parities of the participating currencies were fixed irrevocably by the Council. All new national public debt was to be issued in euros and the TARGET payment system was put into operation. It remained to the ESCB central bankers the task of bringing into circulation the euro banknotes and coins from the start of 2002. One of the most innovative developments in central banking

history and, indeed, the history of world governance, had begun. With over half a century of close, and progressively tighter, cooperation behind them, the Euro-Zone central banks were well placed in their unique position to operate the world's most important multi-national system of central banks.

3
National Attitudes on the ECB and Central Bank Independence

> Money is more than a part of the economy. Money reflects the state, politics, and culture. The euro (however) will be a denationalized and de-politicized currency.
>
> Hans Tietmeyer – Former Bundesbank President and ECB Governing Board Member.[25]

Introduction

Despite the focus of our previous chapter upon the role of European central bankers, the history of monetary cooperation and integration was dominated by the actions and interests of France and Germany, the axis of European integration. We argue that it is necessary to explore the interests and preferences of these two countries and their monetary policy-making traditions in order to understand both the design of the EMU project and the ECB in particular, as well as the current politics of the Euro-Zone in which the ECB must engage. Not to downplay the importance of other Euro-Zone members (the Dutch or Belgians, for example), the institutional structure, roles and powers of the ECB reflect the explicit preferences of these two leading EU member states, notably Germany. The on-going debate about structure, roles and powers is, furthermore, energized principally by French politicians and policy-makers. The emphasis placed upon central bank independence owes principally to the German monetary policy-making tradition. Most other Euro-Zone member states – notably the French – have traditions which rejected independence. This leaves an ideational legacy that views the operation of EMU, and in particular the inadequate political counterweight to the ECB 'Leviathan', with much concern on both political and economic grounds. We therefore

explore French attempts to construct some form of 'economic government' (EG) at the European level which could fill this role of political counterweight, and the diversity of ways in which EG has been presented by French politicians to different audiences. In particular, we examine French attempts to expand the role of the Eurogroup and develop European macroeconomic policy co-ordination. Contrary to the wishes of former Bundesbank and ECB member Hans Tietmeyer, the ECB operates in a political environment strongly shaped by member states.

The following analysis provides an overview of the historical, political and economic factors that have shaped – and continue to shape – the debates and policy developments in Germany and France with regard to central bank independence, the ECB and, more generally, EMU. Our ambition is to develop a more comprehensive understanding of the ECB and its operations. A short section is also devoted to the United Kingdom by way of comparison. The aim here is to explain how widespread traditional hostility to central bank independence in this country contributed to the persistent political hostility to EMU, yet also why, in the spring of 1997, one of the new Labour Government's first measures was to grant considerable autonomy to the governing board (the Monetary Policy Committee) of the Bank of England.

German monetary interests and attitudes: independence and price stability

German monetary interests were most influential in shaping the operation of the EMS, EMU and the institutional structure, roles and powers of the ECB. As a result, the current policy-making process and politics of the ECB bear a deep-seated teutonic flavour. Specifically, to understand Germany's monetary interests in EMU and the ECB is to zero in on a number of critical ECB issues examined in this book: the independence and the transparency of the ECB; the credibility of the ECB's monetary policies; the controversies over exchange rate management; and the interaction of the ECB and Eurogroup. In many ways, these issues mirror the politics and policies of the German national central bank, the Bundesbank, over its long and distinguished history (Loedel 1999a). The ECB was modelled on the Bundesbank, with its high degree of independence, its primary focus on price stability, its federalist structure (the Länder central banks), and its focus, in part, on monetary growth as a key target of policy-making. Moreover, without

Germany's political support for EMU, in particular the support provided by former Chancellor Helmut Kohl, EMU would not have happened. In fact, the ultimately political decision to sacrifice the treasured German deutsche mark for the euro is perhaps one of the most important in postwar German history – and perhaps postwar European history. Finally, with the ECB located in Frankfurt (the location of the Bundesbank) and the German-inspired Stability and Growth Pact guiding macroeconomic policy across Europe, the Germans have institutionalized the Bundesbank's legacy and monetary norm across Europe.

The following section examines the larger historical context of German monetary interests, the politics and policies surrounding the German approach to European Monetary Union, and the current operation of EMU and the ECB. We also examine the German views toward the concept of European monetary authority.

The historical context of German monetary interests

As part of the German national subconscious, monetary policy retains a prominent and consequential role in the political economy of Germany. In fact, the writing of German history can be punctuated by monetary affairs. The social and political consequences, to say nothing of the financial and economic ruin, of the hyper-inflationary period in 1923, for example, led to the undermining of the Weimar government's credibility and legitimacy, exacerbating the attacks of extremist movements on the left and right (Feldman 1993). Following the Second World War, the historic currency reform of 20 June 1948 launched the German *Wirtschaftswunder* that helped lay the foundations for the world-wide admired economic and political ascent of the Federal Republic of Germany (FRG) and its internal social stability and economic dynamism. German Economic and Monetary Union (GEMU) of July 1990 also marked a new era in German politics, as did the replacement of the DM by the euro during the first half of 2002.

These highly visible periods in German political and economic history illustrate the political nature of monetary policy and its importance as a fundamental socio-economic and political foundation or pillar of the Federal Republic of Germany. In fact, as these examples show, the stability and, in extreme cases, the very existence of the democratic order itself may depend on politically sensitive monetary decisions (Emminger 1986; von Arnim 1988). For example, von Arnim sets forth a theory of democracy that posits the primary importance of central bank independence to the stability and democratic order of the

German political system. In other words, the Bundesbank had become the guarantor of German democracy by acting as a guide, protecting the German government from irresponsible policy that could destabilize the democratic order. Arguably, then, monetary stability and social stability are one and the same. It is the confidence of the large German middle class (to say nothing of the upper class) in the money in their pocket, earned after years of hard work, that provides the building blocks of German democracy. German monetary interests and the policy that flows from it should, therefore, be examined for the political and social character it represents rather than in strictly economic or financial terms.

While always difficult to measure precisely or operationalize, the German economic culture is said to demand fiscal rectitude and a deflationary macroeconomic policy targeting price stability (Hanrieder 1989). Two leading commentators on the international political economy state the German case more bluntly: 'The German tribal memory heightens political awareness of the long-run penalties attached to inflation and, therefore, substantially assists inflation resisting policies' (Strange and Calleo 1984: 111). This economic culture gave German monetary policy a special quality, unique to the particular historical experience of the Germans. Some may label this deeply ingrained attachment to currency frugality a peculiar Germanic monetary angst or paranoia, but these features are staples of Germany's approach to monetary policy and EMU, and they reflect the broader social and political context in Germany and have developed into a distinct monetary ideology (see Noelle-Neumann 1968). This ideology presents a fairly simple yet stark view and message to the masses of the dangers of currency instability. This view is captured by Gordon Craig who states that 'the failure of the first German experiment with republican government was fore-ordained when the one commodity (money) that more than any other seemed to give people a means of rational assessment of their situation lost its power to do so any longer' (Craig 1982: 121). Unmistakably, social and economic conditions past, present and future play a powerful role in German society and the course of monetary policy.

This monetary ideology based on the fear of inflation and its socio-political consequence manifested itself in the institutional structures of the German political economy, in particular through the creation of the powerful Bundesbank. Most analyses of the German political economy cite the foundations of the Bundesbank in the postwar German constitution (*Grundgesetz*) which give German monetary

policy its special administrative and legal quality. Therefore, to understand German monetary interests is to examine the quasi-independent Bundesbank that commands a towering and lofty position within the political economy of Germany. For many Germans from all socio-economic strata, the Bundesbank guaranteed the soundness, stability, and foundations not only of the currency, the treasured DM, but also of the democratic and stable political order. Without a sound and stable DM, society could easily be buffeted by un-democratic forces bent on subverting the established political-economic order of which the Germans – rightfully so – are proud. The Germans learned their bitter lesson about defacing and devaluing a nation's currency and entrusted to the Bundesbank the task of defending the 'stability of the currency' (see, for example, Lehment 1981; Kennedy 1991; Marsh 1992).

The strength of public support for an independent central bank guaranteeing the value of their beloved D-mark added to the resources of the Bundesbank in times of conflict. An attentive German public opinion and political, financial and economic elite on monetary affairs helped guard the independence of the Bundesbank. However, if the central bank was badly out of step with current economic conditions and misunderstood the cycles of history, the clashes with finance ministers and chancellors were less easily hidden from public debate, and no amount of independence could save the bank from strongly defending its position with the public. The Bundesbank thus went to great lengths in maintaining a consistent and vocal public relations campaign. It is in this role that the Bundesbank mastered the art of public communication and speaking with one voice. More importantly, that voice focused on one overriding goal for German monetary policy and that goal is price stability. The Bundesbank continually returned to this familiar German monetary leitmotif – a leitmotif surrounded by an aura of familiarity and respect to the public. The goals, objectives and policies of German monetary policy, especially as espoused by Bundesbank officials, remained remarkably consistent over the decades. Significantly, the German voice acts as the conscious of the ECB as the message of price stability resonates strongly through the halls of the ECB.

Germany and EMU: interests and objectives

Given the powerful historical backdrop of German monetary preferences, one wonders why the German government did not dismiss the idea of EMU out of hand (given the implications of the prospective treaty). Despite some of the efficiency gains from a single currency,

Germany would not expect to benefit a great deal from the reduction in transaction costs (primarily on the export side rather than on imports) because a sizeable proportion of German trade within Europe was already denominated in DM. Nor would Germany immediately benefit from the anti-inflationary credibility of the future European Central Bank. Indeed, the reverse could happen. Even if the ECB's independence from political control was more formally guaranteed than the Bundebank's, it was arguable that the ECB would find it hard to inherit the Bundesbank's reputation and credibility. Moreover, the Bundesbank was not altogether convinced that other European central banks could deliver the same level of price stability. Finally, French pressure for a European-level political counterweight to the ECB (see the following section for more detail) raised additional red flags about the future independence of the ECB. In sum, the persuasiveness of economic or monetary motivations should not be stressed in understanding the German approach to EMU.

Instead, a political explanation is required to understand why the Germans were willing to offer the DM as the sacrificial lamb in return for EMU. Internally, the political will of Germany's leading politicians led to a great deal of overt and tacit pressure placed on the Bundesbank not to derail the negotiations on EMU. The key government players, Chancellor Helmut Kohl and his Foreign Minister, Hans-Dietrich Genscher, had a singular interest in EMU which reflected long-standing foreign policy goals and ideas – built on the Treaty of Rome and the Franco-German axis. Most importantly, European integration, while generally supported by the German public, was always an elite driven process of German foreign policy-makers. Moreover, the political importance of European integration for the foreign policy establishment expanded as Germany slowly reasserted its dominant political and economic position in Europe during the late 1980s. It was believed that German reassertion of power and influence could best be expressed with the comforting and binding constraints of the EC and an overall strengthened European identity. Finally, with the seeming month-by-month collapse and disintegration of Eastern Europe through 1989 and with the looming prospect of German reunification into 1990, the political (or foreign policy) salience of EMU moved to the foreground for German and European politicians. As the historic 'German problem' – the long held political, economic, and military-strategic concerns of Germany's geo-political position in the heart of Europe – came to the forefront of debate, irrevocably binding Germany to the EC, with monetary union as the crucial means for doing so,

became the negotiating mantra of German politicians and their European partners.

The Bundesbank was not blind to the pressures coming from politicians. The Bundesbank's distinctive position on EMU and the Maastricht Treaty negotiations is best summarized in its *Monthly Report for September 1990,* 'Statement on the Establishment of an Economic and Monetary Union in Europe'. The bank's views should not have been surprising to anyone and reflected long-standing principles associated with earlier European discussions on EMU, beginning with the Werner Report in 1970. The bank's cautious approach toward EMU centred on its belief in the coronation theory (*Krönungstheorie*) – the view that EMU must result only as the final stage of a prolonged period of convergence of key economic variables (notably inflation, but also budget deficits and public debt) and institutional safeguards (political independence of a European central bank). Apparently, the Bundesbank believed that convergence in line with the Bundesbank model would so slow down the process of EMU such that monetary union might not ever arrive. The bank also argued that 'substantial transitional problems as a result of the intra-German unification process', and the uncertainties in Eastern Europe justified postponement of any further steps on EMU 'until such time as the economic situation in Germany as a whole and in the European Community can be regarded as sufficiently consolidated'. The Bundesbank accurately and justifiably feared being pressed to support EMU because other countries had supported Chancellor Kohl's rapid movement on unification.

Given the political realities and the Bundesbank's concerns, the decision to sacrifice the DM was indeed a profoundly political move. There was some concern over the ambiguity of the protocols on exchange rate management as well as concern over the strength of other countries' commitment to the convergence criteria in the Maastricht Treaty. The timetables for implementing EMU were also seen as problematic by many Germans. But the Germans essentially got what they wanted – especially in monetary terms (Dyson 2001). First and most importantly, they got a powerfully independent ECB with a primary objective defined as price stability. Second, the strict (some would argue draconian) convergence criteria essentially demonstrated agreement among the negotiators that inflation was, in the words of former Bundesbank President Karl Otto Pöhl, 'democracy's enemy number one'. As such, success in ensuring price stability would be taken by many Germans as adequate testimony to the (European) central bank's accountability. Third, the federal structure of the ESCB

would still allow the Bundesbank to have a direct voice in European monetary politics. Moreover, each state committed itself to securing independence for national central banks – a radical departure for countries like France and the United Kingdom. As if the Germans had not gotten enough, in the years following the Treaty of Maastricht, the Germans demanded and received two additional points of monetary interest: the location of the ECB in Frankfurt and the Stability and Growth Pact. More importantly, the political power of the French-led effort to create a more substantial role for the new Eurogroup was significantly watered down. In essence, the Eurogroup would have no formal role in ECB deliberations and would not have any say over monetary policy.

Given the outcome of Maastricht and as the launch of the euro in 1999 approached, the Germans should have felt somewhat reassured that their monetary norm of price stability, central bank independence and fiscal rectitude had been enshrined in EMU and the ECB. But have EMU and the ECB's actions lived up to German expectations? The answer, in short, is largely no.

Germany, the ECB and the euro

Modelled after the Bundesbank and German monetary norms, EMU and the ECB seemed poised to serve the monetary interests of Germans. In addition, in macroeconomic terms, the euro has had very tangible benefits for Germans over the last few years. The cheap euro has boosted exports and employment in the all-important export-intensive sectors of the economy, all with minimal inflationary risks (outside of energy). In fact, German politicians have been accused of their own game of euro 'benign neglect' in order to stimulate economic growth and job creation. Furthermore, in the dynamic telecommunications, financial, and high tech industries, German companies have been on the forefront of developing new strategies – especially Euro-Zone mergers and acquisitions – to confront the newly competitive Euro-Zone market. In part, Germany's somewhat protected economy and society have opened up to the new euro reality and done so with great promise.

But Germans are still concerned about the future of monetary stability and whether national (read German) and European monetary interests will remain largely harmonious in the years to come. The future remained unsettled; the anchor function of the DM had been lost; more importantly, the European monetary ship of state was floating in entirely new seas and guided by a crew not dominated by

the Germans. To say that some Germans were unsettled by the situation was indeed an understatement.

While political and (most) economic elites were supportive, the German public was sceptical of the EMU plan from the start. Already resistant to the idea of relinquishing the DM for the euro, German citizens found added fuel for their EMU scepticism in the government's gold revaluation plan of 1998. As the launch dates for the ECB and EMU approached, the Kohl Government was skating on thin ice in its strong support for the euro – support that could not be found in the public. In a survey conducted by the Allensbach Institute, 47.4 per cent of the German public noted outright opposition to EMU (Loedel 1999b). Only 26.4 per cent signalled support for the euro project, with just as many Germans unclear in their position. More significantly, over 60 per cent of the public had real doubts and fears about EMU; at a ratio of almost 3:1, the German public felt that there were more disadvantages than advantages to the idea of EMU. Perhaps most important, fully 45.9 per cent of the public felt that EMU would have a negative impact on inflation. Also interesting, support for EMU was weakest among eastern Germans, not surprising given that they had only experienced a handful of years of monetary stability in the form of the DM.

Over the next three years, from 1 January 1999 to 1 January 2002, the public remained quite sceptical about EMU and the euro. German public opinion was not convinced that the euro would be as strong and stable as the deutsche mark. And many believed that the ECB would not be quite as vigilant as the Bundesbank in preserving the stability of the money. Given the weak track record of the euro and the repeated communication problems of the ECB during this period (see Chapter 6 for more detail), Germans were still questioning the decision to sacrifice the DM even as they handed over their DMs for euros. Specifically, the German public has been outspoken in its criticism of the euro's declining external value, as well as the operation of the ECB and Duisenberg's repeated misstatements. 'The Bundesbank would never have made the same mistakes' – was a typical German response to our surveys of German public opinion. Even the Social Democratic (SDP) government of Gerhard Schröder has been on the blunt receiving end of public scepticism. Schröder's initial support for the euro depreciation was rebuffed by public criticism so strong and vehement that he had to back down under fire. Indeed, monetary questions remain highly sensitive and overtly political in the German system.

For its part, the Bundesbank watches the unfolding euro drama with a mixture of suppressed delight and public concern. Even with the relinquishing of its power over monetary policy, the Bundesbank has continued to exert a strong influence in the ECB's monetary policy. For example, after only five months in operation, the Bundesbank took on a very public role in championing the euro as it headed toward parity with the dollar. Former Bundesbank President Hans Tietmeyer and current Bundesbank President (and ECB) member Ernst Welteke both signalled strong concern about the currency sliding toward the one dollar level. This was in sharp contrast to some other members of the ECB (and the German government) who were only giving half-hearted support to the euro. 'Clearly the decline in the euro's external value has been overstated', remarked Tietmeyer.[26] Moreover, when Italy was granted some concessions on its budget deficits for 1999, Bundesbank members lashed out at the deal suggesting that EU ministers had 'stabbed monetary policymakers in the back'. Other Bundesbank members described the decision as 'disastrous'.[27]

At the root of the Bundesbank's discomfort is the fact that it put its neck out on the line and, in 1997 and 1998, used its enormous credibility with the German public to reassure the public of the soundness of the EMU project. It consistently suggested the euro would be as strong as the DM. The fear now is that the ECB has neither earned the perception in the financial markets of the Bundesbank's credibility nor has the European bank the inherited authority of the Bundesbank. While most German central bankers note that it took the Bundesbank some time to earn its credibility and that price stability remained steady over the period 1999–2002, there is a good measure of discomfort with the ECB's performance on the communication and credibility front.

The public remains vigilant. All sections of German society are intense 'ECB watchers'. German journalists complain that the press conferences of the ECB come later in the afternoon – different than the Bundesbank – and too late to make the evening news or press editions. German economists have criticized the monthly reports as lacking in enough detail and information. Professor Jürgen Donges, chair of the economic committee known as the 'five wise men' which advises the German government on economic issues has argued that Germans were bitterly disappointed with the EMU project and that they had been promised that the euro would be equal to the DM (*Financial Times*, 6 May 2001). More fundamental structural reform was needed – in labour markets, social security and tax systems, and in countries like

France and Italy – but also Germany. Interest groups also have raised their concerns: labour unions that the ECB has been too tough especially with growth slowing through 2001 and 2002 and savings associations that the ECB has been too soft on inflation. While it is impossible to satisfy all interests, the ECB has struggled to portray a united front to this highly informed and engaged German public.

Even with the successful changeover to the euro on 1 January 2002 and the ECB's seemingly authoritative control over European monetary policy, most Germans still remain fearful of the potential rise of a political counterweight to the ECB. Such concern is drawn from the continued French insistence on some form of an EU-level *gouvernement économique* as well as the potential for continued political concentration of EU authority. Such concerns were formed early in the ECB's history. The dramatic confrontations in early 1999 between the new SPD Government – in particular the finance minister Oskar Lafontaine – and the ECB indicated to many Germans the dangers that the ECB faced in its new task of defending the euro's stability. Despite the popular support for Schröder (and his election victory in September of 1998), the public did not elect him to take on the ECB. Lafontaine's repeated public demands for lower interest rates and target zones for the euro's exchange rate upset many Germans – even Social Democrat supporters. Lafontaine's resignation in March of 1999 – just three months after the euro's launch – is indicative of the sensitivity with which Germans viewed the pressure on the ECB as inappropriate. The replacement of Lafontaine with Hans Eichel – a more moderate less ideological former state premier of Hesse with close contacts with the Bundesbank and the current Bundesbank President Ernst Welteke – helped smooth over some of the earlier tension. But pressure to restructure the Bundesbank to conform with the increasing needs for a more centralized EU process of regulating the integrating financial services industry and banks has put the Bundesbank (and especially the Land central banks) on the defensive.

The particular German view toward European monetary authority outside the hands of the ECB is, as noted, driven by the particular German view and history. Yet the Bundesbank never retained absolute independence from political influence from the chancellor or the finance minister. German chancellors – from Adenauer to Schröder – have repeatedly expressed views on monetary policy at odds with those of the Bundesbank. And while the Bundesbank often actively resisted these overtures, it could still be held accountable for its actions by the German parliament (*Bundestag*). The legislation creating the Bundesbank

– while constitutionally inspired – could be amended by a simple majority vote in the parliament. The government could also delay Bundesbank monetary decisions by two weeks, if deemed necessary by the chancellor. And external financial arrangements and exchange rate management remained firmly in the hands of the government. In short, the Bundesbank was never quite so independent from the government as many believed.

As a result, the real failure to develop an effective political counterweight to the ECB should say something about the high level of political independence that the ECB retains – greater than the Bundesbank (see the following chapters for more detail). German fears about French-led efforts to create some form of EU-level macroeconomic authority with power over the ECB should be understood from this perspective. Even the Bundesbank recognized its own political limitations. The Bundesbank at times retreated on policy differences in the face of political pressure from the government so as to insure its long-term independence (Goodman 1992). For now, the ECB has not had to retreat on any monetary policy decisions in the strict definition of its interest rate policy. With no immediate plans for a more formal or more powerful role for the Eurogroup, Germans should not be concerned about the ECB succumbing to political directives.

In the future, will the residual public discontent with the euro spillover into official government discontent with the project? And will this carry over into the European policy-making arena? There are a number of factors which suggest not: the relative stability of prices; the stabilization of the euro since 2001; recognition that EMU has always been an elite driven process; the weakness of any form of political counterweight to the ECB; the fact that the ECB may be slowly learning from its public missteps; Germany's own failure in 2002 to respect the rules of the Stability Pact and support for a more flexible application of this Pact. More importantly, with the highly successful changeover of the euro in the first months of 2002, Germans have come to accept the euro as a part of their economy and as a part of German history.

French attitudes on European monetary authority: a story of persistent reluctance

The French reluctantly accepted the German-imposed design for the ESCB and independent central banks. Despite the well-entrenched French aversion to central bank independence, President Mitterrand prioritized the achievement of monetary power objectives in the

context of pooled control over monetary policy at the European level. The willingness to accept compromise only came after over a decade of failed attempts to reform European monetary mechanisms to create a more symmetric system in which strong currency central banks (notably the Bundesbank) would share the burden of inter-parity stability by intervening to support weak currencies. The French also consistently supported the expanded use of the ECU, in part as a means to challenge the predominance of the deutsche mark in the EMS. The first national proposals to strengthen European monetary authority thus came from the French who saw this authority's principal task being the promotion of the ECU and eventually its emission as a hard currency. These proposals did not, however, advocate EMU. President Mitterrand imposed the EMU project upon a largely sceptical government, political class and financial administrative elite.

French aversion to central bank independence was rooted in four different factors: the French republican tradition; the belief that control over economic and monetary policy should not be separated; the perception – rooted in the history of French political economy – that low inflationary economic policies can be maintained by democratically elected officials, guided by enlightened bureaucrats and advisers; and power considerations within the French administration. This opposition shaped French positions on the details of the EMU project, the intergovernmental negotiations and their outcome. An appreciation of this opposition is thus necessary to understand the nature of French motives for supporting EMU and the process leading to monetary integration.

The republican tradition in France upholds the control of democratically elected officials over all elements of policy-making. This was reinforced by the strong tradition of '*volontarisme*'. In the case of monetary policy, this must be qualified. The Bank of France enjoyed a semi-autonomous status from the middle of the nineteenth century (Bouvier 1988; Prate 1987). The minister of finance had more or less influence over the decisions of the Bank depending on the matter at hand (a consensus normally existed) and the personalities involved. The height of the Bank's expression of autonomy was during the interwar period of monetary instability when certain Bank governors forced modifications in government economic policy in order to ensure greater stability. On the Left, the Popular Front sought to curtail the growing power of the Bank through a major reform of 1936. Following the Second World War, the autonomy of the pre-war period was widely associated with the protection of elite interests, the general

backward state of the French economy, the Laval deflation of the mid-1930s and the defeat of 1940. De Gaulle further reinforced State control through the nationalization of 1945. However, the precise nature of this control and the legal status of the Bank were not defined. The strong economic growth of the '*Trente Glorieuses*' has been widely seen as the result of an economic, financial and monetary policy designed in co-ordinated fashion by the Treasury, the Planning Commission and democratically elected governments. Given the strong republican consensus of the postwar period and that most Bank of France governors were former Treasury officials (and members of the elite Financial Inspectorate), the expression of Bank autonomy – in defiance of the government – was only periodic and rarely public (Bouvier 1988, Koch 1983, Patat and Lutfalla 1986, Prate 1987). As during previous periods, this expression of autonomy depended upon the personalities involved and the degree to which governments diverged from the goal of monetary stability. Governor Olivier Wormser succeeded in clarifying Bank powers in the context of the January 1973 reform which explicitly granted the Bank greater scope to modify its monetary mechanisms. However, the reform in no way diminished State control over monetary policy. The republican bias in favour of a democratic check on the central bank was reinforced by technocratic arguments which stressed the historic dependence of the Bank of France on the Ministry of Finance as the principal source of monetary and economic information. Treasury officials generally believed that the Bank was unable, technically speaking, to take decisions in matters of credit and money (Koch 1983, Mamou 1987).

Most leading French politicians and financial bureaucrats correspondingly believed that economic and monetary policy should not be completely separated for economic reasons: that the latter should be seen as a tool of the former. While the importance of price stability was perceived by a growing proportion of the political class in the 1970s and 1980s, very few believed that it should be considered a goal to be pursued separately from other economic goals. The relations between French governments and the Bank since the middle of the nineteenth century effectively demonstrated this duality. Beneath the different German and French attitudes on central bank independence, there lay two different conceptions of the role of money. According to the German conception, monetary stability was considered to be a categorical imperative of economic and democratic order linked to the maintenance of the rule of law (inflation is a non-voted tax). According to this tradition, citizens have as much right to a stable cur-

rency, as they have a right to the security of their person and their property. In consequence, macroeconomic policy should involve as little manipulation as possible of credit. Such attitudes, as noted in the previous section, are also rooted in the experience of hyperinflation in the interwar period (Marsh 1992). French monetary history was considerably different from that of Germany. Although inflation had repeatedly been a problem both prior to and since the Second World War, the Laval deflation of the mid-1930s was generally perceived to be the most economically disastrous monetary development in the twentieth century (Patat and Lutfalla 1986). The Delors Report – written by central bankers and monetary economists – reflects the German conception. The strongly negative reaction of most leading French politicians and the Treasury to the report reflected the degree to which this conception was alien to the French (Balleix-Banerjee 1997).

The preference of French governments to link the management of economic and monetary policy does not necessarily indicate a limited commitment to low inflationary policies. It has been claimed that French governments have not been preoccupied with inflation as an economic problem but rather have adopted low inflationary policies in order to achieve a competitive advantage in relation to Germany (most notoriously by Connolly (1995)). There has been an historic preoccupation with the competitive position in relation to the major trade partners, in particular the Germans. The drive to cut inflation – under President Giscard d'Estaing in the late 1970s and early 1980s and then the Socialists from 1982 – was linked closely to competition-oriented goals: inflation led to devaluation which only temporarily improved the competitive position of French industry and discouraged necessary structural change. Competitive advantage was sought via the maintenance of a lower level of inflation than France's European partners (notably Germany): thus the policy of '*désinflation competitive*' (Fitoussi 1993). This policy – linked to the avoidance of franc devaluations through the maintenance of relatively high interest rates given the asymmetric operation of the ERM – also forced French companies to become more cost efficient.

It is important to note that different actors have placed different emphasis on the two goals. Most leading French policy-makers sought both. French governments clearly had to balance monetary with other goals. Competitive ambitions – more acceptable to a French political class traditionally sensitive to the commercial balance – were often appealed to as the justification for the high interest rates needed to maintain low inflation. However, most leading Treasury officials

focused principally upon monetary goals, while those in the Bank of France have been singularly preoccupied with the maintenance of low inflation.

French reluctance to accept independent central banks during the discussions and negotiations on EMU and insistence upon '*gouvernement économique*' was also rooted in the belief that 'sound money' economic policies do not rely on independent central banks (Aglietta 1988).[28] French monetary history was presented in order to challenge the numerous Anglo-American econometric and statistical studies which have shown a strong correlation between central bank independence and lower inflation rates. According to these studies, politicians are likely to adopt monetary policies which do not lead to optimal results on inflation because they are motivated by more than just monetary goals (Goodhart 1988 and 1993). Some in France did support these claims, notably leading Bank of France officials who from the period of increased inflation in the late 1960s repeatedly attempted to convince party leaders of the logic behind increased autonomy (Prate 1987). Correspondingly, the Bank presented the argument that independence would increase confidence in the franc, diminish speculation and allow the lowering of interest rates. Such economic arguments had greater political appeal apparently and convinced Jacques Chirac and other RPR leaders of the logic behind independence prior to the 1986 elections when they supported the Pasqua private member's bill (1985) which granted a large degree of autonomy to the Bank of France. Once in power, however, Chirac's position changed. In the face of the determined opposition of his Minister of Finance, Edouard Balladur, and the Treasury, Chirac's own position on the matter was insufficiently strong to lead to a change in policy (Balleix-Banerjee 1997 and Prate 1987).

Posen (1993) argues that political support for low inflation is responsible for both low inflation and central bank independence. He attributes this political support to the influence of a narrow financial or banking interest group. In the French case, this group can be defined as the financial administrative elite consisting of top Treasury officials (members of the elite *grands corps*, the Finance Inspectorate and other corps, and principally those involved in monetary policy-making); Treasury officials in the support staffs of the president, the prime minister and the minister of finance; and top Bank of France officials, notably the governor who has almost always been a member of the Finance Inspectorate and a former Treasury official. In the Treasury, it was also generally believed that the argument linking central bank

independence and inflation did not take into consideration the rationalized French model of monetary and economic policy-making in which a trained financial administrative elite had considerable influence over the formation of policy. Relative French success in controlling inflation during the postwar period – from 1958 to 1968 and from 1978 to the present (with the brief exception of 1981–83) – was achieved with minimal central bank influence over government policy-making. The inflationary tendencies in the French economy were linked to the excessive dependence of French public and private sector companies upon State-allocated credit, not inadequate Bank of France autonomy (Loriaux 1991; Aglietta 1988).[29] Moreover, from 1991, the French succeeded in lowering inflation well below levels in Germany. Given these achievements, French governments and the Treasury were reluctant to surrender control on the grounds that they were prone to excess. The admiration of the German economic model – and its low inflationary economic growth – did not extend to the institutional structure of German monetary policy-making.

The EMU project modified the economic policy-making power structure of the French State rooted largely in the financial administrative elite (Dyson *et al*. 1994). For the Treasury, central bank independence was one in a series of blows to its power, diminished by privatizations, the liberalization of financial markets and EC rules on competition which limited large state aids, previously managed by the Treasury. Ironically, it also could be seen as the result of the victory of the Treasury in its struggles over a 20-year period with neo-Gaullist and Socialist governments to maintain low inflationary policies. EMU was only made possible by the willingness of both governments of the Left and the Right to embrace 'sound money' economic policies.

The loss of this Treasury power due to the 'independence' of the Bank of France was mitigated somewhat by the close links between the Bank's governor, the French financial administrative elite and leading French politicians. Although opposed to the statutory independence of the Bank of France during the discussions and negotiations on EMU in 1990–91, Treasury officials and the Socialist Minister of Finance, Pierre Bérégovoy focused their opposition on the issue of ECB independence. With power over interest rate policy transferred to the European level, it was necessary to extend Treasury control over this policy through the influence of the French Minister of Finance in the context of ECOFIN, and thus to ensure extensive Council control in relation to the ECB.

There were also other reasons for opposition to central bank independence, although these appear to be secondary. Notable among

these was the concern expressed by several politicians and officials – including Bérégovoy – that independence would not lead to a true sharing of policy-making power at the European level (Balleix-Banerjee 1997; Bauchard 1994). Rather it was his belief that independence would further reinforce the dominance of the Bundesbank in the determination of European monetary policy – principally because most of the participating member states were in effect German monetary satellites, or were insufficiently large to challenge German monetary influence. The concern to diminish Bundesbank and maximize French influence in the context of EMU explains in large part the intransigent French insistence upon Italian participation in Stage Three and upon the choice of Bank of France Governor Jean-Claude Trichet as the first president of the ECB. This insistence was not diminished by Trichet's repeated and public displays of autonomy in relation to the demands presented by President Chirac and the Juppé and Jospin governments (Aeschimann and Riché 1996). The hard-won compromise to replace Wim Duisenburg by Trichet after four years was made palatable for the French by the appointment of Christian Noyer – like Trichet, a former head of the French Treasury – as ECB Vice-President.

Given these views, it is not surprising that none of the political parties supported the concept of central bank independence until 1991 (Balleix-Benerjee 1993, 1995, 1997 and 1999). The RPR was opposed for nationalistic reasons (dropping all further discussion of the Balladur memorandum in the campaigns leading to the Presidential and National Assembly elections of 1988) and sought the maintenance of Council control over monetary policy. The Socialist party placed stress on social goals and the appropriate policy mix, although was forced into acquiescence by the Socialist government. Moreover – and surprisingly – Giscard d'Estaing's centre right party confederation, the UDF, supported only a more cautious, evolutionary approach – although one of its more pro-European components came out strongly in favour of central bank independence. Despite this general party opposition or reluctance, French public opinion was generally – albeit vaguely – in favour of the EMU project and the transfer of monetary power to the European level and thus, implicitly, national and European central bank independence.[30]

The French preference to maintain political/Treasury control over monetary policy helps to elucidate the logic behind the development of French negotiating positions on the details of the EMU project – notably the French draft treaty of January 1991 – and likewise the overall negotiation process. During the period following the first meet-

ings of the Delors Committee, Bérégovoy and Treasury officials introduced the idea of '*gouvernement économique*'. In the French draft treaty of January 1991 they insisted:

> Everywhere in the world, central banks in charge of monetary policy are in dialogue with the governments in charge of the rest of economic policy. Ignore the parallelism between economic and monetary matters ... and this could lead to failure.[31]

Moreover, they proposed that the European Council, on the basis of ECOFIN Council reports, define the broad orientations for EMU and the economic policy of the Community. Within these orientations, ECOFIN would co-ordinate the policies of member states and make recommendations to individual governments and the ECB would manage European monetary policy. Bérégovoy and Treasury officials also argued in favour of giving the ministers of economics and finance control over exchange rate policy.[32] Bérégovoy claimed that the French draft treaty did not seek to challenge the independence of the ECB and the pursuit of the goal of price stability – which the Germans would have refused to accept. However, the draft treaty sought to limit the European bank's margin of manoeuvre as much as possible.[33]

The French draft treaty had to respect the basic conclusions of the Rome I European Council which granted independence to the ESCB. Its article 2-3.2 therefore states that the ESCB will neither solicit nor receive the instructions of the Council, the Commission, the European Parliament or the member states. However, this list omits mention of the European Council which elsewhere in the draft treaty (article 4–1) is given the power to define the major orientations of EMU. In addition to appearing self-contradictory, the French project thus seemed to be in direct contradiction with the conclusion of the Rome I Summit which stated that the ESCB would be independent of *all* instruction. The draft treaty also very much reflects Treasury attitudes regarding the goal of price stability and French monetary policy tradition. It maintains a double language in favour of the primacy of monetary stability (article 2-3.1) while giving the European Council and ECOFIN the means to challenge this primacy.

The Germans opposed any such control beyond ensuring that the member states respect the specific convergence criteria they sought to place in the EMU treaty. Several unsuccessful attempts were made to reconcile the French and German approaches to the link between Community institutions and the ECB.[34]

The opposition of Bérégovoy and Treasury officials to central bank independence also explains, in large part, their consideration of the parallel currency approach to EMU and the British proposal of the hard ECU – effectively as a way to delay the move to EMU.[35] Moreover, the French draft treaty provides for a potentially indefinite period of transition to EMU: article 5–9 requires the Heads of Government and State to meet prior to the end of 1996 to determine by *unanimity* the length of a subsequent transition period prior to the final decision on the move to Stage Three. In other words, Bérégovoy and the Treasury sought effectively the same monetary power objective demanded by previous governments: a reinforced European monetary authority to promote the use of the ECU as a means to weaken the mark and promote a more symmetric EMS.

On parliamentary control, Bérégovoy proposed a combined sitting of European and national parliamentary members to confirm the monetary policies pursued by the ECB.[36] However, he did not elaborate in any detail on this control and nothing was included in the draft treaty on the matter. There is reason to doubt Bérégovoy's democratic motives, especially given the tradition of a minimal parliamentary role in domestic monetary policy-making and French reluctance to extend European Parliamentary powers in other areas. Rather it is more likely that he sought allies for his efforts to establish a political control over the ECB.[37] On the Commission's participation in the economic affairs of the Union, the French draft treaty proposal went further than any previous French document in advocating 'an active role' of proposal and recommendation. Again, given French reluctance to increase Commission control in any other policy-making areas, this reflected Bérégovoy's attempt to balance the powers of the ECB.

There is an apparent contradiction between the demands of Bérégovoy and the Treasury on setting monetary policy within an economic policy framework established by elected politicians, on the one hand, and their relatively easy acceptance of the Treaty based economic convergence criteria, on the other, given that the imposition of these criteria would severely constrain the economic policy-making powers of national officials. In other words, Bérégovoy and the Treasury appear to have been more concerned with the elements of formal control than the details of permissible economic policy.

The logic of this apparent contradiction can be explained principally in terms of the degree of the loss of the government's control over policy-making. In principle, the independence of central banks ended most government control over monetary policy, which the French

believed should not be disassociated from economic policy, whereas the convergence criteria only provided limits not to be exceeded by national policy-makers. Moreover, in 1990 and 1991, the French thought that the criteria could easily be respected. Only from 1992 did it become clear that considerably more rigorous economic policies were necessary in order to meet the criteria. During the negotiations, French concern with the criteria reflected more a desire to ensure Spanish and Italian participation in the EMU project in order to balance German monetary power.

It can be argued that Treasury opposition was as much rooted in a desire to avoid losing control over monetary policy as it was in any perception of the link between economic and monetary policy, French institutional tradition or democratic sensitivities. It should, however, be noted that Bérégovoy's position reflected the intensity of opposition to central bank independence in political circles which was only fully expressed during the 1992 referendum campaign. Bérégovoy conceded defeat on the matter, after a prolonged and much publicized outcry, only when the President forced his acquiescence. Treasury was not in a position to damage the project once arranged.[38] Moreover, the political and economic situation of the post-Maastricht period demonstrated that the EMS was not sufficient to ensure monetary stability or low inflationary policies in the context of liberalized capital flows and growing demands to devalue the franc outside the ERM, in order to lessen the economic difficulties created by high German interest rates.

Given the control that he exercised over European policy and his decision to force the acquiescence of Bérégovoy and the Treasury, the President's own position on central bank independence was of considerable importance in determining the development of French policy. There has been some difficulty in understanding the precise development of Mitterrand's stance on central bank independence and the EMU project. In terms of public announcements, it appears that he did not support independence until the end of 1990 when he endorsed the conclusions of the Rome I European Council, which accepted the independence of the ESCB. If his position did change at this point, this suggests the importance of two considerations: first, that German reunification encouraged his willingness to accept German demands on the matter in order to push ahead with EMU (Grant 1994) and second, that after a couple of years of discussions, it was very clear that the Germans would not alter their position on the matter. In any case, Mitterrand continued to allow Bérégovoy and Treasury officials to push for more political control throughout the IGC of 1991.

An alternative perspective on Mitterrand's position on independence comes from the Bank of France governor at the time, Jacques de Larosière, who met with the President in May 1988 and presented the necessary conditions (notably those imposed by the Bundesbank) for the successful conclusion of the EMU negotiations. De Larosière claims that Mitterrand understood and accepted these conditions from the start of the negotiations.[39] However, given the President's decision-making style – his preference to meet his advisers separately and to demonstrate a strong empathy for their position – there is reason to doubt this.[40] It is possible that he understood the nature of German demands and was willing to compromise at the end of the negotiations, but that in the meantime he would allow the Treasury to demand as much political control as possible.

Mitterrand's own position on central bank independence, as on many policy questions, is far from certain. According to both perspectives, the President's willingness to allow Bérégovoy and the Treasury to make their demands was likely rooted in his own personal support for the maintenance of a political control.[41] It is also likely that he used the matter of independence as a bargaining chip in the negotiations in order to secure German agreement on an automatic move to stages two and three. Furthermore, he likely sought to prevent a Treasury revolt on the matter and that he was very sensitive to 'republican' opinion on central bank independence. This sensitivity was most clearly demonstrated in the President's misleading statements during the campaign prior to the September 1992 French referendum on the Maastricht Treaty. On one significant occasion, during a major televised debate on the Treaty, Mitterrand claimed that elected officials would establish the economic policy framework for the formation of monetary policy: an interpretation of the Treaty inconsistent with its actual provisions.[42] Nonetheless, according to both perspectives, Mitterrand was not prepared to allow demands on the maintenance of a political control – from French or other member state officials – to derail the negotiations (Bauchard 1994).

Mitterrand's insistence upon satisfying the German demand for independent central banks in exchange for a fixed date for the start of EMU – despite the impact on the republican model and the structure of power within the French State – perhaps demonstrates the importance that he placed on European power motives. French governments sought to end the independent expression of German – that is, the Bundesbank's – monetary power. They sought to maximize control over domestic monetary and economic policy-making by sharing monetary power at the

European level, as a more acceptable alternative to Bundesbank dominance. Previously, French governments had demanded that German monetary policy incorporate the interests of other EMS member states, notably French interests. Specifically, this meant lowering German interest rates. In the context of the asymmetric operation of the EMS, French governments sought maximum German financial support for the defence of the franc–mark parity and extended monetary assistance to prevent excessive currency fluctuations within the ERM margins. German refusal to create a truly symmetrical EMS – in which strong and weak currency countries were equally responsible for the maintenance of inter-parity stability – led Mitterrand to the conclusion that German power could only be reduced in the context of EMU. The French were also concerned about the international implications of German monetary power. Sharing this power in the context of EMU was deemed the only way to avoid the creation of a tri-polar world of monetary power around Germany, Japan and the United States. Power motives also shaped the perception of other leading politicians of the EMU project. The psychological impact of German reunification, and its perceived strategic impact, further increased the importance of power arguments and thus helped to convince many former sceptics in the Socialist government of the merits of the project, including Prime Minister Michel Rocard and diminish the opposition of some government members, including Bérégovoy himself (Bauchard 1994).[43]

French opposition to central bank independence also explains the negotiation strategy of Commission President, Jacques Delors and Chancellor Kohl. The March 1988 proposal of the German Minister for Foreign Affairs, Genscher, on the creation of a European System of Central Banks (ESCB) stated clearly that central banks would have to be made independent.[44] Delors and Kohl's decision to convene central bankers in the Delors Committee for the initial examination of the project was clever strategy both to overcome Bundesbank reluctance on EMU but also to side-step the inevitable opposition of certain member state governments and treasuries – notably the French – to central bank independence (Dyson 1994). The aim was to accustom governments to independence via the decisions reached by their own central bankers, acting in a personal capacity. The deliberations of the Committee imposed a central banker's bias on the project and shaped future discussions (Ungerer 1993; Østrup 1995). The Delors Report recommended both the independence of national central banks and the ECB, in addition to precise measures on the manner in which this development was to be ensured.

In the negotiations on the ECB, the French succeeded in establishing a certain role for the Council of Ministers – notably with regard to external monetary policy – but had to accept German demands that this role be contained within a tight framework which respected price stability.

French policy on EU Economic Government: the ECB's political interlocutor in European level economic policy co-ordination

The issue of '*gouvernement économique*' ('economic government' (EG)) has been raised by the French more than other Euro-Zone member states: a preoccupation that reflects concerns linked to the traditionally widespread reluctance in France to accept central bank independence. Since the Maastricht Summit, the issue of EG has resurfaced in French political discourse and in French demands at the European level. The Jospin-led Plural Left Government prioritized the reinforcement of economic policy co-ordination among the 11 (12 since the start of 2001) Euro-Zone member states, notably in the context of a new body, the Euro XI (Eurogroup). The term 'economic government' can signify several different things. In general terms, EG is an institutional set up at the European level that is designed to establish some form of macroeconomic policy, be it only economic policy co-ordination, that has direct impact upon the member states. This is a form of collective governance (Wallace 2000; 541*ff.*) 'among core actors from several institutions and bodies in a multi-faceted network which is constituted by mutual participation patterns' that can be called horizontal fusion (Wessels and Linsenmann 2001).

There is then disagreement about what EG should amount to, both in France and in all the Euro-Zone member states and various proponents of the idea are frequently not very clear about their preferred version. Pierre Bérégovoy, worried about central bankers dominating the discussions over the shape of the future EMU project, raised the need for a political counter power to the ECB in order to achieve an appropriate policy mix at the EU level. At the time of the December 1996 Dublin European Council, the then Prime Minister Alain Juppé claimed that he had secured general agreement to create a 'Euro-Council' – consisting of Euro-Zone ministers of finance – which would form the core of 'economic government', a reinforced economic policy co-ordination among the Euro-Zone government and an improved dialogue with the ECB. The French Socialists made 'economic government' a central element of their policy on EMU during the campaign prior to the June 1997 National Assembly elections. They had been rad-

icalized in opposition, during the recession of the early- to mid-1990s which was blamed widely on the high interest rates required to keep the franc in the ERM and the cut backs required to meet the deficit convergence criterion. The Socialists' joint election manifesto with their Plural Left coalition partners pulled them further to the left. They forwarded European 'economic government' as a means to promote growth and employment, goals which were ostensibly given equal weight to the 'growth and stability' goals in the Amsterdam Treaty due to Jospin's insistence on parallel resolutions. Rhetorically, the building of EG was linked to the establishment of a 'euro-social': an EU-level economic and monetary policy mix that would counterbalance the 'sound money' policies pursued by the ECB. Socialist Finance Minister Dominique Strauss Kahn succeeded in achieving a more formal agreement on the creation of what he labelled the 'Euro-Council' (*conseil de l'euro*) in December 1997 which the Jospin Government widely presented as a manifestation of 'economic government'. This body was subsequently relabelled the Euro-X due to German opposition that the label Council incorrectly suggested that this new body had legal status. This body became the Euro-XI following the determination of the number of member states participating in EMU and was subsequently officially relabelled the Eurogroup during the French Council presidency during the second half of 2000. Leading French officials also claimed that the creation of the new Economics and Financial Committee, the rebaptized Monetary Committee, helped to reinforce the control of the Euro-XI over the economic framework in which monetary policy was made, and thus was a step closer towards the creation of 'economic government'.[45]

What different French politicians mean exactly when they espouse EG has often been unclear. Nonetheless, different governments – indeed different policy-makers – place different emphasis on different kinds of co-ordination and the appropriate role to be fulfilled by the Eurogroup. There are at least five understandings of 'economic government' that can be discerned from French policy statements, each having a potentially different impact on the role of the ECB in the co-ordination process.

1. EG as co-ordination of macroeconomic policies to achieve greater stability – to support fiscal policy co-ordination (which is supposed to involve binding rules and even fines). In this sense EG contributes to the construction of the 'stabilization state' (Dyson 2000). This reinforces the primary objective of the ECB and

promotes a positive co-ordination role between ECOFIN and the ECB – which was also charged with promoting convergence. EG as stabilization has involved the 'hard' co-ordination of the convergence criteria rules (with rules for the imposition of fines established in the Stability Pact) and the mutual surveillance of national macroeconomic policies begun in Stage One of EMU in 1990, which was reinforced by the Maastricht Treaty and the Stability Pact requiring member states to prepare and submit medium term stabilization reports (Broad Economic Policy Guidelines).

2. EG as co-ordination of macroeconomic policy to achieve a good policy mix aims to promote a more activist co-ordinated policy of member state governments to increase economic growth and create employment. This is about qualifying/counterbalancing the drive for monetary stability by achieving an 'appropriate' policy mix. This form of EG can involve a positive co-ordination between the Council and the ECB – which also has for goals the promotion of employment and investment in the Euro-Zone – as long as the Council places clear limits on its pursuit of improved economic growth and this does not become inflationary.
3. The third version of EG that can be discerned in French government policy speeches is more interventionist involving EU job creation strategies and programmes. This could involve varying degrees of intervention in the context of the EU's employment and social chapters or in terms of EU sponsored investment.
4. EG has also been perceived and advocated in a fourth way – notably as a means to improve the credibility of ECB monetary policy. In large part this links in with the first version (EG as stabilization). But this is also crucially about communication – the co-ordination of government voice regarding ECB monetary policy and desirable economic policy. As shown in Chapter 6, there is a problem of many voices making different pronouncements on ECB policy-making (notably German Chancellor Schröder on the positive aspects of a weaker euro in September 2000 and several public criticisms of ECB management, etc.) which in turn can be blamed for contributing to the weakening of the euro. This version of EG involves the creation of a clear political interlocutor of the ECB, which focuses on maintaining good relations with the ECB. This would also – as noted in Chapter 3 – contribute to the improved co-ordination of the international representation of the Euro-Zone. The Eurogroup would play this role.

5. This is linked to a fifth version of EG (which is compatible with all the previous versions with the exception of the third) which involves embedding the independent ECB in a political framework: to reinforce its democratic legitimacy and public accountability. This version provides a partial response to those who express concern for the problematic existence of a single currency without a single state (see Chapter 4).

Initially, in the discussions and negotiations on EMU in the late 1980s and early 1990s, French use of the term 'economic government' was linked closely with the need for an effective policy mix (the second version mentioned above). Such a policy mix would be impossible to achieve with one monetary policy and several varying economic policies, potentially going in different directions and not responding in a co-ordinated manner to asymmetric shocks in the Euro-Zone. Rules on fiscal policy were not enough to ensure effective co-ordination (as the Irish case of early 2001 demonstrates). Other governments (notably the German and the British) feared that the French Socialist government of the day had too Keynesian a vision of appropriate policy mix and intervention that would undermine the stabilization goals of the ECB. The Plural Left Government's rhetoric (notably that of certain government ministers including Prime Minister Jospin himself and the powerful Social Affairs Minister Martine Aubry) emphasized a much more interventionist EG linked closely to an activist EU employment policy. However, the Jospin Government's preferences in this area were not met: the Employment Chapter of the Amsterdam Treaty, the Luxembourg and Cardiff Jobs Summits of November 1997 and March 1998, and the Cologne and Lisbon Summits of June 1999 and March 2000 established a non-binding 'soft' or 'open' form of co-ordination that fell far short of the kind of intervention sought by the French.[46] Nonetheless, EU employment policy served its legitimizing purpose at the domestic political level and French Socialist ministers consistently stressed – if not exaggerated – the significance of developments in this area.[47]

Interventionist Jospin Government rhetoric effectively damned the term 'economic government' in the eyes of several other EU governments, which largely explains why the term was largely absent from French government rhetoric during the French Council Presidency of the second half of 2000 (although the state-sponsored studies on EG produced in the lead up to and during the Council Presidency used the term quite freely). Nonetheless, the discourse of Jospin, the Socialist

Minister of Finance Laurent Fabius and President Chirac regarding the role of the Euro-XI and economic policy co-ordination continued to focus on all versions/logics of EG with the exception of the more interventionist third.

In order to strengthen its hand in discussions with its EU partners, in 1998 the Jospin Government created a group of the French Planning Commission to examine possible scenarios of improved economic policy co-ordination in the Euro-Zone. The group was led by Robert Boyer, a leading academic critic of the lack of economic policy co-ordination at the European level (see Boyer 1999), and the group's May 1998 Report demonstrated both the problems of increased co-ordination and the potential paths for co-ordination. Furthermore, Jospin called upon the Council for Economic Analysis linked to the Prime Minister's office to examine economic government and to produce a report at the start of the French Council Presidency, to provide the intellectual backing for the project. The report by Pierre Jacquet argues that economic growth over the upcoming decade would be considerably lower without tightened co-ordination and the European partners would not be able to meet their goal of 'full employment' by 2010 (set by the March 2000 Lisbon European Council).[48]

In his June 2000 speech before the German Bundestag, President Chirac called for improved economic policy co-ordination and a stronger Euro-XI as a key component of his vision of a 'pioneer group' needed to make EMU work. The French Council Presidency thus had two specific goals: improve the visibility of the Euro-XI and improve economic policy co-ordination. Progress in both goals was limited during the French presidency but potentially significant. Regarding the first goal, the Jospin Government had unsuccessfully sought to give the Euro-XI a legal personality of its own. Thus all Euro-XI agreements had still to be ratified by ECOFIN. The Germans insisted that the commonly used label 'Euro-Council' be dropped. Also, ECOFIN remained very much the most important body for co-ordination (including discussion of the stabilization plans which were also prepared by the four ESCB members not participating in the Euro-Zone). Nonetheless, the French scored a minor victory in convincing the Euro-Zone governments to relabel the Euro-XI the Eurogroup. The French also succeeded in bringing an agreement to produce a clearer, published agenda for Eurogroup meetings, to have longer meetings, to discuss more current matters at them and to improve their communication output (notably through the organization of a press conference immediately after the Eurogroup meeting, prior to the ECOFIN the following day). This was

very significant because it gave the Eurogroup the opportunity to make policy announcements prior to their confirmation by all EU finance ministers in ECOFIN, effectively turning ECOFIN into a subsidiary body. With regard to Eurogroup–ECB relations, Laurent Fabius, unsuccessfully, sought the organization of more frequent bilateral meetings between the presidents of the two bodies. The aim here was to improve the co-ordination of member state positions on ECB policy-making and channel this through the Eurogroup to the ECB president. Fabius also blamed the weakness of the euro on the lack of strong political leadership in the Euro-Zone, the absence of an EU equivalent to the American Secretary of the Treasury.[49] He raised the idea of a Mr. Euro – previously introduced by the French – to be held by an individual over a period of several years and responsible, in conjunction with the Council presidency, for the international representation of the Euro-Zone (an economic policy equivalent to the Mr. CFSP, the EU's foreign policy representative). The campaign for a Mr. Euro by the end of 2001 was intensified by the Belgian Eurogroup President – although to little avail.

With regard to the second goal of the French Council Presidency, some progress was achieved when the Euro-Zone finance ministers reached an unbinding agreement to improve the co-ordination of economic policies and statements on the major economic issues of the day and of member state analyses of economic developments in the Euro-Zone. The official French aim was to improve the co-ordination of these analyses with the policy 'map' being developed by the ECB in order to give clearer signals to financial analysts. However, the Eurogroup's communication problem arguably worsened during the French Council Presidency – notably the different views on the decline of the euro and attacks on Duisenberg's competence as ECB president – contributing to the general state of disorder fanned by inappropriate policy statements emanating from the ECB (see Chapter 6). This version of 'economic government' as confidence booster still has many growing pains to endure. Another perceived co-ordination problem of the Eurogroup concerned its failure to be more active in intervening and reaching agreements with the United States and Japan to boost the euro – using the new Article 109 provisions on exchange rate interventions agreed the Amsterdam Summit.

Despite the efforts of French and other governments there have not been great strides towards tightened co-ordination. The Eurogroup is clearly more visible than the Euro-XI and is discussing a wider range of problems, which contributes to the development of the fourth and

fifth versions of 'economic government' and the legitimization of the ECB. However, some – principally Anglo-American – observers argue that there is a very real risk that the Eurogroup is not performing its core task successfully enough, that is ensuring stability: the first version of economic government. Peer pressure in the Eurogroup has failed to prevent delays to major structural reforms in several countries, including France. This in turn places the ECB in the spotlight – along with the Commission – as the main watchdog of price stability in the Euro-Zone. However, this stabilization goal of 'economic government' was clearly not prioritized by the Jospin Government – despite the constant assurances of Socialist finance ministers to their Euro-Zone counterparts and the international financial markets – and President Chirac's own election campaign rhetoric of the first half of 2002 suggested that the achievement of the stabilization goals of the French medium-term programme could be delayed three years (2004 to 2007) to allow for tax cuts and increased government spending.

The United Kingdom, central bank independence and the EMU project

The Attlee Government nationalized the Bank of England in March 1946 as one of its first acts. Opposition to central bank independence soon became wide-spread across the ideological spectrum and well-entrenched. As in France, government control over monetary policy was seen as necessary for economic reasons – a manifestation of the Keynesian consensus – and political reasons – democratic control, with focus in Britain upon the doctrine of parliamentary sovereignty (Busch 1994; Cairncross 1988). Monetary policy, it was frequently argued, was not to be left to 'unelected bankers' but rather democratically elected governments should maintain their control. The Bank of England between 1946 and 1997 has been ranked as one of the most dependent on government (Busch 1994; Elgie and Thompson 1998). Busch (1994) explains the comparatively well-entrenched opposition to independence also in terms of the high degree of centralization and concentration of power in territorial, institutional and political terms (the regularity of single-party majority governments).

It is thus understandable why, even though the British record on inflation was very poor,[50] central bank independence was rarely presented as a solution to the problem by either Labour or Conservative governments. Indeed, Britain was affected far more than France by high inflation in the 1970s. The shift in governing economic policies

towards 'sound money' was initially imposed by outside sources: principally, the International Monetary Fund, of which Britain had been by far the largest borrower of balance of payments facilities, which imposed tighter conditionality, and pressure from the US Treasury department. 'Sound money' arrived in force as part of the revival of monetarism and neo-liberalism under the Conservatives that went much further than any other West European country. Nonetheless, the Thatcher and Major Governments of the 1980s and 1990s – which embraced monetarism, of which central bank independence is a central tenet, and New Public Management reforms, creating quasi-autonomous organizations to manage a wide variety of policy areas – refused to accept granting central bank independence, despite growing support for independence in the City. At least two chancellors of the exchequer proposed independence. Nigel Lawson did so in November 1988 (revealed only in his resignation speech in the House of Commons on 31 October 1989) but was refused by Margaret Thatcher, who subsequently argued that this would have been 'seen as an abdication by the Chancellor when he is at his most vulnerable' (Thatcher 1993: 706). Following his departure from the Chancellor's office in September 1992, Norman Lamont claimed that he had tried unsuccessfully for two years to convince Prime Minister John Major of the benefits of an independent Bank of England. When the Delors Committee proposed independent central banks – a move clearly supported by Bank of England Governor Leigh-Pemberton – there was very little public political backing in the United Kingdom.

The opposition of Thatcher and Major to EMU was only partly based on the requirement of central bank independence (see Blair 2002). The transfer of monetary policy-making power to the European level was the much more important cause for concern. During the 1993 debate on EMU and the ratification of the Maastricht Treaty, the issue of independence was raised more as a reason for opposing European monetary integration and very few Members of Parliament (MPs) supported independence. There remained some confusion about the impact of the British opt-out of Stage Three of the EMU project upon central bank independence which was required as part of the second stage, in which the British were supposed to be participating. However, in January 1993, Prime Minister Major reaffirmed the continued opposition of his government to independence (the *Financial Times*, 23 July 1993). A 1993 private member's bill on Bank of England independence was rejected by the government majority and a substantial number of opposition MPs (Marcussen 2000: 255–6).

Most left-wing opponents criticized European monetary integration, central bank independence and 'sound money' principles on the grounds that they conformed with the dominant monetarism of the day, while independence involved unacceptable forms of accountability and gave 'narrow minded' central bankers excessive power. Much of the opposition to central bank independence was linked with the broader xenophobic opposition to EMU, including fear of German domination and the problematic trustworthiness of the Mediterranean member states in money matters, in addition to more general – widespread – opposition to further European integration. The opposition MPs who supported the private member's bill did so for three reasons (Marcussen 2000: 254–5): to enable the Bank of England to participate fully in the ESCB and thus enhance British influence in the EU; to redefine the manner in which the concept of 'political accountability' had traditionally been defined in Britain; and, on economic grounds, to improve inflation performance and the operation of the single market.

Given the widespread hostility in the Labour Party to central bank independence, most observers were very surprised when – only a few days after the May 1997 election – the new Labour Government's Chancellor of the Exchequer, Gordon Brown, announced the decision to grant 'operational independence' to the Bank of England and the creation of the Monetary Policy Committee (MPC) as the Bank's decision-making body. This was justified in terms of providing monetary stability, presented as a pre-condition for improved economic performance. As noted in Chapter 1, Marcussen (2000) explains the move to independence in Britain (as well as the other EU countries not participating in the EMU, Denmark and Sweden) in terms of the ideational coercion of EU policy elites. Entrenching causal ideas about the positive relationship between central bank independence and low inflation in the Maastricht Treaty made it increasingly 'illegitimate' to deviate from this norm. The British Labour Government was also able to place the move to independence in the context of its broader constitutional reform package: independence was presented in terms of modernizing an 'old-fashioned' system. The justifications for reform thus tended to differ from the pro-independence arguments presented in 1993 (Marcussen 2000: 258–63). Crucially, independence was not justified with reference to European monetary integration: it was necessary in itself, not as a stepping-stone to British participation in EMU.

The reluctance of British governments to participate in European exchange rate mechanisms (the Snake of the 1970s and the ERM of the

EMS) and the highly negative experience – in both economic and political terms – of participation (forced removal from the Snake in 1973 and the ERM in September 1992) can be seen as both relating to opposition to central bank independence as well as reinforcing this opposition. The reluctance stemmed in large part from the unwillingness of British governments to restrict their margin of manoeuvre in monetary and macroeconomic policy-making. The monetarism of the 1980s also prohibited exchange rate targeting (although Nigel Lawson secretly/unofficially shadowed the deutsche mark and sought to keep the pound within the fluctuation margins of the ERM for most of the 1980s, he subsequently justified doing so in order to reinforce the pursuit of low inflation in Britain). British non-participation also weakened the role of British central bank governors, who did not participate in the co-ordination exercises of their European counterparts. Non-participation also decreased the likelihood that British governments would accept the reinforcement of central banking power and participate in EMU.

Does the move to Bank of England 'operational independence' suggest that the Prime Minister is determined to push ahead with his plan to hold a national referendum on British participation in EMU? This – in the final months of 2002 – remains far from certain. The decision not to announce a referendum following the June 2001 national election surprised many observers and the continued opposition of a solid majority of British voters to EMU and strong divisions in the Labour cabinet – with Euro-sceptics in the ascendant – may delay a referendum for several years to come. However, it is not the purpose of this brief presentation of British attitudes on central banking and monetary policy to analyse the debate on EMU in broader terms. The crucial question here is whether or not Bank of England 'operational independence' – and we can add the widely proclaimed success of the Bank's MPC in managing monetary policy – has helped to change the views of Euro-sceptic British politicians and public opinion and accept the transfer of monetary power to the ECB? The answer to this question is almost certainly no. Opposition to EMU is rooted in much more than attitudes on central bank independence. Moreover, we should also add that there is a crucial difference between Bank of England operational independence and ECB independence: in Britain, governments set the inflation target that the Monetary Policy Committee must attain by manipulating the short term level of interest rates. If the MPC does not attain the target, the government is entitled to replace its members. In this sense the MPC is more like the governing

body of the Bank of New Zealand or, in some respects, the executive board of a 'quango'. That the British government continues to determine the desirable rate of inflation – at least in official legal terms, however restricted it is in terms of how it uses this power – can be said to conform to the British tradition of parliamentary sovereignty (Busch 1994). The Governing Council of the ECB, on the contrary, sets its own inflation target. The 2 per cent figure that it has decided upon has been challenged by many British observers as being excessively restrictive (the current Bank of England target is 2.5 per cent) and likely to hinder economic growth in the Euro-Zone in up-coming years (and unlikely to be met thus weakening the bank's credibility). However, it is impossible for governments to change this figure (and problematic for them to argue in favour of doing so, given the potential impact upon ECB credibility). Given the important difference in the political control over the two institutions it is not surprising that many British politicians, journalists and even members of the Bank of England's MPC have been critical of the ECB's institutional structure. One MPC member, Willem Buiter (1999), has criticized the ECB for being undemocratic, unaccountable and lacking in transparency.

Moreover, well-informed British opposition to EMU has long focused on the difficulty of adopting a single Euro-Zone monetary policy that best meets the economic needs of a dozen different member states. The first three years of the operation of EMU – with strong divergence in economic growth and national inflation rates and the widespread criticism of the ECB's refusal to cut interest rates as rapidly as the Bank of England – have largely reinforced this concern (see Chapter 6). Many politicians and commentators argue that the ECB's pursuit of the narrow inflation target is inappropriate given the diversity of the Euro-Zone national economies. The Blair Government has embraced five economic conditions that need to be satisfied before it will hold a referendum on EMU participation. Most observers agree that the difficulty of determining whether or not Britain has met these conditions makes the future decision on a referendum principally a political one. However, some (see for example, *The Guardian,* 28 January 2002) have also argued that ECB reform should be incorporated into this list of conditions. It is argued that without reform that allows greater flexibility in ECB monetary policy-making, Britain and other member states will not be able to 'live comfortably with euro interest rates on a permanent basis', one of the five conditions. Many British and foreign observers thus hold up the post-1997 Bank of England as the model for ECB reform.

It was also unsurprising when on 23 January 2002, Pascal Lamy, the Socialist French commissioner for trade and Jean Pisani-Ferry, Prime Minister Jospin's economic adviser, published (in a 'personal capacity') a pamphlet echoing British concerns about the structure and monetary policy-making of the ECB (*L'Europe que nous voulons*, 2002).[51] In their pamphlet, Lamy and Pisani-Ferry argued for what could be described as a sixth form of 'economic government': that the ECB should imitate the practice of the Bank of England in following a less constraining monetary policy set by government (2–3 per cent as opposed to the ECB's 1–2 per cent) and being less secretive. They also noted that ECB's structure had been determined by the need to reassure the German public that it would be as tough on inflation as the Bundesbank. The changed economic conditions – especially in Germany – required a different approach to monetary policy. Only reform along British lines would enable a more flexible monetary policy that could better respond to the economic downturn in most of the Euro-Zone. However, for the moment, it appeared unlikely that a German government – even Social-Democratic led government – was prepared to reconsider the original cornerstone upon which EMU was established – ECB autonomy and the singular pursuit of monetary stability.

Conclusion

In this chapter we have attempted to explain the complicated interrelationship between dominant national attitudes on central bank independence and attitudes regarding the structure, roles and powers of the ECB and the operation of the Euro-Zone in which the ECB must operate. The Germans dictated so much of the structure, roles and powers of the ECB, to replicate to a large degree the Bundesbank and the German monetary policy-making tradition at the European level in exchange for the loss of a national central bank and currency that had been the envy of much of the world and the model upheld by adherents to the 'sound money consensus'. President Mitterrand accepted the German design despite the strong reservations of his government and Treasury. However, French efforts since the Maastricht Summit have focused upon developing an EU-level 'economic government' to ensure an 'effective' dialogue between political leaders and the ECB, although to achieve what precise goal remains unclear. We have demonstrated that the use of the term 'economic government' in French government discourse has shifted over the years and varies depending upon the proponent. The dominant versions of EG appear

to have shifted from those emphasizing a political counter-weight designed to qualify the 'sound money' bias of the EMU project and the ECB, to those emphasizing the Eurogroup–ECB partnership in the process of stabilization and the building of European monetary policy credibility. It is with this aim, that the German government and ECB Executive Board members have increased their support for a reinforcement of EU-level economic policy co-ordination.

Opposition to central bank independence in the United Kingdom was less easily overridden than in France, where the pursuit of monetary policy power and other objectives through the EMU project outweighed national policy-making tradition. The move to Bank of England 'operational independence' in 1997 and the widely proclaimed success of the MPC in managing British monetary policy are unlikely to contribute to a shift in elite and public attitudes in the United Kingdom on the transfer of monetary power to the ECB, especially given the distinct differences between the Bank of England and ECB models. However, in this context, the January 2002 pamphlet by Pascal Lamy and Jean Pisani-Ferry – setting the Bank of England as the example to follow and thus encouraging British entry into the fray – presents an interesting twist in the on-going Franco-German debate about the ECB and its relationship to political authority.

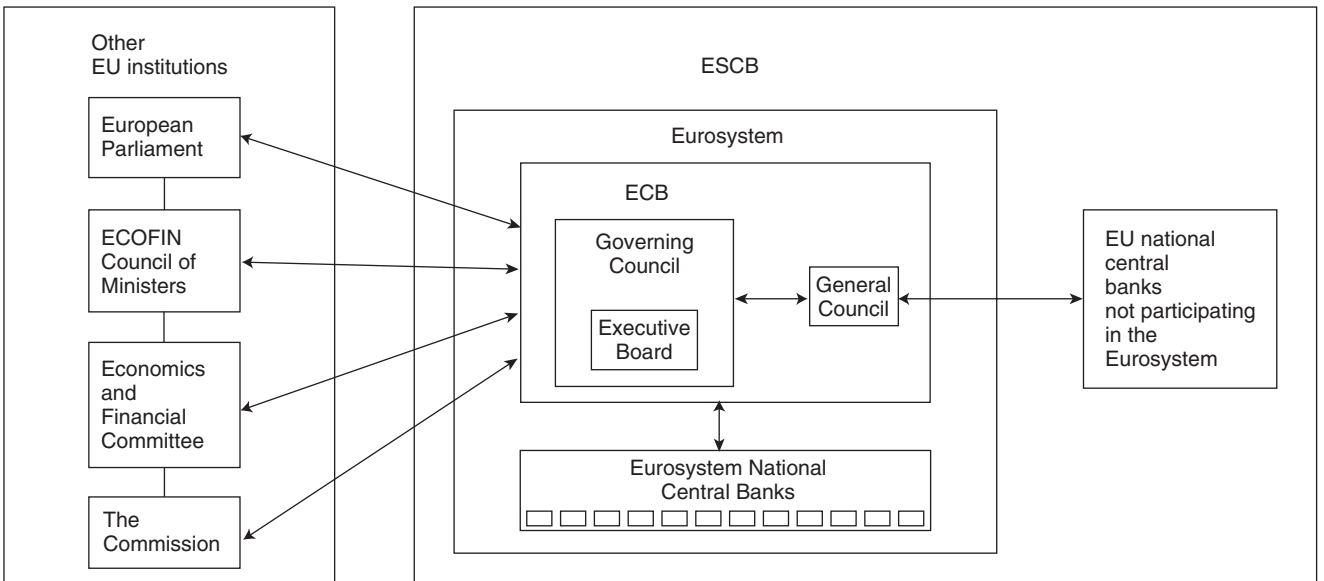
4

Managing Europe's Money: the Organization, Powers and Functions of the ECB

Introduction

The aim of this chapter is to provide a brief overview of the organization – including voting procedures – powers and functions of the ECB and the organization of the ESCB. We also take the opportunity to explore some of the main issues of concern and debate regarding the operation of the ECB and its relationship with other institutions, although we discuss the larger issues of the bank's independence and problematic legitimacy in the following chapter. Despite the ECB's statutory independence, our 'Leviathan' must operate as part of a constantly developing and controversial EMU 'regime' that has a substantial impact on the bank's activities. One issue of debate concerns the role of the ECB over prudential supervision. The ECB argues in favour of transferring control over prudential supervision to NCBs on the grounds that, as part of the Eurosystem, the NCBs are more likely to be effective supervisors of banks which operate in an EU-wide/international market. We also examine the developing and often unclear role of the ECB in the context of four levels of co-ordination. The first is within the Eurosystem and the respective roles of the ECB and NCBs in the management of Europe's money. The second level is in relation to other EU institutions, notably in the context of the 'soft' macroeconomic policy co-ordination managed by the Council of Ministers (the Eurogroup) and the co-ordination with the Council on external monetary policy. The third level is with other EU NCBs participating in the ERMII. Finally, there has been much disagreement regarding the co-ordination of the external representation of the Euro-Zone and the role of the ECB in international level cooperation.

Figure 4.1 The European System of Central Banks: ESCB structure



Composition (see Table 4.1)

The ECB consists of two main decision-making bodies: the Executive Board and the Governing Council. The Executive Board comprises the President, the Vice-President and four other monetary policy and banking experts.[52] They are appointed for non-renewable eight-year terms by the European Council on the recommendation of the Council of Ministers after it has consulted the European Parliament and the Governing Council of the ECB (the Council of the European Monetary Institute (EMI) for the first appointments in 1998) (Articles 11 and 50, ESCB Statute). The first Executive Board members (with the exception of the President) were given terms of different length so that future members can be given staggered terms in order to ensure the continuity of policy-making. According to the Treaty, the Executive Board is appointed on the grounds of recognized standing and professional experience in monetary or banking matters (Art. 109a, Art 112 EC). Officially, Board members, like European Commissioners and European Court of Justice judges (etc.) are not supposed to represent the participating Member States. However – as the designation of the first Board in May 1998 demonstrated – some governments have placed great emphasis on the inclusion of a member from their country and five of the six original members were citizens of the most populous participating member states with the largest economies (German, France, Italy and Spain).

The Governing Council comprises of all the members of the Executive Board and the 'Eurosystem' NCB governors – that is of those EU member states which participate in the Euro-Zone (12 following the accession of Greece on 1 January 2001). NCB governors are appointed by governments for minimum renewable terms of five years. Like the Executive Board, most decision making in the Governing Council takes place, officially, on the basis of simple majority voting. Each member possesses one vote, including the NCB governors regardless of the population and GNP of their member state. In the event of a tie, the President casts the deciding ballot. However, so far, decision-making has been based on consensus and no voting has taken place. Qualified majority voting is used on most matters concerning the ECB's capital. Votes in the Council are weighted according to the national central banks' subscribed capital in the ECB (the NCBs are the only shareholders in the ECB) and Executive Board members possess no votes (Art. 10.3). NCB subscriptions to ECB capital will depend on a formula, the weights of which reflect national shares in the population and gross national product (GNP) of the entire Euro-Zone

(articles 28, 29, 32, 33 ESCB Statute). A third voting system – a qualified majority vote of two-thirds (of the votes cast, each member possessing one vote) – is used to adopt the use of new operational methods of monetary control. The President of the Council of Economic and Finance Ministers (ECOFIN) (the Minister of Finance of the member state holding the EU Council Presidency) and a member of the Commission attend the Governing Council and can submit motions to it (Art. 113(3) (ex 109b) EC). However, they have no voting rights. The Governing Council meets normally in Frankfurt roughly every second week on alternate Thursdays (normally twice a month and at least 10 times a year). However, the President or three members of the Governing Council can call a meeting at any time. It was agreed in 1999, that starting in the year 2000 two scheduled meetings each year would be held in a venue in another member state of the Euro-Zone. Several meetings of the General Council have also been organized as teleconferences. Press conferences are held after the first meeting of every month.

The ECB is at the summit of the European System of Central Banks (ESCB), created by the TEU, which consists of the NCBs of *all* 15 EU member states (including those not participating in the Euro-Zone). The governors of the non-participants – currently Britain, Denmark and Sweden – are not entitled to take part in decision-making on the single monetary policy. During the 1991 IGC, the British and Danish governments, anticipating that they would not initially participate in EMU, sought to include all EU NCB governors in the deliberations of the Governing Council even if those from countries not participating in the Eurosystem were not entitled to vote. However, most other governments insisted that non-participants be excluded. The compromise reached involved the creation of a third body, the General Council, to deal with matters concerning the entire ESCB, and thus consist of all ESCB (EU) central banks governors in addition to the President and Vice-President of the ECB.[53] Voting in the General Council also takes place according to simple majority with each member possessing one vote. The four other members of the Executive Board (in addition to the President and Vice-President) are entitled to attend meetings of the General Council, although they have no voting rights. General Councils are held once a quarter on the same days as Governing Council meetings.

The ECB administrative and operational staff is divided into nine directorate generals (DGs): administration and personnel; legal services; information systems; statistics; operations; economics; research; international and European relations; and payment systems. The DGs fall under the

responsibility of one of the five members of the Executive Board other than the President. They are further subdivided into either directorates and then divisions or simply divisions. Several directorates stand on their own outside the framework of the directorate generals (for example, prudential supervision, banknotes, and controlling and organization). A total of 770 policy staff from the 15 Member States of the ESCB – including those not participating in EMU – work for the ECB. There are currently over 50,000 employees working in the 12 Eurosystem NCBs. This imbalance suggests the ECB's considerable operational reliance upon the NCBs, an issue discussed below in the context of ECB–NCB relations. The ECB also has working groups (on matters including forecasting and econometric modelling) consisting of experts from the NCBs and the ECB, and committees (notably on monetary policy and international relations) consisting of heads of departments from the NCBs and the ECB.

Powers and functions

Prior to exploring the powers of the ECB it is important to note that it is – like the rest of the NCBs participating in the Eurosystem – an independent institution. The issue of independence is discussed in the following chapter. Here it is helpful to quote article 107 of the TEU (108 EC):

> When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any members of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and bodies and governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision making bodies of the ECB or of the national central banks in the performance of their tasks.

The basic power of the ECB is to define and implement the monetary policy of the Euro-Zone. According to the TEU and the Statute of the ESCB and of the ECB '[t]he primary objective of the Eurosystem [is] to maintain price stability. Without prejudice to [this] objective, the ESCB shall support the general economic policies in the Community and act in accordance with the principles of an open market economy with free competition, favouring an efficient allocation of resources' (Art. 105). The general economic policies of the Community include:

Table 4.1 Current members of the ECB Governing Council (as of 1 July 2001)

Executive Board members and responsibilities
Willem F. Duisenberg (The Netherlands),
President of the ECB: Directorates Communications, Secretariat and Language Services, Internal Audit.
Christian Noyer (France)/Lucas Papademos (Greece) (from 31 May 2002),
Vice-President of the ECB: DGs Administration, Legal Services, Directorate Planning and Controlling.
Eugenio Domingo Solans (Spain),
DGs Information Systems, Statistics, Directorate Banknotes.
Sirkka Hämäläinen (Finland),
DG Operations, Payment Systems, Risk Management.
Otmar Issing (Germany),
Chief ECB economist: DGs Research, Economics.
Tommaso Padoa-Schioppa (Italy),
DGs International and European Relations, Prudential Supervision. ECB Permanent Representation in Washington, DC.

National Central Bank Governors
Jaime Caruana (Spain)
Antonio Fazio (Italy)
Klaus Liebscher (Austria)
Lucas D. Papademos (Greece)/Nicholas C. Garganas (from May 2002)
Yves Mersch (Luxembourg)
Maurice O'Connell (Ireland)/John Hurley (from Feburary 2002)
Guy Quaden (Belgium)
Vitor Manuel Ribeiro Constâncio (Portugal)
Jean-Claude Trichet (France)
Nout Wellink (Netherlands)
Ernst Welteke (Germany)
Matti Vanhala (Finland)

'… balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion' (TEU, Article 2). These goals are cited at the start of the ESCB statute and in so far as price stability is not put at risk, the ESCB *must* take them into consideration when formulating monetary policy. The Executive Board of the ECB implements monetary policy in accordance with the guidelines and decisions laid down by the Governing Council and, in doing so, gives necessary instructions to the NCBs. The Executive Board also executes those powers which have been delegated to it by the Governing Council.

The Statute (principally Article 3) sets out the tasks of the ESCB. Some of these are explored in the previous chapter given the debates during the discussions and negotiations on the ESCB design in the 1988–91 period. Several of these tasks are also discussed in greater detail below.[54]

1. To define and implement the monetary policy of the Community.
2. To conduct foreign exchange operations consistent with the provisions of Article 109 of the TEU.
3. To hold and manage the official foreign reserves of the member states.
4. To promote the smooth operation of payment systems.
5. To contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

Although the ECB does not possess a general power to make regulations, it can do so to the extent necessary to implement specific tasks (Art. 110(1) (ex 108a(1)) EC), notably with regard to the operation of the ESCB (see Craig 1999). Some of the ECB's regulatory power also depends upon what the Council of Ministers grants to it (for example, regarding the establishment of the minimum and maximum reserves to be held by national credit institutions with the ECB). The ECB possesses the limited power to impose fines or periodic penalty payments for failure to comply with obligations contained in its regulations and decisions (Art. 110(3) (ex 108a(3)) EC); notably, with regard to the reserves which credit institutions should hold with the ECB and the prudential supervision of credit institutions.[55] However, it remains the power of the Council of Ministers to establish first the rules. While the possibility exists for the ECB to be taken to the European Court of Justice (ECJ) or Court of First Instance (CFI) on matters pertaining to its management of the ESCB (Craig 1999; Zilioli and Selmayr 2001), the ECB can itself have recourse to the courts (as stated in Article 230(3) (ex 173(3)) EC) in particular with regard to inter-institutional disputes – for example, if the Council fails to consult the ECB on matters where it is expected to do so.

The Governing Council specifically has several responsibilities. It formulates the monetary policy of the Eurosystem 'including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the [Eurosystem] and shall establish

the necessary guidelines for their implementation' (Article 12.1 ESCB Statute). Thus the Governing Council has the exclusive right to authorize the issue of bank notes in Eurosystem countries, although the notes themselves may be issued by either the ECB or the NCBs. The Governing Council adopts the monetary policy strategy and makes the decisions necessary to ensure the maintenance of price stability. The three elements of monetary policy strategy, adopted on 13 October 1998, are a quantitative definition of price stability and the 'two pillars' used to achieved this objective: the announcement of a quantitative reference value for the growth rate of a broad monetary aggregate (namely, M3: the stock of notes and coins in circulation, the value of bank current accounts, and deposit or interest-bearing accounts), and a broadly based assessment of the forecast for price developments and risks to price stability in the Euro-Zone (ECB 1998 and 1999).[56] The Governing Council may decide by two-thirds of the votes cast to use other operational methods of monetary control as it sees fit but must respect the price stability and open economy requirements of the ESCB. The Governing Council adopts the internal rules of the ECB and exercises its advisory functions vis-à-vis other Community bodies. It has the power to form opinions on its own initiative on the economic policies adopted by the Community and member state governments on matters which fall within its jurisdiction, crucially with regard to the pursuit of 'sound money' economic policies. The Governing Council has also assumed control over the statute provision that allows 'recourse to the national central banks to carry out operations which form part of the tasks of the ESCB' (Article 12, ESCB Statute). The Governing Council performs these functions on the basis of the work undertaken in the ECB's working groups (NCB and ECB experts) and committees (NCB and ECB senior officials) which prepare reports (monthly, quarterly and annually) that are forwarded to the Executive Board and Governing Council for final approval.

The Executive Board implements the Eurosystem's monetary policy – giving necessary instructions to the NCBs – in accordance with the guidelines and decisions established by the Governing Council. This consists of initiating open market operations which play an important role in the Eurosystem's monetary policy for the purpose of steering interest rates, managing the liquidity situation in the market and signalling the system's monetary policy stance. The Executive Board decides the precise instrument to be used (there are five major instruments to conduct open market operations[57]) and the terms and conditions for the implementation of such operations: on the basis of

standard tenders, quick tenders or bilateral procedures. The Executive Board may have certain powers delegated to it by the Governing Council (Article 12 ESCB Statute). The Board prepares the meetings of the Governing Council.

The General Council has assumed responsibility for the tasks previously performed by the European Monetary Institute (EMI) which must still be assumed by a body that includes *all* ESCB NCBs. These tasks include the preparations for setting the irrevocable exchange rates of the currencies joining the Euro-Zone in the future (as in the Greek case in the run-up to its accession in 2001). The General Council also contributes to several ECB functions including: the collection of statistical information; the setting of rules for standardizing the accounting and reporting of operations undertaken by the NCBs; and the establishment of the conditions of employment of ECB staff (some of which come from the three ESCB countries not participating in the Euro-Zone). According to the ESCB's operating procedures, the General Council is also supposed to contribute to the preparation of the ECB's quarterly and annual reports and weekly consolidated financial statements. However, in practice it would be inappropriate for the central bank governors of countries not participating in the Eurosystem (currently Britain, Denmark and Sweden) to make substantive comments on the ECB's reports and statements. The General Council has no role in making Eurosystem monetary policy. It is informed by the ECB President of Governing Council decisions and discusses them. However, the General Council does not have the right to be informed (or consulted) on matters pending before the Governing Council. Moreover – even though the General Council is supposed to continue the work of the EMI – the TEU and the ESCB Statute fail to give it the explicit power to advise the ECB or even nonparticipating EU NCBs on monetary matters.

The debate over prudential supervision

The issue of the role of the ECB in prudential (banking) supervision was discussed briefly in the previous chapter: during the 1991 IGC it was decided to strongly limit the ECB's potential role in this area. The TEU grants the Eurosystem the responsibilities to 'contribute to the smooth conduct of policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system' (Article 105.5), as already encouraged by the First and Second Banking Directives (1977, 1989) and the so-called BCCI Directive which lay the foundations for cooperation (exchange of information), but does not contain specific provisions or institutional

arrangements to this end. The Treaty and Article 25 of the ESCB Statute also grant the ECB the right to offer advice and be consulted on the adoption of EC and national legislation relating to prudential supervision and financial stability and the right to perform specific tasks concerning policies relating to this supervision. Moreover, the TEU establishes a simplified procedure – demonstrating the hope of most member states for progress in this area – that makes it possible, without amending the Treaty, to entrust specific supervisory tasks to the ECB (Article 105.6). However, the precise role of the ECB in this area remains the subject of ongoing debate. It is not unusual that the ECB lacks control over banking supervision, in that the central banks in many advanced industrialised countries do not have this power or share it with ministries of finance (more often there are completely separate institutions responsible for supervision). However, the Euro-Zone is rather unique in that the areas of jurisdiction over monetary policy and over banking supervision – which remains nationally based – do not coincide. ECB Executive Board members argue in favour of improved cooperation between Eurosystem central banks (including the ECB) and national banking supervisors on the grounds that central banks are, because of their responsibilities – including money creation, payment services provision, savings management, etc. – necessarily concerned with the health of the banking system and central bank credit control is managed in 'a situation that is generated by problems of interest to the supervisor' (Padoa Schioppa 1999).[58]

The Basle Committee on Banking Supervision – which was the main forum in which multilateral cooperation among EU banking supervisors could be enhanced – assumed the task of promoting cooperation between the ECB, the NCBs and national supervisory authorities. To give the EU members of this Committee a more specifically Eurosystem profile, their gatherings were officially labelled the Banking Supervision Committee of the ESCB. ECB Executive Board members have sought to develop this cooperation further: to ensure that the system of national supervisors can operate as effectively as a single authority when required, in particular when dealing with local or national banking problems which may have wider effects. In a personal capacity, Executive Board member Padoa Schioppa (1999) argues that it is not necessary to take advantage of the possibility created in the treaties and give the ECB greater powers in this area. Rather he seeks the transformation of the largely voluntary cooperation among banking supervisors into 'a sort of euro area collective supervisor to emerge that can act as effectively as if there were a single supervisor' which will 'assist the Eurosystem in the

performance of its basic tasks'. The simplified legal procedure established in Article 105.6 could be interpreted as a 'last resort clause', which might become necessary if the development of cooperation between the Eurosystem and national supervisory authorities fails to develop. Kenen (1995, 35) argues that if the ECB is not given responsibility for prudential supervision, then it 'must at least have access to the information gathered by [the prudential supervisors] and it must be consulted by them whenever they expect to act in ways that might affect the banking system or the financial system as a whole'.[59]

The ECB has sought to clarify its position on the role of central banks in prudential supervision, most recently in a March 2001 report. The ECB makes the point that the organization of the institutional framework of the Eurosystem weakens the arguments in favour of a separation of banking and supervisory functions, in large part due to the NCBs' loss of control over monetary policy to the ECB. Furthermore, the ECB claims that EMU and the financial integration that it encourages strengthen arguments in favour of a fusion of responsibilities under the control of NCBs. The growth of large banking conglomerates and the increased risk that bank failure could lead to systemic instability increases the need for NCB surveillance: NCBs are part of the wider Eurosystem with greater capacity to assess effectively the potential for systemic crisis. The emphasis placed on the role of NCBs as opposed to the ECB is due in large part to their role managing the Target payment system, which gives the NCBs much greater awareness than the ECB could ever have regarding the situation of the banks.

The handling of solvency crises is neither within the competence of the NCBs nor that of the ECB. Although it is expected that NCBs will be consulted as they have been in the past, the precise role of the ECB remains unsettled and the lack of crisis management capacity of the Eurosystem has been the subject of some criticisism including from the IMF.[60] Most importantly, the worry has existed that the ECB could become an overly generous lender of last resort which would divert it from pursuing price stability. However, ECB Executive Board members and others argue that that these concerns are overstated.[61]

Four levels of co-ordination

I. Within the Eurosystem: the ECB and the NCBs

The ECB's relatively small Executive Board and its weight on the Governing Council (6 out of 18 places, or a third) demonstrates an important feature of the Eurosystem. Compared to other federal

banking systems – including the American Federal Reserve – the Eurosystem is relatively decentralized: national central bankers have more sway collectively than, say, representatives from the American state banks. This reflects the highly decentralized nature of the EU political system and the problematic legitimacy of EU in many member states. Arguably, European citizens are more likely to accept ECB monetary policy if they know that they are represented, however indirectly and unofficially, by NCB governors, and that policy is designed in the fora of working groups, committees and the Governing Council, where NCB experts and officials predominate.

The relative importance of the NCBs in the Eurosystem also reflects practical reality: they are well-established whereas the ECB is a fledgling and small institution. Eurosystem NCBs perform several operations vital to the operation of the Euro-Zone: notably, they conduct foreign exchange operations and ensure the smooth operation of payment systems (including Target). The NCBs hold and manage the official foreign reserves of the Member States (of which they can provide up to 40 billion euro to the ECB) and hold the capital of the ECB (just under 4 billion euro). However, NCBs must follow the regulations, guidelines and instructions of the ECB in these and several other areas: buying and selling securities and other claims; borrowing and lending securities; dealing in precious metals; conducting credit operations with banks and other financial institutions based on adequate collateral; acting as fiscal agents for public entities (although they may not grant them credit facilities or buy their debt instruments directly from them). The ECB can also engage in these activities. The precise role of the ECB in relation to the NCBs depends on the kinds of open market operations selected (with regard to aim, regularity and procedures). NCBs are able to perform tasks beyond those specified in the ESCB Statute, except if the Governing Council decides that these activities interfere with the work of the ESCB. The ECB alone attends Eurogroup meetings and ECOFIN Councils. However, all 12 Eurosystem NCBs (and all 15 ESCB NCBs) occasionally attend informal ECOFIN meetings with varying degrees of participation.

The important role of the NCBs in ECB decision-making (in the working groups, committees and the Governing Council) reflects the reliance of ECB upon the much greater analytical – including statistical – resources available in the NCBs. In this regard, the American Federal Reserve is much better endowed than its Euro-Zone equivalent and relies less on the state reserve banks. The importance of the NCBs in ECB decision-making encourages a combination of collaborative and competitive work (Goodfriend 1999; Mayes 1998 and 2000). In their

attempt to have an impact on Governing Council decision-making, each NCB governor will use the resources of his own NCB to provide the necessary information and strengthen his position in the on-going debate with other NCBs and the ECB Executive Board on appropriate policy and the way that the Euro-Zone economy works.

Despite the often heated debate over appropriate policy, members of the Governing Council are expected to speak with one voice on the basis of the agreed upon forecasts, although there is no legal requirement to do so. The President is spokesperson in the official press conference following the bi-weekly meetings, while the other members of the Council have to explain Eurosystem policy in the member states in their own languages, which arguably creates the possibility of diverging expression and interpretation of ECB policy. However, there has yet to be a publicly expressed substantive difference of opinion between members of the Governing Council (as there has been in several member states between members of national monetary policy committees).[62]

Another potential source of divergence in the public expression of policy is the separate national forecasts published by the independent NCBs. Varying NCB forecasts could send different signals to market operators about the development of ECB policy. However, it is the role of ECB working groups and committees to iron out differences and ensure coherence in all the forecasts of the Euro-Zone prior to their publication. In a move that may spell the beginning of the end of separately published NCB forecasts – or at least their slide in significance – the ECB published its first Eurosystem forecast ('Staff economic projections for the euro area') in its *Monthly Bulletin* in December 2000 (with which the NCB forecasts are expected to be consistent).

A major issue of debate in ECB–NCB relations has concerned the appropriate degree of centralization in the different ways that the ECB uses the NCBs to implement its monetary policy and the harmonization of national practices. Prior to the 1990s, the operational procedures of Eurosystem NCBs differed considerably. However, much of this difference reflected the varying structures of national financial systems and of commercial banks asset holdings. With financial integration and growing convergence, the difference in operational structures has diminished. By the mid-1990s, several EU NCBs, including the four largest, were using similar methods (Kenen 1995: 63–4). Nonetheless, in the third year of Stage Three, variations in methods remain due principally to lingering differences in financial markets

which result, for example, in various forms of collateral. The Eurosystem is the most decentralized banking system in the world. However, national differences do not prevent the operation of a single monetary policy.

II. Within the EU policy-making system

The provisions of the TEU have created a distinct institutional setting for monetary policy-making with the ECB at its core and a unique policy-making style which can be labelled 'supranational'. The Treaty gives some of the other institutions – notably the EU Council of Ministers, the European Council and the European Parliament – specific responsibilities with regard to monetary policy. However, the ECB interrelates informally with a large number of other actors with distinct roles at both the EU and national levels.

The ECB/ESCB does not have complete control over all aspects of European monetary policy. The Council of Ministers (the Council of Economics and Finance ministers, ECOFIN) is given limited powers over monetary policy and the management of the ESCB. These powers are de facto exercised by the Euro-X (renamed the Eurogroup in mid-2000) consisting of the finance ministers of only the member states participating in the Euro-Zone. Lacking a legal personality, the Eurogroup must have ECOFIN confirm all its decisions. The Council can adopt complementary legislation concerning the operation of the ESCB in a limited number of areas, by qualified majority voting on a recommendation from the ECB after consulting the Commission or by unanimity acting on a proposal from the Commission and after consulting the ECB (Art. 42 ESCB statute). In both situations the European Parliament must give its assent. These articles of the ESCB statute concern the following matters:

- the limits and conditions to be imposed on national authorities seeking to consult the ECB on draft laws in the banks field of competence (Art. 4);
- the people subject to reporting requirements to the ECB and the confidentiality regime (Art. 5.4);
- the 'basis for the minimum and maximum reserves to be held by national credit institutions with the ECB, and the maximum permissible ratios between these reserves, as well as the appropriate sanctions in the case of non-compliance' (Art. 19.2);
- the definition of the scope of other operational methods of monetary control if they impose obligations on third parties (Art. 20);

- the limits and conditions on any increase to the ECB's capital (Art. 28.1);
- further calls for foreign reserve assets beyond the limit set in the ESCB statute (Art. 30.4);
- the limits and conditions on the ECB's power to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions.

The Council of Ministers is thus empowered to influence future developments of the operation of the ESCB. However, the Council is unable to modify the objectives or tasks of the ESCB or the provisions regarding its independence. The Council of Ministers is also responsible for setting the rate at which new currencies merge into the euro – as with the drachma – while the European Council makes the final decision on entry. Notably, the Council is responsible for the establishment of exchange rate agreements with third countries and has final say over most aspects of external monetary policy. However, when performing these tasks, the Council must consult the ECB, attempt to reach a consensus, and respect the goal of price stability. The organization of co-ordination, focusing upon the role of the ECB, in the area of external monetary policy is discussed in greater detail below.

The ECB also maintains direct relations with the European Parliament (EP), notably in terms of *ex post facto* reporting and questioning. (These relations are discussed in the context of the issue of the ECB's democratic legitimacy in the following chapter.) The EP must be consulted on appointments to the ECB Executive Board. It receives and debates the ECB's annual report and requests that the president and other Executive Board members appear before its committees (notably, the Committee on Economic, Monetary Affairs and Industrial Policy (C4) and the Subcommittee on Monetary Affairs (SC4)) (Art. 113 (ex 109b) EC) (see, for example, ECB 2000b). The TEU and Statute establish no specific appearance requirements. The EP succeeded in obtaining Duisenberg's agreement that he would appear before the Committee C4 four times a year. In its relations with the EP, the ECB pursues several goals. The wide-ranging review of the ECB by the EP's committees can ensure that the Bank's technical decisions are subject to scrutiny from beyond the ESCB. This review can increase awareness and widen support for the Bank's underlying policies and principles. Regular meetings with the EP's committees can also help to personalize the ECB and build public support for its actions. Overall, however, the EP has little say over the ECB's management of monetary policy. As

Dyson (2000: 69) notes, the model of ECB–EP relations 'is no match for the more Lockian-informed practice of US Federal Reserve-Congress relations'. The ECB is not responsible to the EP or other EU institutions: none have the power to dismiss ECB Executive Board members on the grounds of unsatisfactorily performance according to fulfilment of the Bank's own goals (as in New Zealand) (Taylor 2000).[63]

Co-ordination at the European level in the areas of fiscal and macroeconomic policy is leading to greater horizontal fusion and the creation of a form of 'economic government': (as defined in Chapter 3) an institutional set-up at the EU and national levels 'of collective governance among core actors from several institutions and bodies in a multifaceted network which is constituted by mutual participation patterns' (Wessels and Linsenmann 2001; see also Wicks (1999), Wyplosz (1999) and Boyer (1999)). Fiscal, economic and employment policies are all of great concern to the ECB as they have a direct impact on the capacity of the central bank to manage monetary policy to achieve the goal of price stability (the search for an appropriate 'policy-mix') and shape public perception of both the nature of this goal and the ECB itself (Aglietta and de Boissieu 1998). The nature of policy-making differs considerably from the 'supranational' policy-making in monetary matters where the ECB is dominant. The European bank's role in both the 'hard' – binding – co-ordination of fiscal policy (Art. 105 EC and the Stability and Growth Pact) and 'soft' – largely unbinding – co-ordination of macroeconomic and employment policies (Art. 99 and 128 EC) is more subtle and not yet fully fleshed out.[64] Nonetheless, the ECB is an important part of the institutional set-up in these areas of policy-making which directly influence the manner in which it carries out its monetary policy responsibilities. Collectively, these policy processes form part of a 'stabilization state' (Dyson 2000). Unlike the regulatory state, the instruments of stabilization will need to be used in a discretionary and sometimes discreet manner given the likelihood of problematic political implications in many of the Euro-Zone member states.

According to the TEU, the ECB is expected to be involved in a 'constructive dialogue' with the other institutions engaged in this co-ordination – crucially the Council. Opportunities for constructive dialogue are invariably increased by the right of one ECB Executive Board member (normally the President) to attend Council/Eurogroup meetings where matters pertaining to the tasks of the ESCB are discussed. Two members of the ECB Executive Board – along with representatives from national ministries of finance and central banks and the Commission – also attend meetings of the Economics and

Financial Committee, where the negotiations on the details of macroeconomic policy co-ordination take place. The presence of the President of ECOFIN/the Eurogroup and a member of the Commission at ECB Governing Council meetings – and their right to submit motions – also contributes to the constructive dialogue (Art. 113(3) (ex 109b) EC) (Everson 1999).

The precise role of the ECB in these policy areas varies. In the 'hard' co-ordination of fiscal policy, the ECB contributes to policy-making in the Eurogroup aided by the presence of its President (Eijffinger and de Haan 2000). The European Bank consults informally with the Commission alone and formally with national and Commission officials in the Economic and Financial Committee which are given the power (Art. 104 EC) to watch over national budgets. The Stability and Growth Pact (agreed at the December 1996 Dublin European Council) gives the Commission – not the ECB – the power to express opinions to ECOFIN to adopt recommendations, requirements and ultimately impose sanctions if the obligatory annual national fiscal and structural plans are deemed insufficient (Artis and Wrinkler 1997). However, the ECB will also have its word to say on national plans, notably in the Eurogroup and through the Economic and Financial Committee (which must also be consulted) and informally. What the ECB thinks about national plans will invariably have as much influence on Council pronouncements as the Commission's opinion – if not more. The manipulation of interest rates – or the threat of doing so – can be seen as the ECB's most effective sanction of inadequate member state policies. Likewise, the ECB President can appear before the European Parliament to defend the continued imposition of Stability and Growth Pact rules and (one day) even recommend the use of fines, however politically problematic this might be.

The interest rate weapon is likewise a source of influence in the context of the 'soft' (largely unbinding) co-ordination on economic and employment policies. In addition to its links with the Eurogroup (ECOFIN) and the Economic and Financial Committee, the ECB has input in the macroeconomic dialogue (the Cologne process) initiated by the Germans during their 1999 EC Presidency as a means of improving the interaction between monetary, budgetary and fiscal policy and wage developments in order to achieve stronger growth and higher employment – although this dialogue accepts that price stability and appropriate wage developments are crucial to good and sustainable economic performance over the medium and longer term. The Broad Economic Policy Guidelines (BEPGs) – established in the Maastricht

Treaty under article 103 (article 99 of the consolidated treaty) – were clarified to integrate the different 'soft' co-ordination processes at the EU level including the stability and convergence programmes of the Stability and Growth Pact, the National Action Plans for Employment and the Joint Employment Reports. Because of the lack of binding EU rules in this area, however, national central banks will continue to play a vital role in the co-ordination process as the interlocutors with the other elements of the ESCB and national finance ministries (see below).

Despite the gradual development of 'economic government', the lack of binding EU rules in these areas means that co-ordination on macroeconomic and employment policies will remain 'soft' for the foreseeable future despite pressures for continued convergence. In the context of 'soft' macroeconomic policy co-ordination, the links between Eurosystem NCBs and national governments remain vital in terms of establishing the precise policy-mix that is best for each country, in the context of the maintenance of sound money policies, and for the Euro-Zone more generally. However, the ECB will increasingly take centre stage in the co-ordination of NCB efforts.

To date discussions in the Eurosystem have been rather general in nature and, as noted above, the ECB only published its own Euro-Zone-wide forecasts and simulations for the first time in its December 2000 *Monthly Bulletin* (ECB 2000c). The refinement of Euro-Zone-wide analysis should improve co-ordination by helping the Commission and national governments set the guidelines for fiscal, employment and structural policies. It should also improve ECB policy-making transparency which – linked with the accountability of ECB – is a major concern of both economists and political scientists.

Moreover, co-ordination is a two way process: it is meant to shape national government policy-making as well as the formulation of ECB monetary policy (via the NCBs). Much of the co-ordination is informal and indirect (as in most countries where the central bank is independent). The main players never physically sit around the table and agree on what to do. In terms of national policy-making, the focus is currently on actions rather than outcomes. However, the process of policy co-ordination has been improved with the implementation of the Broad Policy Guidelines and the Annual Review of Structural Policies which focus on longer term structural questions such as pensions. Member state governments have to set out their fiscal and structural plans on an annual basis. As noted above, the ECB takes a great deal of interest in the plans and expresses its views to the Council. In the light of the likely developments of national fiscal and structural policies, the

NCB governors and Executive Board members debate appropriate monetary policy. The NCBs will also express the ECB's opinion of the plans at the national level.

Confusing co-ordination on external monetary policy

The respective roles of the ECB and the Council of Ministers in the formulation of external monetary policy were the subject of considerable debate during the 1991 IGC and the contents of Article 109 TEU went through numerous draft versions. The central bankers and several member state governments – notably the German government – were concerned with the inflationary effects of exchange rate agreements which might require ECB intervention on the foreign exchange markets in a manner damaging to the pursuit of price stability (precisely the Bundesbank's fear with regard to its obligations in the context of the EMS). Because of this concern several pro-EMU economists, including Gros and Thygesen (1992), opposed the creation of a residual EMS. Other member state governments insisted that governments, through the Council of Ministers, keep their control over exchange rate policy. The careful, rather complex, wording on this matter in Article 109 TEU should be quoted at length.

> 1. … the Council may, acting unanimously on a recommendation from the ECB or from the Commission, and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, after consulting the European Parliament, in accordance with the procedure in paragraph 3 [below] …, conclude formal agreements on an exchange rate system for the ECU in relation to non-Community currencies. The Council may, acting by a qualified majority … and after consulting the ECB in an endeavour to reach a consensus consistent with the objective of price stability, adopt, adjust or abandon the central rates of the ECU within the exchange rate system.
> 2. In the absence of an exchange rate system in relation to one or more non-Community currencies as referred to in paragraph 1 [above], the Council may, acting by a qualified majority either on a recommendation from the Commission and after consulting the ECB, or on a recommendation from the ECB, formulate general orientations for exchange rate policy in relation to these currencies. These general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability.

> 3. … where agreements concerning monetary or foreign exchange regime matters need to be negotiated by the Community …, the Council … shall decide the arrangements for the negotiation and for the conclusion of such agreements. These arrangements shall ensure that the Community expresses a single position. The Commission shall be fully associated in the negotiation. … Agreements concluded in accordance with the paragraph shall be binding on the institutions of the Community, on the ECB and on Member-States.
> 4. Subject to paragraph 1 [above], the Council shall, on a proposal from the Commission and after consulting the ECB, acting by a qualified majority decide on the position of the Community at the international level as regards issues of particular importance to economic and monetary union and, acting unanimously, decide its representation … .

The interpretation of Article 109 remains a matter of debate.[65] Paragraph 1 is relatively clear, although there is no indication as to what the attempt to reach consensus would really amount to. Paragraph 2 fails to note which body has the power to judge whether exchange rate agreements are inflationary – or how it would do so. The answer cannot be found in the third paragraph's stipulation on the Council's decision-making power which is cited in the first but not the second paragraph. The lack of clarity raised concerns regarding the ECB's ability to maintain price stability, heightened since the exchange rate crises of 1992–93 and the obligation placed on the Bundesbank to provide massive assistance to support weaker currencies in the ERM.

However, the threat to price stability is not particularly great for reasons that are both institutional and practical. On the institutional side, the Council can only enter into a formal agreement on a proposal from the Commission or the ECB, preventing unilateral action. Moreover, any 'general orientation' guidelines for exchange rate policy that the Council establishes on its own or with country partners (such as those found in the Plaza and Louvre Accords of 1985 and 1987) would not be binding on the ECB. Although not clearly established in Article 109, it has also widely been accepted that the ECB could be the only judge to determine the compatibility of these guidelines with the goal of price stability (Kenen 1995).

On the practical side, Euro-Zone member states are far less interested in exchange rate agreements with major currencies such as the US dollar and the yen than previously because of the much diminished exposure of the Euro-Zone economy to foreign currency fluctuations

than that faced by individual EMS countries prior to the start of Stage Three. Moreover, most members of the ECB Governing Council, emphasizing the ECB's primary goal of price stability, appear to share the Bundesbank's scepticism towards exchange rate agreements and even currency stabilization on the grounds that this could distract domestic monetary policy from the primary purpose of securing internal price stability.[66] The ECB thus ignored the demands of German Social Democrat government leaders (both Lafontaine and Schroeder) for more active policies in this area.

Some observers claimed that for much of 1999 and 2000 there were strong tensions within the ECB Governing Council between supporters of a flexible currency regime and supporters of a more managed exchange rate policy (Padoan and Henning 2000: 41). The dramatic decline of the euro versus the dollar since January 1999 – and the considerable attention paid to this by the European media – finally prompted coordinated interventions with the US Federal Reserve and the Japanese central bank in September and November 2000. (See Chapter 6 for detailed coverage on the interventions.) Officially, these interventions were justified on the grounds of the impact of the dollar's rise and 'economically unjustified' slide of the euro on the world economy and the potential contribution to Euro-Zone inflation. They were designed to break the widespread expectations in the markets that the ECB would not intervene and to discourage the reigning pessimism in the markets on the value of the euro. Support for occasional interventions, however, does not mean that the Governing Council has embraced an actively managed exchange rate policy let alone growing support for exchange rate target zones. ECB President Duisenberg (2000c) has repeatedly reaffirmed the ECB's opposition to the establishment of any exchange rate target and the dangers of ex ante exchange rate co-ordination to the ECB's mandate and independence. The overall policy mix in the Euro-Zone of tight fiscal policy required by the Maastricht convergence criteria and the Stability Pact, combined with a flexible monetary policy (the so-called Clinton–Greenspan combination) appears sustainable in the medium term.

A further reason for the limited preoccupation with the potential impact of external monetary policy on the Euro-Zone has been the small number of ERM II members. Interventions in the context of ERM II – consisting initially of Denmark and Greece alone and now just Denmark – cannot seriously threaten the pursuit of price stability in the Euro-Zone. However, the extension of the ERM II to central and

eastern European accession countries will create more concern for the ECB.

It is perhaps surprising that the complicated machinery of the Euro-Zone's external monetary policy-making has not yet been clarified and the elements addressed in the TEU not yet fully operationalized. ECOFIN (Eurogroup) possesses the leading role in the formulation of external monetary policy, except for foreign exchange operations for which the ECB is responsible. However, there is a lack of clarity on several matters: the line between policy formulation and operations, the organization of internal consultation between the ECOFIN and the ECB on intervention and the role of the Commission. Padoan and Henning (2000) argue that it would be highly problematic if the ECB had to assume authority over external monetary policy in the event that the Eurogroup was incapable of taking action. They doubt that a central bank alone could sufficiently manage a number of international contingencies. They point out (2000: 36) that:

> Financial relations with countries such as Russia, international financial rescues, and even foreign exchange intervention have a heavy political content and are generally negotiated by political authorities. A central bank whose transparency and democratic accountability were under scrutiny, such as the ECB, would be well advised to secure political cover for external monetary operations (36).

III. Cooperation and co-ordination with other EU NCBs

A third level of cooperation/co-ordination concerns the relations between the ECB and those ESCB central banks not participating in the Eurosystem – the United Kingdom, Sweden and Denmark (since June 1998), Greece (from June 1998 to the end of 2000) and future new EU member states. The TEU imposes no reciprocal responsibilities on the ECB with regard to the management of the exchange rates between the euro and non-participating currencies. Article 109k requires EU member states not participating in EMU to assume only a vague exchange rate obligation (to treat their exchange rates as matters of common interest). The ECB's General Council is the only forum for the meeting of all the ESCB central bank governors. However, the TEU and the ESCB Statute fail to note that the General Council inherits the responsibilities of the EMI for fostering monetary and exchange rate policy co-ordination and monitoring the EMS. Indeed, given its lack of

powers and right to information (discussed above), the General Council is an inadequate body to bring about this fostering.

Kenen (1995) argues that the organization of an adequate forum for promoting exchange rate co-ordination between the ECB/Eurosystem and the non-participants is important. Although the number and economic importance of the member states not participating in EMU is lower and less than Kenen had feared, the future accession of central and eastern European countries will likely increase the significance of this level of co-ordination. Kenen (1995; 190) recommends that

> the treaty should be amended to establish a new body comprising the president of the ECB and the governors of the central banks of the nonparticipating countries. It should not replace the General Council, which will have duties of its own, but should have responsibilities and powers similar to those of the EMI. It should have the right to be consulted in advance concerning important policy decisions by the Governing Council of the ECB and the right to give advice to individual central banks, including the ECB. Furthermore, it should be made responsible for managing exchange rate arrangements linking the ECU with the nonparticipants' national currencies.[67]

Kenen also anticipated the creation of a residual EMS with mutual obligations for the ECB and the participating countries. All four member state governments not participating in EMU signed up to the ERM II agreement in September 1998. However, they were not required bring their currencies into the mechanism. Greece and Denmark did so, which potentially mitigated the co-ordination problem. However, the ERM II has kept the ±15 per cent fluctuation margins of the post-1993 ERM and it minimal reciprocal agreements. Moreover, the United Kingdom and Sweden have opted for floating. As members of the ERM II they would have been obliged to continue respecting the conditions of the original EMS: a regular exchange of information with the ECB on developments in foreign exchange markets and prior agreement of other EU central banks to use currency issued by them for interventions or other transactions in excess of certain amounts. The more general aim of the ERM II agreement is to encourage all participants to orient their economic policies towards encouraging stability and convergence. However, this does not encourage cooperation, let alone co-ordination, in exchange rate management. In the obviously

asymmetric ERMII, the burden of adjustment falls on the participating countries outside the Euro-Zone.

IV. The ECB, the external representation of the Euro-Zone and international level cooperation

What role should the ECB play in the external representation of the Euro-Zone in intergovernmental organizations and international level cooperation that touches upon its areas of competence? This issue links into the broader problem of the division of responsibilities among EU institutions over the major elements of economic policy and the respective roles of ECOFIN, the Commission and the ECB in external representation.[68] The current absence of a Euro-Zone equivalent of the US Treasury Secretary (despite efforts by the French and Belgian Eurogroup presidencies to create a 'Mr Euro') potentially strengthens the role of the ECB (however desirable). The issue of representation has been a subject of debate since the Delors Committee. However, serious discussion on the matter only began following the creation of the ECB in June 1998, awaiting a decision by both international organizations and ECOFIN (as stipulated in Article 109.4 TEU).

The official ECB position on external representation runs as follows (Duisenberg 2000). The ECB plays three different roles in the international community which are determined by the Eurosystem's tasks involved in international relations. First, the ECB is a major and autonomous counterpart of the Eurogroup whenever the Eurosystem's exclusive jurisdictions – monetary policy and related central banking tasks – are involved in international relations. Second, with regard to issues relating to the exchange rate of the euro, the ECB shares with the Eurogroup the responsibility for consultation with third parties. However, the ECB is solely responsible for external representation concerning foreign exchange operations. Third, within the limits of the Eurosystem's field of competence, the ECB can advise other Euro-Zone policy-makers on international issues. In specific circumstances the ECB may also act as 'catalyst for cooperation' with third countries. This may happen when the Eurosystem develops common views on issues which fall within the competence of other Euro-Zone authorities (mainly national governments), but in which the Eurosystem has a strong institutional interest, in accordance with its statute. This applies, for example, to issues related to the stability of global financial markets and the architecture of the international monetary system, which in turn affects the ability of the ECB to pursue its price stability goal in the Euro-Zone.

The ECB made its initial demands for right to external representation on the basis of Article 6 of the Statute of the ESCB. Article 6.1 provides that 'in the field of international co-operation involving the tasks entrusted to the ESCB, the ECB [namely, the Governing Council] shall decide how the ESCB shall be represented' by the ECB and/or by Euro-Zone NCBs.[69] Moreover, ECB officials have pointed to Article 109 TEU, paragraph 3 which stipulates that the coordination on external monetary policy must 'ensure that the Community expresses a single position'. ECB officials claim that in order to ensure consistency and coherence in the development of Euro-Zone positions, the ECB must be present whenever matters falling into its jurisdiction are discussed (Padoa-Schioppa 1999). ECOFIN/Eurogroup also has an interest in ECB participation in international fora. The potential success of (eventual) international exchange rate cooperation (under the aegis of the G-7) or concerted intervention (organized through the IMF) will rely very much on both ex ante and ex post internal Euro-Zone co-ordination that ensures that the ECB will be willing and able to implement the policy bargain (Kenen 1995; 118). Dobson (1991) argues that the difference between success and failure in the work of the G-7 depended crucially on the degree of agreement between the German government and the Bundesbank (see also Kennedy 1991, Henning 1994). The ECB will likely play a similar role in the context of international exchange rate management.

On 1 December 1998, ECOFIN proposed arrangements endorsed by the Vienna European Council a few days later. These dealt with ECB representation in bilateral and multilateral intergovernmental fora, including the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD) and the Group of Seven (G-7) Finance (meetings of finance ministers and central bank governors from the G-7 countries, distinct from the summit meetings of heads of state or government, and responsible for exchange rate policy cooperation). ECOFIN wanted three-member Community delegations to attend these international fora, including the ECB president and a Commission representative. The arrangements were described as pragmatic and temporary to be developed further. ECB representatives were also to be actively engaged in the preparation of Euro-Zone positions for these meetings within the Economic and Financial Committee (EFC) prior to being finalized in the Eurogroup. Given the diverse circumstances of bilateral economic relations with third countries, the EU finance ministers did not set arrangements for Euro-Zone representation. The presence of the ECB in these bilateral discussions would be left to the Council Presidency.

The organization of ECB representation in international fora required difficult negotiations with international partners. Difficulty arose in part from the fact that intergovernmental institutions such as the IMF or the OECD are – with minor exceptions such as Belgium and Luxembourg – organized on the basis of a strict correspondence between one currency and one country. The situation was potentially less problematic with regard to the G-7 Finance and the G-10 Governors which, set up under the aegis of the BIS, are informal, less institutionalized fora. Special arrangements therefore had to be designed in order to enable the ECB to contribute to the representation of the Eurosystem in these institutions. With regard to the IMF, this was less problematic given that there was no question that the ECB could gain membership and voting powers. The major concern was the over-representation of the Euro-Zone; thus Commission representatives were not allowed to attend IMF Executive Board meetings. In December 1998, the IMF Executive Board agreed to grant observer status to the ECB (IMF 1998) and the right to send a representative to Executive Board meetings (which did not require an amendment to the Fund's Article of Agreement).[70] The ECB representative attends and has the right to speak at meetings on the role of the euro in the international monetary system, multilateral surveillance of the Euro-Zone and individual countries within the zone, international capital market reports and world economic and market developments. The ECB observer represents the ECB at IMF Executive Board meetings on agenda items recognized by the ECB and the IMF to be of mutual interest for the performance of their respective mandates. The representative can also be invited to other Executive Board meetings – such as discussion on international financial architecture – although s/he does not have the *right* to attend. The official Euro-Zone representative on the IMF Executive Board remains the Council President (chair of the Eurogroup). The ECB's role is limited compared to that of the member state governments, although its presence may help to unify the views of the EU participants on particular matters.[71]

Likewise with the OECD, another intergovernmental institution, ECB membership was out of the question. However, the organization deals with issues – notably its surveillance of the Euro-Zone – relating to the tasks assigned to the Eurosystem. In February 1999, the OECD Secretary General confirmed that the ECB would be allowed to participate in the work of the relevant committees and working groups as a separate member of the EC delegation alongside the European Commission.[72] The ECB also obtained observer status in the meetings

of the G-10 Ministers and Governors which are organized in connection with the IMF Interim Committee meetings. It should be stressed that observer status in these fora does not mean a passive role for the ECB: the ECB is the most independent central bank in the world and responsible for the monetary policy of an area with the second largest economy. ECB Executive Board members (and Eurosystem governors) have taken strong outspoken positions on major international monetary, financial and other economic issues.[73]

Despite its informal status, ECB representation in the G-7 (G-8 including Russia) proved more problematic. The EU's proposals were rejected by the non-European members of the G-7 on the grounds that the Euro-Zone would be over-represented in the organization, given the presence of Euro-Zone NCBs. Nonetheless, on an ad hoc basis the President of the ECB started participating in G-7 Finance meetings from October 1998 on issues related to monetary policy and multilateral surveillance, including exchange rate policy cooperation. Provisional arrangements for Euro-Zone representation were finally agreed upon at the June 1999 G-7 meeting in Frankfurt. The ECB president would replace Euro-Zone NCB governors during the first part of G-7 Finance meetings when monetary matters are discussed. The viability of these arrangements remains to be seen. The aim of many G-7 participants and Euro-Zone member states is to form a 'monetary G-3' (following the eventual accession of the UK to the Euro-Zone) which might eventually be paralleled by a finance trio. The eight smaller Euro-Zone member states currently excluded from the G-7 have a particular interest in strengthening the role of the ECB. In central banking fora, the participation of the ECB has been more straightforward: the ECB president participates in the meetings of the G-10 Governors organized in the context of the BIS and in the committees under the aegis of the governors, notably the Basle Committee on Banking Supervision and the Committee on the Global Finance System.

The ECB does not find the temporary ad hoc approach to its representation in international fora satisfactory. Duisenberg (2000b) argues for the gradual but fundamental adaptation of the traditional institutional framework of international relations on the grounds that the existing framework – based on the representation of national governments – 'was not tailored to the involvement of monetary unions, nor to the advent of the Eurosystem, and more generally the [Euro-Zone], as a new actor in international relations'. In other words, the observer status of the ECB in the IMF and OECD is acceptable, but only as a first step to improved representation. With regard to

Eurosystem representation in international fora where both ministers and bank governors are represented (G-7 Finance, G-20), Duisenberg focuses on the capability to speak with one voice (if and when appropriate). He argues that the specific arrangements already established 'may still call for some improvement'. In these fora, Duisenberg seeks a clearer Euro-Zone political counterpart for the ECB: instead of the four or twelve Euro-Zone member state finance ministers (in the G-7 and G-20 respectively), he would prefer a single Eurogroup representative with a higher profile. This would make it easier to achieve and maintain single policy positions in the context of multilateral discussions and negotiations, and thus simplify international level decision making as well as the ECB's role. The aim here is to overcome a more general problem with the internal coordination of external monetary policy: namely, the lack of rules to oblige member states to adhere to a common policy and speak with one voice.

At the bilateral level – notably in terms of intervention in foreign exchange markets and the organization of financial rescues – the respective roles of the Council President and ECB have yet to be determined. The ECB has proceeded in forging improved bilateral relations with other central banks. Notably, it has become involved in the EU enlargement process by providing assistance to the central banks of central and eastern European candidate countries to prepare them for participation in the ESCB following accession and their eventual participation in the Eurosystem. In Helsinki in November 1999 and Vienna in December 2000, the representatives of the ECB Executive Board, the then 11 Eurosystem NCBs and the central banks of the 12 countries applying for EU membership met together in seminars to review the central banking issues involved in the accession process, identify the main problem areas and enhance cooperation between the Eurosystem and applicant NCBs. Issues of common interest include primarily monetary and foreign exchange policy matters, financial market structures and the legal convergence of central bank statutes in applicant countries. Tommaso Padoa Schioppa, the Executive Board Member responsible for international and European relations has also visited other central banks – starting with Japan, Korea and China in early 1999 – and other central bankers have been received in Frankfurt, with the aim of improving bilateral ties on issues of mutual concern including operational facilities, cooperation in matters concerning prudential supervision and financial stability, the provision of technical assistance but also systemic issues, such as the strengthening of the international monetary and financial system. In addition to central

banks, the ECB has begun to establish contacts with other relevant foreign institutions, such as banking supervisory authorities, local banking associations, stock exchanges and national public administrations. ECB Executive Board members have, in numerous private banking fora called upon improved cooperation between the ECB and the private sector with the aim of strengthening the international financial architecture (for example, Duisenberg 2000).

Duisenberg (2000b) explains the rationale behind the ECB cooperation activities at the international level. Much of this cooperation is consultation, which consists of a regular mutual exchange of information and views in both international fora and bilateral contacts. The principal aim here is to better incorporate possible spill-over effects from third country policy actions into the ECB's analysis of price developments in the Euro-Zone. In the IMF and OECD, cooperation also involves Euro-Zone surveillance: the regular monitoring and assessment of the economic policies of the Euro-Zone and its member states. International surveillance contributes to the transparency of both the ECB and Euro-Zone governments as both the IMF and the OECD make their assessments of Euro-Zone economic policies available to the public. Cooperation can then extend to the development of 'standards' and 'codes' developed by the international community which constitute a form of multilateral rule-making to be implemented on a voluntary basis, for example, 'The IMF Code of Good Practices on Transparency in Monetary and Financial Policies'. The ECB participates in international organizations also to watch closely over the development of cooperation – consultation, surveillance and co-ordination – among macroeconomic policy-making officials. Above all, ex ante co-ordination[74] of macroeconomic policies and exchange rates creates the greatest potential danger for the ECB's mandate and independence.

Conclusion

This chapter has provided a brief overview of the organisation, powers and functions of the ECB. We have also explored some of the main issues of concern or debate regarding the operation of the ECB and its relationship with other institutions at the four different levels of co-ordination: Eurosystem NCBs in the management of monetary policy; other EU institutions (notably the Eurogroup) in the co-ordination of EU macroeconomic and Euro-Zone external monetary policy; ESCB and specifically ERMII NCBs; and Euro-Zone governments, NCBs and the European Commission within international

institutions and gatherings (IMF, OECD, G-7 and G-20). The role of the ECB and Eurosystem in the monetary and economic management and representation suffers from a lack of clarity in some areas (notably in external monetary policy) or, in the ECB's view, insufficiency in others (notably prudential supervision and representation in international relations), and is still being fleshed out. The question of the ECB's role in the four levels of co-ordination is complicated in that it frequently involves wider issues, crucially the bank's problematic legitimacy. The precise role of the ECB in the four levels of co-ordination will remain the subject of debate for some years to come.

5
The Independence of the ECB

> It's normal for the political side to give suggestions or opinions, but it would be abnormal if these suggestions were listened to.
>
> Wim Duisenberg, President, European Central Bank[75]

Introduction: the institutional dilemmas of an independent central bank

The monetary policy of the European Central Bank (ECB) was in many ways supposed to be different than the policies pursued by national central banks. As the *Financial Times* noted, 'It was not meant to be like this'.[76] From the ECB's first days in office in June 1998, the ECB's policies were extremely politicized, its independence questioned, and its credibility doubted. What is immediately and abundantly clear is that the institutional and policy dilemmas faced by the ECB are quite similar to the dilemmas faced by other national central banks over the last 50 years. Exchange rate fluctuations, to say nothing of internal political pressure from the Euro-Zone governments, act as a direct constraint on the ability of the ECB to pursue an independent monetary policy. The ongoing efforts of the ECB to prop up the sagging euro – which has lost over 20 per cent of its value since its inception in January 1999 – illustrate the dilemmas the bank faces. While the weak euro boosts exports from and employment within the Euro-Zone, the euro's value demonstrates in part the power of the markets over the ECB, contributes to the credibility problems of bank, complicates trade relationships with non-euro members and the US, and undermines public support and confidence in the euro. The first years have been difficult ones for the ECB.

With the ability of nations to restrain capital all but eliminated as a viable policy option, the choices facing the ECB are clear. The ECB can retain 'domestic' (meaning within the Euro-Zone) monetary autonomy and pursue targeted monetary objectives, but sacrifice a measure of exchange rate stability in the process. Or the ECB can pursue a monetary policy emphasizing exchange rate stability but at the expense of 'domestic' monetary policy autonomy. Although the choices for central bankers and politicians may not always be so simply arranged on an autonomy–exchange rate stability continuum (Cohen 1993), for analytical purposes such an approach can be useful to understanding the degree of ECB independence. This chapter examines the level of political, personal and financial independence of the ECB. Drawing upon previous analyses of other independent central banks, in particular the Bundesbank, we can set forth some basic propositions on the likelihood of an independent ECB monetary policy. Indeed, most studies have suggested that the ECB is in fact more independent than the Bundesbank (DeHaan 1997; Elgie 1998). Our analysis confirms this impression and suggests that we should expect the ECB to be quite independent in terms of its strict mandate on interest rates and price stability.

At the same time, the ECB will experience increased and ongoing difficulties as a result of external exchange rate politics that will complicate its Euro-Zone monetary objectives. Adding to these difficulties is the lingering debate over the democratic accountability of the ECB. Can an independent ECB be held accountable for its actions? Indeed this question is central to our analysis of the possible new 'leviathan' emerging on the European landscape. This chapter seeks to clarify some of the debates over the accountability and independence of the ECB and provide our conception of the relationship between these two concepts.

Debating central bank independence

In the negotiations leading to Maastricht, the key debate over the institutional structure and the policy-making powers of the future ECB was over the issue of the degree of central bank independence from political influence (Hasse 1990; De Haan 1997; Brentford 1998; Verdun 1998a; and Loedel 1999a). More directly, would nation states have any authority and influence in the policy decisions of the future ECB? While most analysts focused on the influence of states, other possible influences – business and banking associations, and labor unions, for

example – would also need to be limited. The focus on central bank independence was strongly articulated by Germany and especially Bundesbank officials, given Germany's strong tradition of non-inflationary monetary policy and independent central bank (Loedel 1999b). Germany's views were also shared by a number of the leading architects of EMU, primarily within the Delors Committee (Verdun 1999).

The view from Germany and the Delors Committee was based on a series of arguments. Most empirical studies have shown that countries with independent central banks achieve substantially lower rates of inflation than countries in which the central bank is controlled directly by the government (Alesina and Summers 1992; Bernard 1998; Blinder 1998), although there is mixed evidence from some other countries – primarily in the developing world (Posen 1993). Others argue that independence is important due to technical factors – policy-making from an independent central bank can be more straightforward and responsive to short-term needs of the economy in order to avoid the inevitable delays or 'decision lags' that exist in the normal political process. While some can argue that central banks also suffer such 'time-lags' (for example, 6–9 months or even much longer) and their decisions have not always been accurate or timely in nature, proponents counter that an independent central bank will at a minimum remain consistent in its monetary policy orientation.

One can also see constitutional principles at work and envision an independent central bank as a separate branch of government that can check potentially damaging policies of other government branches (Issing 1999). For example, the German Bundesbank has long suggested that that the bank acted as a state within state, a coalition partner of the government. In other words, the Bundesbank could act as a check upon the actions of the federal government if the government's spending policies threatened price stability. The same logic could be applied to the ECB as it constantly reminds the Euro-Zone governments to reign in spending under the limits set forth in the Stability and Growth Pact. Furthermore, in view of the politicians' short term motivation and propensity to spend in support of lobbies, interest groups and other pressures, issuing money, that is, making the central bank provide credits when needed, should be limited or capped to some ceiling. Tight money can only be insured if the central bank acts as an independent economic and political counterweight to the spending proclivities of the government. In short, the lessons of history have provided substantial evidence that a nation's currency

should be protected by an independent central bank due to the government's inability to properly manage a nation's monetary stock.

Central bank independence and its corresponding impact on policy credibility have also been cited by many analysts as an important reason for freeing the hand of a central bank. Independence has a strong impact on policy credibility and vice versa (Blackburn and Christensen 1989; Woolley 1992; Schaling 1995; Nolan and Schaling 1996; Mayes 1998). A central bank with a strong reputation for credible anti-inflationary policies may be able to resist political pressures to reform the legal structures and statutes of the bank that might threaten price stability. More importantly, perhaps, the issue of credibility centres on whether and how policy-makers can make credible commitments about their future conduct. Independence and the credibility that flows from it need to be understood in terms of actual behaviour and not just institutions. The structure of the economy and internal politics may present policy-makers with difficult tradeoffs between short-run policy benefits and long-run policy costs that may impact credibility. An institution such as a central bank can be considered credible if it is willing to let the government, the public and the economy incur the costs of their decisions.

For example, during the speculative crises within the EMS in 1992–93, many observers puzzled over the fact that the French franc came under more pressure than the DM, despite the franc's underlying strength in terms of the economic fundamentals (primarily inflation) of the French economy. The answer to this puzzle is rather simple. It centres on monetary credibility: the markets trusted the Bundesbank to bring the inflationary pressures in Germany under control; the markets did not believe the French government's ability – in the face of elections and growing unemployment – to withstand the pressure to reflate. The question today: Has the ECB established the same level of credibility as the Bundesbank? While this chapter touches on this subject in so far as it relates to independence, Chapter 6 tracks in more detail the credibility crisis of the European Central Bank.

Credibility of monetary policy will also depend not just upon monetary policy alone but rather upon the perceived coherence of the overall macroeconomic programme. This coherence, together with the intellectual and political consensus on the monetary theory being used and the objectives and conduct of monetary policy, subject to the conditions of the current political climate, significantly influences credibility (see, for example, Schaling 1995). Not surprisingly, the independent structure of institutions makes any promises about future behaviour

more believable. The Bundesbank used this understanding of credibility in its decision to publish yearly quantitative targets of the money stock. Focusing on a medium term monetary target like M3, the Bundesbank believed it could make credible commitments to ensuring a pre-determined range of monetary growth. If the bank failed to meet such targets, which it did on occasion, the credibility of the bank can be harmed.[77] Despite some problems with the M3 indicator, the markets ultimately trusted the Bundesbank to control monetary growth.

As for the ECB, it employs the M3 indicator, after the insistence of the Germans, but also targets other macroeconomic indicators like inflation (following the lead of the British). The OECD has argued that the ECB's intermediate monetary target of M3, which was set at a reference value (or loose target) of 4.5 per cent (measured on an annual basis) for 1999, 2000 and 2001, may not be useful for setting policy.[78] This broad monetary measure most likely will be subject to great instability as the single currency markets develop. Moreover, the ECB must deal with vastly divergent economic indicators in growth and unemployment, for example, rates of higher growth and lower unemployment in Ireland as compared with lower growth and higher unemployment in Germany. Early decisions by the ECB to emphasize one target over another when setting interest rates has in part weakened the perception that the ECB has full mastery over the numbers. Whatever the disagreements over M3 or other measures, the freedom to decide which measures are employed and the freedom to stick to these measures despite political protest from governments, should be seen as important pillars of an independent central bank establishing credibility.

Democratic accountability

While these arguments carry with them considerable merit, they should not go unquestioned. Perhaps the strongest argument against central bank independence is based on legal or democratic theory (Arntenbrink 1999; Berman and McNamara 1999; Buiter 1999; Magnette 2000; Majone 1996, 1999; and Verdun 1998a). The theory would contend that an independent central bank cannot be held democratically accountable for its politically sensitive actions. In other words, the delegation of power to non-elected officials (the ECB Governing Council) can only be acceptable in a democratic society if the bank is accountable in some manner to democratically elected

institutions. One might ask who should be held responsible for the effects on employment created by the ECB's monetary policy – the bank or the governments of the Euro-Zone? Central banks remain free from the task of legitimating their power (via elections), unlike other representative institutions. This is of central concern to the ECB and the institutions of the European Union as they grapple with questions of democratic deficits, pressures of regionalism, and issues of transparency. General consensus exists that the EU – and thereby the ECB – should be transparent and largely accountable to its citizens in the future.

ECB President Duisenberg's assertions – that the ECB's definition of price stability as an annual increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2 per cent acts as a yardstick against which the public can hold the ECB accountable[79] – suggest a differing (economist) view on accountability. This view sees accountability and independence as mutually dependent. But Duisenberg's confidence in the ECB's monetary indicators and objectives do not necessarily assuage sceptics who see the ECB as beyond the control and legitimacy of democratic processes and institutions. While we recognize that accountability and independence can be served by quantifying monetary objectives (see also Arntenbrink 1999) and are interrelated, we do not fully accept the notion that merely publishing monetary objectives meets the full standards of democratic accountability.

Specifically, as Verdun notes, 'the lack of formal parliamentary control over the (ECB's) decision-making process … has led to considerable concerns about democratic accountability: the aspect of secrecy, technocracy and lack of transparency …' within the European Union (Verdun 1998: 111). More bluntly, Buiter warns that the 'lack of openness, transparency and accountability …' threaten to 'undermine the viability of the whole enterprise' (1999: 185). In principle, one can argue that the final decisions and the priorities, which are given to monetary policy, must lie with the European Parliament or some other nominally representative body – perhaps the Council of Finance Ministers. It follows that if necessary, monetary policy should be subordinated to fiscal policy or other objectives laid out by popularly elected officials. Only democratically elected officials of the government have the respective legitimacy and authority to proceed with the negotiations and reach an agreed upon solution. As powerfully stated by Berman and McNamara, allowing the ECB 'to rest unchallenged both damages democracy and begs important questions about who the

winners and losers of economic policy should be' (Berman and McNamara 1999: 2). In this vein, noted economist Peter Kenen has suggested that the European Parliament be given greater authority over the European monetary policy-making process (Kenen 1995). Again, more bluntly, Buiter suggests evolving a 'European Parliament with teeth' (1999: 207).

Clearly, the issue of transparency and accountability is framed politically in the context of a concern for the lack of democratic control over monetary policy-making and democratic legitimacy of the EMU project more broadly (see Elgie 1998 and Elgie 2001; Taylor 2000; Verdun and Christiansen 2000). In a democratic society, transparency and accountability are essential if central bank independence is to remain politically acceptable. Political scientists are concerned about the exceptional strength of the ECB's policy mandate and independence, the absence of counterbalancing EU institutions and the weakness of democratic accountability.[80] Verdun and Christiansen (2000) discuss the problematic nature of the establishment of a powerful ECB prior to the emergence of a political community, and notably the institutions of representative democracy, in which the bank's decisions, or, more significantly, the procedures for the taking of such decisions can be grounded (163). The ECB lacks the societal embeddedness that legitimizes the policy-making of other non-majoritarian institutions such as independent national central banks and supreme courts. Verdun and Christiansen (2000) write:

> The output orientation of much of the debate about the benefits and the costs of EMU signifies that policy-makers regard its economic and social effects as the strongest, perhaps even as the only, possible legitimating aspect of the single currency. Such a perception makes it hostage to the economic fortunes of the day… (176–7).

The legitimacy problem has placed increased focus on the matters of accountability and transparency. Monetary policy decisions will affect member states differently due to different national economic cycles (despite some convergence) and differently structured economies. Given the lack of financial transfer payments to compensate those parts of the Euro-Zone suffering from asymmetrical shocks, limited labour mobility and the strong constraints placed on the use of national fiscal instruments, the ECB's response to these shocks will be of considerable importance.

The risk remains strong that some member states may come to feel disadvantaged by ECB monetary policy, that the legitimacy of the bank will be called into question and the pressure will increase on governments to speak out. Doubts about the ECB's legitimacy increase the need for Executive Board members to give frequent interviews, press conferences and speeches about goals and instruments. National central bank governors need to do the same at the national level. Likewise, the decision to hold two Governing Council meetings a year in other member states was designed to improve the visibility of the ECB. Many call for strengthened links between the ECB and the EP as another move to improve the legitimacy of the ECB. However, this is inherently problematic given that the EP, despite being directly elected, is neither well understood nor well liked by many Europeans (Dinan 2000, 478). Other observers, led by the French government, argue that the legitimacy problem can be partially resolved by creating a stronger and more visible political counterweight to the independent ECB: the European equivalent of the American Treasury Secretary.

Despite the view of political scientists, the precise nature of ECB transparency and accountability is still a matter of some debate. Many economists and market analysts define transparency and accountability in terms of monetary strategy, communicative effectiveness, and co-ordination with other policy-makers. In particular, they focus on the two-pillar strategy of the ECB, the bank's ability to communicate its strategy to the public and the markets, and the ability of the bank to co-ordinate the strategy with leading policy-makers – whether at the national level or through EU institutions (the Eurogroup, for example). Central banks need to make the public aware of the benefits of price stability as memories of high inflation are fading. Clear monetary goals can also help to guide inflationary expectations and thus influence the behaviour of firms and workers. But perhaps most important of all, central banks need to communicate clearly with the financial markets. By becoming more predictable, central banks can help to make market reactions to interest rate changes easier to predict, which then makes monetary policy more effective. In this regard, and with the ECB's own admission – confirmed in a number of interviews – the ECB has not always performed effectively.[81] 'We need to sell it better,' confided one EC banker. Another EC banker indicated that transparency demanded that the ECB avoid mistakes and, if mistakes were made, to be 'honest' with the public about these mistakes.

The Treaty on European Union supplements the considerable degree of institutional independence granted to the ECB by extensive

provisions concerning transparency and accountability. Articles 253–56 (ex 190–92) oblige the European Commission to provide extensive justification for its actions, to publish documents and studies, and provide access to documents and the like. Article 110(2) (ex 108a(2)) EC stipulates that this duty apply to regulations and decisions made under Article 110 EC. Article 110(2) EC notes that, while the ECB is under no obligation to publish recommendations, opinions and decisions, it may choose to do so. The national central banks of the Eurosystem currently produce full forecasts at six–monthly intervals. As noted above, the ECB began to publish full annual forecasts in December 2000. The ECB also publishes its *Monthly Bulletin* that can be used to provide updates on policy developments, while the press conferences that follow Governing Council meetings can be used to announce policy changes if the ECB thinks that the ECB and national central bank forecasts have become too out of date to be useful.

Economists – concerned about the dangers of separating monetary from fiscal and macroeconomic policy (the 'assignment problem') – have also tended to focus on policy-making transparency and accountability as a way of helping the ECB maintain price stability by improving coordination with national fiscal and macroeconomic policy makers (Favero *et al*. 2000; Issing 1999; Mayes 2000). There is considerable disagreement as to precisely what the ECB should publish and how often it should do so. Most central banks only publish a discussion of published indicators and very few publish disagreements and voting records. Those which do so will either produce a single set of indicators or supplement them with simulations or a discussion of 'risks' or discuss the range of possible outcomes on the basis of an agreed distribution of risks. Because the ECB Governing Council has not agreed upon publishing the kinds of detailed texts produced by national central banks. The Governing Council has opted for a form of '*ex ante*' transparency that involves the establishment of a map that sets out the rules by which the ECB makes monetary policy and reacts to fiscal and macroeconomic policy developments and external shocks. The annual publication of detailed forecasts – based on what the ECB sees as the two pillars of monetary policy: a reference value for money and a broad based assessment of price developments – was begun in December 2000. However, this is only part of the required map which will include documentation on monetary models, simulation properties and a discussion of how they are used in policy formulation. Most national central banks do not publish the whole map. The Eurosystem's currently published map is, one could argue, vague and consistent with a large range of policy reactions. In order to improve transparency and

meet the demands of many observers a great deal more information must be made available.

Mayes (2000) and Issing (1999) all point out that the map will never be crystal clear: some eventualities will not be covered and monetary policy will always tend to be more contingent than other policies because of the characteristics of the decision-making procedure involved. Government expenditure can vary frequently while the formulation and implementation of structural policy is a slow process and can be altered at any time. Co-ordination between monetary and macroeconomic policy in the Euro-Zone has not been successful. As Mayes (2000) writes: 'No central bank can commit itself either to maintaining current monetary conditions or to following some explicit path in the future come what may. It can only commit itself to following a predetermined strategy' (15) (see also Issing 1999b, 517). The Stability and Growth Pact obligation to present fiscal and structural *plans* also works in this way and helps the ECB formulate its own strategy. However, effective co-ordination is inherently difficult because different policies (structural, fiscal, monetary and so on) take different lengths of time to affect the same variables (Mayes 2000, 16).

In sum, from an economic policy perspective, monetary policy should be considered an integral part of the government's overall economic policy. The government's ability to successfully deal with economic difficulties would be strengthened if fiscal and monetary policy were co-ordinated. Working from this idea, Dyson, Featherstone, and Michalopoulos suggest that the lack of linkage between fiscal and monetary policies within the EU worsens the problem of the 'insularity' of the EMU process (Dyson, Featherstone, and Michalopouls 1995). Although most governments now accept that low inflation is essential for sustainable growth, the trade-off between a bit more inflation and a bit more unemployment can still be made in the short term – especially with elections looming in the horizon. As a result of this short-term motivation, an independent central bank and monetary policy could very well lead to government frustration, friction and conflict. In this view, monetary policy and the central bank should be considered one important part of a government's overall arsenal in dealing with weighty economic problems.

Independence and accountability: a balancing act for the ECB?

It is clear that both sides of this argument carry with them considerable merit. The position of the authors is one of balance. The recognition

that the decisions surrounding monetary policy in the Euro-Zone already carry with them an almost extra-governmental aura, limits of some degree to the role citizens, the government, and interest groups should have in monetary decisions must be accepted. History provides a painful reminder to many Europeans, especially the Germans, of the dangers to the state if there exists too much 'political' involvement in monetary policy. The ECB for its part must attempt to walk a very fine tightrope between complete institutional independence and direct political accountability. When the bank pushes toward either end of the independence–accountability spectrum, conflict within the Euro-Zone will erupt. Restoring a careful equilibrium between absolute independence and close cooperation with the Euro-Zone governments will be an ongoing task of the European Central Bank.

At the same time, within a democratic order (within which the ECB operates), there must remain some mechanism of accountability to all governmental and administrative institutions and agencies. Only with some stronger mechanism of democratic accountability can the emerging European Union gain and retain the legitimacy and credibility of its constituents. The fear for many analysts of the European Union is that the EU has sold its democratic soul in return for the security that the ECB can provide in a world of globalized financial markets (Buiter 1999). The volatility, instability, and near anarchy of the global exchange markets have led the EU to contract with the ECB for some measure of monetary stability. Have EU and national leaders created a new Leviathan for Europe? If so, the ECB and the EU may be in urgent need of institutional modification.

The following section explores the level or degree of ECB independence in order to better assess the question of accountability and transparency.

The independence of the European Central Bank

Given the arguments both in favour and against central bank independence, did the Treaty on European Union create an independent ECB? Specifically, there are three distinctive contexts that we can identify within which the influence of the government, societal interests and international actors must be excluded or greatly curtailed in order for a central bank to be considered independent. These three contexts are political independence, personal independence, and financial independence (Alesina and Summers 1992; Bernhard 1998; Loedel 1999a). Within each one of these contexts, a range of possible constraints on

the ECB's independence will be analysed. In order to draw some useful conclusions about the degree of ECB independence, we compare the ECB's independence to that of the Bundesbank (before the euro).

Political independence

Perhaps the pivotal concept in the study of central bank independence is its functional or political independence. For purpose of definition, Woolley distinguishes two types of independence that prove useful here (Woolley 1984). Political independence refers to the ability of a central bank to choose a course of action independently without yielding to the pressures of others as to what that action should be. In the second sense, functional independence refers to the central bank's ability to achieve its objectives without being affected by the actions of others. Functional independence, as Woolley argues, is generally not characteristic of monetary policy (Woolley 1984: 13).[82] For our purposes, we will focus on political independence.

Political independence refers to the formal legal competence of the ECB to choose a course of action independently and without yielding to the overt or covert pressures of other political actors. By almost all accounts and universal consensus among analysts, political independence should characterize the monetary policy of the ECB. The ECB's independence is enshrined in the Maastricht Treaty – a Treaty that would be extremely difficult (and unlikely) to revise. Article 107 of the Treaty clearly states that 'neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from community institutions or bodies, from any government of a member state or from any other body'. Furthermore, the Treaty narrowly defines the ECB's primary objective as maintaining price stability (Article 105). The ECB is also required, albeit in vague terms, to support the economic policies in the European Union but 'without prejudice to the objective of price stability'. The President of ECOFIN and a member of the Commission may participate on the Governing Council of the ECB, but they do not have the right to vote (Article 109b). Given the clear legal mandate, there is little chance that the ECB's political independence will be watered down in the areas it has sole responsibility.

Most significantly, the informal body made up of the euro-twelve finance ministers (originally called the Euro-XI, now known as the Eurogroup) will likely be the most consistent political threat to the political independence of the ECB. Demanded by the new French Socialist-led government in 1997, the Eurogroup concept was

presented as part of an attempt to limit the austerity measures imposed by the convergence criteria which were explicitly prolonged into Stage Three of the EMU project by the Stability and Growth pact. Within the Eurogroup, the voices and concerns of national governments regarding the ECB's monetary policies will be articulated – a necessity given the belief among the Euro-Zone members that non-euro members (UK, Denmark, and Sweden) should not have a say over the ECB's monetary policy. Resisted by the German government under Kohl, the Eurogroup has somewhat ironically become a forum of German concerns with the ECB's monetary policy, given the persistent high levels of unemployment in Germany. From the French perspective, the Eurogroup was their creation and fits within the traditional French view of a more politicized monetary policy serving national employment interests, not just price stability measures. The French also see the Eurogroup formulating positions on exchange rates (more below) as the French also tend to see the link between the price of a currency and competitiveness – albeit now the competitiveness of the Euro-Zone.

As a result, the ECB has already faced overt political pressure from national governments within the Euro-Zone to pursue a particular monetary policy. The governing council faced concerted pressure and attacks on its policies including heated pressure from the former German Finance Minister Lafontaine prior to a 4 March 1999 council meeting.[83] Along with some of the other left-of-centre European governments, Germany's new Socialist Government led by Gerhard Schröder had also raised the issue of political independence to the forefront of debate. Schröder stated that the ECB 'doesn't only have responsibility for monetary stability but also for economic growth in a sensible way'.[84] With a general shift to the left across many European governments, there has been a sense of an increase in the willingness of governments to use fiscal and monetary policy to stimulate growth and reduce unemployment. The euro's stability and the Stability and Growth Pact's credibility have in part been undermined by this manner of questioning – particularly from Germany. The ECB has responded to such pressure by indicating that it would be forced to act with interest-rate increases if governments were to fail in their attempts to keep government deficits under control.

Lafontaine and others have also criticized the bank's secretiveness and refusal to reveal the minutes of the governing board meetings. Christian Noe, State Secretary at the German Finance Ministry accused the Bundesbank – and by extension the ECB – of engaging in 'pre-democratic' behaviour.[85] The issue of transparency and accountability

is critical here. While the President of the ECB Wim Duisenberg has gone out of his way to speak openly of the ECB's policies,[86] including ongoing presentations within the Monetary Committee of the European Parliament, he has stated cogently that some measure of secrecy is needed in order to keep the market off balance. Indeed, speculation that the ECB would never lower interest rates so soon after the resignation of Lafontaine proved wrong as the bank lowered rates a full half percentage point in early April 1999. Keeping the markets and analysts guessing, and guessing wrong, are early signs of independent-minded ECB.

In summary, even with the Eurogroup body, there is no clear institutional political context within which the ECB will have to answer for its policy. As noted, the President of the ECB will be called before the European Parliament – but the Parliament lacks its own credibility among the electorate. Also as noted, the President will attend meetings of the Eurogroup where he will face questioning and possible pressure, but these meetings are also secret and will not serve a true 'accountability' forum. Moreover, as the ECB has already firmly demonstrated, it takes its price stability mandate and its institutional protection of political independence seriously. The ECB to date has not once backed down on any serious decision it has made whether on interest rates, monetary objectives or indicators, or secrecy. The ECB has had a baptism of fire in its first years of operation, but in terms of political independence, it has largely emerged unscathed and focused on its mandate of price stability.

Personal independence

Personal independence is a second crucial determining factor of central bank autonomy and is intricately related to political independence. If the members of the ECB are selected for political, ideological, and/or national reasons, one would have to question the overarching independence of the ECB to pursue its price stability mandate unfettered by national or political constraints. The ECB's decision-makers will have to assume a transnational identity and act in the interests of Europe first instead of national interest. If one senses the slightest national bias in the bank's decision-making, one would have to question whether it has established a transnational European identity and whether personal (read 'national') interest has trumped the interests of the institution.

Institutionally and personally, the ECB is a hybrid of transnationalism and intergovernmentalism. The two key bodies in the ECB are the

executive board, made up of a president, a vice-president and four additional members, each appointed to eight-year, non-renewable terms; and a governing council, comprising the Executive Board and the central bank governors of the euro-twelve members. The national central bank governors will also have, at a minimum, five-year contracts so as to ensure some continuity on the Council. The Executive Board is appointed by agreement (consensus) of the political leaders of the European Union, after consulting the European Parliament and national central bankers. The Executive Board is clearly the transnational European part of the ECB and is seen as the leading articulators of the bank's European policies. While undoubtedly interested in supporting the ECB's European price stability mandate, the national bank governors will also be representing the concerns of their respective nations. As such, they will undoubtedly bring an intergovernmental voice to ECB deliberations.

The Executive Board has not always found its footing as a strong united body pursuing the interests of the Euro-Zone. While detailed more specifically in Chapter 6, the Governing Council has at times experienced divergent views on ECB policy – especially in the area of exchange rate management. Moreover, the high-profile squabble over the appointment of its first president, Wim Duisenberg, has given some tarnish to the personal independence of the ECB. All the member governments except for the French, who desired their own candidate, Bank of France President Jean Claude Trichet, favored Mr. Duisenberg. At the May 1998 summit to decide euro participants and to finalize the 1999 launching date, Duisenberg was appointed for a full eight-year term, but 'volunteered' to step down after four years to allow Trichet to take over. Duisenberg will in fact step down after five years in office. And while no one doubts the anti-inflationary credentials of Trichet, the embarrassing episode may lead some to question the future personal independence of the ECB. Nonetheless, with the lengthy eight-year terms of office and the squabble over the presidency receding in memory, one can argue that the executive board will continue to emerge as a forceful independent and transnational voice of European monetary politics. Such a view of consensus and Europeanism is confirmed by a number of interviews conducted by the authors of the staff and leadership of the ECB.[87]

The role of the national central bank governors in ECB deliberations has been extremely important. The ECB is really the European System of Central Banks (ESCB) based on a Bundesbank-modeled 'federalist' structure. Power within the Governing Council is therefore

decentralised in favour, based on numbers, of the national central bank governors. Monetary policy decisions will be taken by a simple majority on the Governing Council. Small countries arguably could carry undue weight in the system. Austria, Belgium, Finland, Ireland, Greece, Luxembourg and the Netherlands and Portugal will between them have nine of the 18 votes on the governing council (including members of the executive board) compared with Germany's two, even through their combined GDP is only half of Germany's.[88] Not surprisingly, the Bundesbank and Bank of France Presidents have often spoken with a louder voice within the forum. One might also expect that the national central bank presidents to have their own views and data. This makes co-ordinating the ECB's message quite difficult. Therefore, the role of the President Wim Duisenberg has been especially important in moving the governing council in his and the executive board's direction – something he has not always been able to do. More problematic for the Governing Council will be enlargement and the difficulty in incorporating new national central bank governors into the decision-making process. The one country one seat on the Governing Council rule might have to be restricted (see Chapter 7 for more discussion on enlargement).

One important reason why we should still expect a generally united voice within the ECB's Governing Council on euro-policy is due to the overriding 'economic culture' of its membership (Kaltenthaler 1999). Economic culture can be see as the social perceptions that structure macroeconomic policy. Based on the membership of the executive board and most of the national central bank governors, one can argue that the ECB's economic culture is structured by a strong interest in fiscal rectitude and a deflationary macroeconomic policy targeting price stability. The members of the governing council are what most analysts would describe as believers in the benefits of an independent central bank; almost all members retained strong anti-inflationary credentials – a bank full of Bundesbankers (residing in Frankfurt no less), but even more powerful. They believe that safeguarding the value of the euro and maintaining price stability are the preconditions to a sound European economy. Too much inflation, even at an annual rate of 2–3 per cent, is seen as a cancer on the economy that will destroy the European economy over the long term. In other words, there can be no short-term tradeoffs between a little bit more inflation for a little less unemployment. Keynesian-inspired macroeconomic policy finds little if no support among the ECB's Executive Board and, in large part, the national central bank governors.

Financial independence

The third and final important aspect determining the level and degree of central bank independence is its financial independence from either the obligatory financing of government debts (internal) or exchange rate arrangements or obligations (external) such as those that existed under Bretton Woods and more recently within the EMS.[89] The latter concern is especially relevant as the euro emerges as an international *numéraire*. The euro will likely, albeit modestly, increase its role as a unit of account, a means of payment, and a store of value (Hosli 1999). If so, the euro's influence in global monetary relations will increase pressure on the ECB to stabilize the value of the euro externally.

First, regarding government financing, a government can exercise influence over and limit the discretion of central bankers if there exists the possibility that the government can finance its expenditures either directly or indirectly via central bank credits. Access to central bank credits, especially direct access, can result in an overlapping or fiscal circular flow of money into the money supply. If such financing mechanisms exist, monetary policy is by necessity subordinated to the diktat of fiscal policy.[90]

Currently, the ECB is not directly subordinated to the fiscal demands of member states. However, the bank is necessarily concerned about the potential of national governments to increase spending during the transition phase to the full implementation of the euro by 2002 – and after. For example, the ECB fears the very real scenario in which Italy, now comfortable in its inclusion within the Euro-Zone, might be tempted to fall back into past proclivities of fiscal profligacy. As a result, bolstered by the Stability and Growth Pact, which demands continued fiscal discipline within the boundaries of the convergence criteria (with exceptions for recessions) under the threat of stiff penalties, the ECB continuously warns the Euro-Zone governments to maintain fiscal discipline. While it is not impossible that member states might stray from the convergence criteria (even with Italy's additional room for fiscal spending, it remains well within the criteria), one suspects that the fear of penalties, the ongoing political commitments in each country to fiscal stability, and with the ECB ready to pounce on any divergence, states will try to hold spending steady. It remains to be seen whether a future centralized EU fiscal policy might alter this arrangement. But for now, no such scenario looks imminent.

Most importantly the ECB may face the financial constraints associated with the intervention requirements, institutional commitments, and interest rate pressure associated with exchange rate mechanisms.

Exchange rate policy for the Euro remains unclear and the debates over clarifying exchange rate policy remain extremely controversial (Henning 1997). More importantly, the ECB and the EU will face the very same choice as faced by the Bundesbank: pursue monetary autonomy (albeit within the Euro-Zone member states) or sacrifice a measure of autonomy in return for exchange rate stability vis-à-vis the dollar, yen or some other currency. The scenario sounds like one drawn straight from German monetary history: a powerful independent central bank with the goal of internal price stability pitted against an external monetary policy subject to the domain of the politicians – in the European Union, the Eurogroup, or other EU actors.

Specifically, Article 109 of the Maastricht Treaty lays down the legal relationship and general parameters between the ECB and the Council of Ministers on exchange rate policy. While still not entirely clear, it is assumed that representatives of the Council hold authority to negotiate formal and informal exchange rate agreements with foreign governments under consultation with the ECB. Formal agreements that peg the euro, for example, to the dollar or yen would require a unanimous vote within the Council after it consulted with the ECB, the European Commission, and the European Parliament. Such an arduous process of agreement or ratification will likely decreases the likelihood of increased exchange rate management at the international level. Exchange rate flexibility – or European monetary autonomy at the expense of exchange rate stability vis-à-vis the dollar or yen – will likely be the result.

Nevertheless, as Henning observes, if cohesive, 'national governments, operating through the Council, appear to hold a strong position vis-à-vis the ECB on the matter of formal arrangements' (Henning 1997: 36). While the search for consensus on exchange rate policy is required, actually attaining consensus is not required. Moreover, it is not clear which institution, the ECB, the Council or some other institution, would determine whether an exchange rate agreement would do damage to the price stability mandate of the ECB. In Germany, the government held the final say over such questions. A similar scenario for the EU depends on the cohesiveness of national governments – a pattern for which the EU national governments are not often known.

However, in an interesting set of exchanges in April and May of 1999, Tietmeyer and Trichet openly questioned Duisenberg's decision to take a hands off approach to the sinking euro. Tietmeyer (now replaced by Welteke as head of the Bundesbank) and Trichet were responding to domestic pressures in Germany and France, especially

among the general public, which had been promised a 'strong' euro, and savings and financial interests intent on preserving euro-denominated assets. In this way, Tietmeyer and Trichet were advocating 'national' interests within the supranational Governing Council. More interestingly perhaps, within the German Länder (mainly those dominated by SPD governments) and among Germany's leading export industries, voices could be heard counter to those of Tietmeyer. Parallel interests were expressed in France. The sinking euro actually was improving the export dependent economy, creating new jobs for workers, and enhancing the general Euro-Zone's competitiveness.

Moreover, informal exchange rate arrangements such as those of Plaza and Louvre can be negotiated by the Council under the rubric of setting a 'general orientation' of exchange rate policy. The general orientation must not, however, prejudice the primary objective of the ECB 'to maintain price stability'. This would suggest that the ECB would have a right to reject such orientations, although this again is not clear and will be subject to later determination under actual practice. If the ECB is bound to keep exchange rates stable – a political decision made by ECOFIN – the ECB may be forced to intervene automatically in foreign exchange markets or may be pressured to pursue an interest rate policy so as to ensure the proper exchange rate levels. In a system of freely fluctuating exchange rates, this constraint does not hold true and the central bank can pursue a policy solely concerned with domestic affairs. However, in a system of dirty floating as exists in the international monetary system, the ECB may be placed in a situation where it might have to buy and sell foreign currency or pursue an interest rate policy in order to meet some form of external exchange rate commitments. In fact, in the Fall of 2000, the ECB intervened jointly with the US and Japan in order to ease pressure on the sinking euro. This decision was made largely by the ECB and carried out by the ECB. The success of these operations were limited (see Chapter 6).

The ECB may also face pressure from the United States, Japan or the IMF to intervene in the currency markets in order to achieve a prearranged euro–dollar–yen rates (Henning and Padoan, 2000). Already the US has voiced concern about the euro's weakness vis-à-vis the dollar and what impact that is having on US competitiveness.[91] As noted at the beginning of this paper, the ECB has already found that the external scope of its monetary policy range has narrowed, certainly with the increasing integration in financial markets and with greater global interdependence. Although no formal exchange rate system currently exists between the euro and the dollar, external exchange

rate commitments may circumscribe the ECB's financial independence. For example, during his short tenure, Lafontaine sought to resurrect a 'target zone' scheme for the Euro. From the perspective of the ECB, the proposal fortunately disappeared along with Lafontaine.

Summarizing ECB independence[92]

Table 5.1 compares the independence of the ECB with that of the Bundesbank.

Table 5.1 cont'd Comparing European Central Bank and Bundesbank independence

	European Central Bank	*Bundesbank*	*Comparison*
Political	Primary Objective of Price Stability	More general mandate to 'safeguard the currency'	ECB has a more clearly articulated mandate on price stability
	Free from 'instructions' of community institutions and member states	'Independent' of the advice of the government	'Freedom' of ECB and 'independence' of Bundesbank from political pressure provide roughly similar protection for each institution.
	Mandates enshrined in Maastricht Treaty	Bundesbank Law not guaranteed constitutional protection	Hard to envision Maastricht Treaty being revised.
	Threat of pressure from Eurogroup and other actors (US, IMF).	Threat of pressure from Federal Government and domestic interest groups	Bundesbank Act had aura of 'constitutionality' but could be amended by simple majority in the Federal Parliament
Personal	Executive Board selected by consensus of member states	Directorate has eight-year terms.	Bundesbank was subject to personal issues related to Chancellor preferences, party preferences, Land Bank Presidents.
	National Bank Governors chosen by	Land Bank presidents in	Eight-year terms similar.

Table 5.1 con't Comparing European Central Bank and Bundesbank independence

	European Central Bank	***Bundesbank***	***Comparison***
	member states (majority in the Federalist structure)	majority on council; Federalist structure	
	Eight-year terms (non-renewable) on Executive Board	Strong sense of German monetary culture *Stabilitätsgem-einschaft* (culture of stability)	ECB will face similar pressures, but culture of central bankers will be strong – like Bundesbank – but maybe no culture of stability within the European public? Conflict over Duisenberg embarrassing; will likely not affect independence
Financial	Not required to finance government debt	Bundesbank not required to finance government debt	Bundesbank and ECB have to deal with government spending.
	Must contend with member state budgets (strengthened by Stability and Growth Pact)	Had to contend with government spending.	Similar scenario for ECB and Bundesbank on spending since con vergence criteria in place.
		Required to hand over profits to government	
	No centralized European Union budget	Finance Ministry controlled exchange rates	Bundesbank faced more exchange rate pressure within EMS.
	No formal (external) exchange rate commitments	Often found itself constrained by exchange rate regimes (Bretton Woods and EMS)	ECB will face possi ble exchange rate pressure as ECOFIN controls exchange rates; No strong pressure currently
	Possible exchange rate pressure as ECOFIN controls exchange rate policy		

First, in terms of political independence, we can state that the ECB has perhaps an even greater level of independence than that of the Bundesbank, at least as based on the statutes creating the ECB. The role of the Eurogroup remains a bit of wild-card, but given the first example drawn from the clash between LaFontaine and the ECB and other rather weak efforts on the part of the Eurogroup to speak with one 'political' voice vis-à-vis the ECB, the ECB has maintained its political independence with full vigour and clarity. Moreover, the ECB's statutes are part of the Treaty on European Union – and will not be subject to revision (other than when enlargement becomes problematic). The constitutional protection for the ECB remains indeed stronger than the Bundesbank's own constitutional protections (simple majority vote could change the Bundesbank act). The ECB, however, does not operate in a complete political vacuum. The bank's decision to lower rates in April 1999 (after Lafontaine resigned) and May 2001 (following US and IMF pressure) does show a pragmatic political side to the bank. Nevertheless, the ECB appears to be the model for a political independent central bank.

In terms of personal independence, the ECB faces some complementary concerns that often plagued the selection of personal on the Bundesbank. The much-cited problem with Wim Duisenberg's appointment does raise some concern about future manipulation of the selection process. These concerns have been raised again given the speculation over who will replace Duisenberg in 2003. But we would contend that the overriding economic culture of the Governing Council will moderate any concerns about national bias or national governments manipulating the selection process of Governing Council members to serve national or personal interest. More interestingly, perhaps, is the role that the national central bank governors will play in the determining the outcome of ECB policy. While most if not all of the current governors subscribe to the dominant economic and monetary culture of European central bankers, if more difficult economic times develop national interest may increasingly play a role in the decision-making dynamic of the ECB. German preferences may diverge from Irish or, imagine in the future, British preferences. To date, while not always speaking with one voice, the ECB has chosen to act in consensus and avoided the appearance – through the decision not to take any published vote on interest rates – of division within the Governing Council. One could speculate that the Executive Committee is fearful of being outvoted by the national central bank governors. For now, these issues are still

difficult to assess but will not likely weigh significantly in the ECB's independent room for manoeuvre.

Financial independence is a bit more complex and depends on whether one examines internal or external sources of constraint. Even with the decision in mid-1999 to relax some budgetary constraints on Italy (the Germans' worst nightmare), internal financial independence appears for the moment to be quite strong. However, even with the Stability and Growth Pact, modest economic growth in Europe, and the overriding commitment among the Euro-Zone members not to stray far from the price stability model, especially during the transition phase to 2002, the ECB will still expect in the near term to face mounting budget deficits among member states. External financial constraints, in the form of exchange rate pressures and the declining euro, will continue to pose very difficult and serious dilemmas for the ECB. While no formal exchange rate agreement between the euro and the dollar, for example, currently exists – providing the ECB with greater policy latitude in the near term – the euro's problems accentuate the concerns over democratic accountability and the bank's own monetary credibility. The last section of this chapter focuses largely on these external policy dilemmas.

In sum, the ECB has in many respects – political, personal, and financial – to have at a minimum the same level of independence as the Bundesbank. In some areas, particularly political and financial independence, the ECB can be seen as perhaps maintaining even greater amounts of independence (see also, Elgie 1998). In its brief history, the ECB has already established itself as an independent actor focused on its primary objective of price stability. However, internal pressure from the Eurogroup, national governments, and external exchange rate pressures will make the ECB's balancing act a difficult one indeed. Here we must return to the question of credibility – developed in Chapter 6.

Institutional expectations of the ECB

Based on the above analysis, European monetary politics under the ECB will take on the institutional dynamics of the German model – a highly independent central bank (the ECB) obligated to pursue price stability as its primary objective within the Euro-Zone member countries. The objective of price stability is potentially constrained, however, by political institutions within the structure of the EU and external exchange rate arrangements governed by the ECOFIN or some other body like the Eurogroup.

Initially, the euro will be less vulnerable to speculative attacks that often beset the old ERM.[93] However, the steady slide of the euro from 1999–2001 has confronted the ECB with the dilemma of accepting depreciation of the euro vis-à-vis the dollar (and the inflationary impact of the depreciation) or raising interest rates that might force one or more euro countries deeper into recession, and conceivably, one might argue, out of EMU. Or, the ECB might have to engage in exchange rate politics within a reformed G-7 (and IMF) that would require intervention to shore up the euro within various ranges or zones. Given the fact that each Euro-Zone member has forgone using exchange rates as an instrument of adjustment, conflict among euro countries and conflict between the ECB, ECOFIN, euro-member countries and non-euro members like the UK will likely erupt. The decision to stick with the euro in difficult times will ultimately be a political one. Much will depend on the public's acceptance of the sacrifice of their particular currency for the historic leap to EMU and the euro. The member countries, the European Commission, and ECB will have to continue their public relations campaign. Neither the euro nor the ECB will be de-politicized. The euro will be by definition politicized and, in many ways, it will still retain a nationalized context through the EU's traditional governing institutions.

The lessons of Bundesbank independence should not be lost on the ECB, European Union officials, EMU member countries, or the European-wide public. The ECB will be more powerful and independent than even the Bundesbank. The ECB's mandates for price stability are unambiguous. Its political independence is unquestioned. However, unlike the Bundesbank, which did have a political counterweight in the form of the German government, a political counterweight of any importance does not exist – the Eurogroup notwithstanding. The euro will thus be a challenge to all Europeans to accept the implications of a stability-oriented monetary union. More precisely, does a *Stabilitätsgemeinschaft* exist in Europe that would be willing to accept the costs of a strict price stability policy? We know that the German economic culture supported such a mandate and undoubtedly supports the same mandate for the ECB. But no such consensus or European economic culture exists across the EU. While the Bundesbank could call upon a collective German understanding of the problems of inflation, the ECB will not be able to call upon a similar collective European understanding. As such, it will make the ECB's initial actions more difficult than the Bundesbank's own early efforts at securing public support for its price stability policies. This difficulty will be accentuated by the likelihood that the ECB will first

pursue an aggressive anti-inflationary monetary policy in order establish its credibility in the eyes of the markets.[94]

Furthermore, clarifying how exchange rate policy will be determined is undoubtedly a difficult task. If the lessons of German monetary politics are of any relevance, the degree of political control that the Eurogroup (or some other body) has over the ECB in the matter of exchange rate policy will be crucial to determining the full extent of ECB independence from the political fetters of exchange rate policy. The Eurogroup has only begun to detail some of the conditions that it would pursue an exchange rate policy. As agreed to at the Luxembourg summit in December 1997, the conditions that could lead to the development of an exchange rate policy are cited as 'definite exchange rate distortions'.[95] These conditions were, however, not clearly defined. Nor was it determined who would decide when exactly such 'distortions' demanded action. Without prejudicing price stability or the independence of the ECB, it is thought that the Eurogroup will undertake this role. With consultation with the ECB and Commission, the Eurogroup will act to formulate a policy. How this all will develop over time remains unclear.

Specifically, informal exchange rate agreements will likely not find much support within the ECB and will thus have a limited impact on the ECB's monetary policies since the bank will likely find it easier to disregard such arrangements and/or frustrate any new initiatives. With weak governance structures of the G-7 existing today, the European Council will have a low level of political leverage over the ECB to go along with any exchange rate initiatives coming from the G-7 forum. As a result, given the difficulty in securing the ECB's support for such arrangements, we should expect ECOFIN to be hesitant to enter into any serious exchange rate negotiations. Assuming that the Council is responsible for negotiating exchange rate agreements, we should not expect any new major exchange rate initiatives in the international monetary arena.

We would argue that the experiences of German monetary authorities under the Bretton Woods system now frame the ECB's view toward the international monetary system. Proposals to resurrect some new form of global monetary regime (a fixed exchange rate system, a gold standard, and a basket of commodities) will be met with a large measure of scepticism and rejection by the ECB. The ECB will likely not be interested in returning to a system that might undermine the its efforts to maintain European price stability or the EU's efforts to solidify and enhance the processes of collective European monetary cooper-

ation. Automaticity and supranationality, at least at the international level, are not concepts that are accepted easily among European central bankers. The ECB will likely prefer not to rely on mechanical rules, obligatory standards, or automatic guidelines in external monetary affairs. Price stability and securing the value of the euro will take priority over exchange rate objectives. If it has not already, the German monetary norm will likely become the European monetary norm guiding Europe's exchange rate policy.

Conclusion

Even with the exceptional amounts of independence, the ECB sees its status and its policies as accountable and transparent. This view is not shared by all – the public, the markets, and national governments. While no one suggests anything that might undermine the ECB's mandate on price stability or that threatens its independence, many argue that the ECB must make a better effort to legitimize its policies with the public and the markets. While the ECB's interest rate policy has, by most accounts, been appropriate to the conditions of the Euro-Zone, it does not mean that all has been smooth sailing or without negative consequences. As a result, some analysts go further and demand stronger democratic controls and constraints in the form of EU institutional checks on the ECB.

Our analysis suggests a stronger effort on behalf of the national governments, the European Union, and the ECB to sell the policies of the ECB and the benefits of the euro. We accept the notion of an independent ECB (and its requisite desire to focus on price stability and monetary targets), but also recommend increased efforts to balance the ECB's policies with political input from national governments, the Eurogroup, and the European Parliament. Until a proper balance of independence and accountability can be achieved, the ECB will continue to find itself exposed politically in the rapidly transforming political and economic context of the Euro-Zone and the European Union. This exposure will cost the ECB some of its credibility – to say nothing of the entire process of European integration.

6
A Question of Credibility: a Short History of ECB Monetary Policy

> Any monetary policy that lacks credibility must be paid for with higher interest rates. The expectations of a well-informed and fundamentally critical general public must not be disappointed. Central banks have to take this into account in pursuing their policy; above all, they should take care not to exacerbate any prevailing uncertainty through their own policy.
>
> Otmar Issing, ECB Governing Council[96]

> Monetary policy is a matter of confidence. You don't get confidence for nothing; you have to work and earn it. It's a great effort for us at the Central Bank to explain why we are doing it. I believe we are more open, more transparent than any central bank in the world.
>
> Wim Duisenberg, ECB President[97]

Introduction

As noted in the previous chapter, credibility centres on whether and how central bankers can make credible commitments about their future conduct. Importantly, central bank independence and the credibility that flows from it needs to be understood in terms of actual policy and behaviour. It is one thing to proclaim a central bank independent – and, as we have demonstrated, the ECB maintains high levels of independence. It is another thing to proclaim the central bank's policies credible. Monetary policy credibility must be measured over time and must be evaluated in terms of the monetary policies and behaviour of the bank. Moreover, the structure of the economy and

internal politics may present the ECB with difficult tradeoffs between short-run policy benefits and long-run policy costs that may have an impact upon credibility. Such tradeoffs present the central bank with difficult policy choices that will be analysed in minute detail by politicians and markets alike. Such choices are the basis of evaluating central bank credibility.

Are the ECB's policies credible? Has it earned the same level of credibility that the Bundesbank, for example, earned over its long history? One could argue that the ECB's interest rate policies have remained largely consistent over the period 1999–2001; in fact the bank's interest rate policies have, some would argue, benefited Europe's economy by maintaining control over inflation. Its mandate of price stability has largely been fulfilled. However, the ECB's credibility in terms of communicating a consistent message, formulating a coherent monetary strategy, and developing a clear line on exchange rate management has suffered noticeably. In one sense, the euro's weakness vis-à-vis the dollar (losing over 20 per cent of its value since 1 January 1999) indicate that the ECB's credibility has deteriorated due to the varying pressures coming from the markets, the public, and politicians. Currency traders and other ECB watchers point to a number of public misstatements and other communication gaffes by Duisenberg and the Governing Council. These statements, coupled with the apparent inability of the ECB Governing Council to speak with a single voice in public, have exacerbated existing uncertainty in the market and the public about the euro project. Finally, the lack of clarity over which EU body is responsible or accountable for the external valuation of the euro has also eroded some of the bank's reputation.

This chapter analyses the actions of the ECB starting in mid-1998 when the ECB came into its formal institutional role through the launching of the euro on 1 January 2002. While not every action and policy shift is highlighted in detail, the analysis focuses on the major flow of ECB policy. Although discussed in the chapter, our analysis is not necessarily focused on whether the ECB has acted independently without regard to political pressure. Indeed, the ECB has consistently resisted any pressure for rate cuts. Rather, our focus is on the credibility question. Despite an independent track record, credibility has not flowed easily or smoothly to the ECB. Answering this question is crucial to developing a comprehensive understanding of the policies and politics of the ECB.

Our analysis also must also be tempered by the relative short history of ECB policy-making; however, some basic trends and patterns have

already emerged. Using the framework of policy credibility and our earlier analyses of the independence of the ECB, we highlight the twists and turns and ups and downs of the ECB as it has struggled to find solid footing in the slippery world of globalized foreign exchange markets and political trap doors. From the initial pressure on its independence, to the crisis of the weakening euro (and its first forays into intervention), to the ongoing question of transparency, the ECB has had a difficult start.

At the same time, the fact that the launching of the euro on 1 January 1999 was a notable success and the fact that the ECB has found more solid footing give grudging acceptance to the notion that the ECB has learned from earlier missteps. Moreover, the ECB has carefully struggled to balance political input and an independent policy so as to assure its long-term credibility on the key issue of price stability. Moreover, we contend that the ECB has found a stronger focus with the generally successful changeover to the euro on 1 January 2002. With an emphasis on the introduction of notes and coins, the ECB's power and competence should come into sharper focus as well.

The ECB gets started: early controversies and successes

Commenting shortly before taking office on June 1998, Duisenberg suggested that the ECB would not conduct an 'extra tight monetary policy' just to make the ECB more credible. Credibility 'must be earned. You do not gain it in one day'.[98] Nevertheless, with money supply targets (based on the broader measure M3) above 5.5 per cent annually, some senior European monetary officials were suggesting that interest rates would have to go up in the third or fourth quarter of 1998.[99] While prediction was difficult, estimates of the official ECB interest rate for the launch of the euro stood somewhere between 3.5–4 per cent. At the same time, others commentators – mostly politicians and government ministers – warned against stifling economic growth which stood at a sluggish 2.5 per cent across the Euro-Zone.[100] Almost immediately upon inception, the ECB was thrown into the middle of a classic monetary dilemma: raise interest rates to satisfy the currency traders and monetary hawks in national central banks or keep rates stable (or even lower rates) and satisfy the politicians. Whichever side the ECB came down on, it would immediately be placed in the pressure cooker of European politics.

In addition to facing possible problems over its early stand on interest rates, the ECB was warming to its first public confrontation with

Euro-Zone governments over public spending. In a July 1998 ECB announcement, Duisenberg stated bluntly that governments in the Euro-Zone should aim to run balanced budgets in accordance with the mandates of the Stability and Growth Pact. Fiscal profligacy would, according to the bank, have negative consequences for monetary policy – a thinly veiled threat of higher interest rates. More specifically, he suggested that countries with particularly high levels of national debt should be running surpluses.[101] Furthermore, Hans Tietmeyer, still at the helm of the Bundesbank, supported Duisenberg by suggesting that some states – including Germany – would soon be in the danger of running an inappropriate fiscal–monetary mix. Even with inflation virtually absent and economic growth just starting to pick up, the ECB was staking out what it argued was the higher ground in any future debate on monetary policy and fiscal policy.[102]

Taking the financial markets by surprise, on 3 December, the Bundesbank, followed by the 10 other central banks of the countries that were to join EMU on 1 January 1999, cut interest rates. Based on the earlier statements of Duisenberg, economists had largely predicted that there would be no interest rate changes before the 1 January launch date. The economic data supporting a rate cut was mixed (low inflation, sluggish growth – but money growth slightly above targets) and the reliability of Euro-Zone data was still an unanswered question – an early indicator of the troubles the ECB would face in communicating its strategy and decisions to the public and the markets. Nonetheless, the Bundesbank cut its repo rate from 3.3 to 3 per cent. The other euro countries trimmed their interest rates to the same level. Italy cut its rate to 3.5 per cent under the assumption that its rate would converge to 3 per cent by 1 January. One explanation for the co-ordinated rate cut was to signal the markets prior to the launch that all Euro-Zone members were strongly committed to the success of the euro. It would also likely ease pressure off the ECB to cut rates at its first meeting in January. Finally, the ECB also mentioned the ongoing monetary and financial troubles in Asia, Russia and Turkey that might put a drag on economic growth in Europe. Despite widely different explanations for the co-ordinated move, a statement issued by the ECB suggested that the decision was the result of a 'common assessment of the economic, monetary and financial situation in the euro area'.[103]

One can perhaps interpret the rate cuts more cynically. The decision was the national central banks' last moment of power as interest rate policy would then slip beyond their sovereign control. In its last decision as the sole protector of German monetary stability (and true to form),

the Bundesbank argued that strict monetary considerations were behind the decision to lower rates. The decision was a 'sovereign decision of the Bundesbank that was uninfluenced by political expectations … We are deaf to political pressure, but not blind to arguments and facts'.[104] For Tietmeyer, the move to co-ordinate interest rates and to move them in line in anticipation of the launch date was desirable based on low inflation levels in the Euro-Zone. The Bundesbank was adamant that it was still in sovereign control of German monetary policy and still firmly independent in its capacity as a national central bank.

One reason for the Bundesbank position was the increasing political pressure on the ECB that had been coming from the new German Finance Minister Oskar Lafontaine. Discussions between Lafontaine and his French counterpart, Dominique Strauss-Kahn, over co-ordinated economic policies and target zones for the euro signalled the turbulent time to come once the euro had been officially launched. Lafontaine envisioned the Euro-XI group as a political counterweight to the ECB (and as a symbol of the price the United Kingdom would have to pay for remaining outside EMU). For Lafontaine and others in the leadership of the new German government, questions needed to be raised in terms of the public interest – not the narrow monetary or financial interests advocated by the ECB and the Bundesbank. As Lafontaine suggested, 'we have to carefully ask ourselves: does our monetary policy hinder the reduction in joblessness or not?'[105] Raising these issues could, according to Lafontaine, be legitimately done in the Euro-XI forum. As the ECB began its activities in July, the Euro-XI also held its first meetings. France pressed for a body that would meet regularly, schedule a rough timetable for future meetings, develop more reliable Euro-Zone economic statistics (perhaps in competition with the ECB), and reach an understanding on contacts with international bodies such as the IMF. With strong resistance from the Bundesbank (and Great Britain on the sidelines), the more moderate Socialist German Chancellor Gerhard Schröder did not fully support France's or Lafontaine's efforts to build the Euro-XI into a de-facto decision-making body. As it would turn out, the Euro-XI (Eurogroup) would remain largely impotent and without clear guidance as an effective counterweight to the ECB.

Launching the euro: 'an abrupt change in regime'[106]

The launch of the euro truly marked a momentous change in terms of monetary governance in Europe; the ECB would now have sovereign

control over interest rates within the Euro-Zone and currencies would be permanently fixed. Despite the historical nature of the change, the ECB would have no honeymoon period in which to act. 'Extreme uncertainty', as one EC banker noted, pervaded the minutes before the launch. But the fact that nothing dramatic happened was an indication of the relative success of the euro's birth. The target system of payments was up and running and the ECB was calling bids on 13-day refinancing agreements. All appeared normal accept Duisenberg's interview in a French newspaper indicating that he might not retire after four years.[107] In its first full day of trading, the euro opened at 1.17 and climbed to more than 1.19 before settling at 1.18. Stock markets in Frankfurt, Paris, Milan, and Madrid all jumped by 5 per cent or more. Banks reported minimal problems as they spent most of the weekend prior to the launch reprogramming computers to use euros. The long anticipated day had come and gone without a hitch.

Despite the relative smooth start, with no honeymoon period or '100 days' to seize the agenda, the ECB was immediately having to defend its policies. Shortly after the launch of the euro, the ECB's Vice President Christian Noyer was questioned in an interview about the ECB's independence. Given the pressure coming from France and Germany and the co-ordinated effort to lower rates in December of 1998, had the ECB given in to political pressure? Noyer responded that the ECB did not cave in to German and French demands for a decrease of interest rates. Given the sluggish Euro-Zone economies, Noyer focused instead on the fact that inflation was well under the target rate of 2 per cent – giving the Euro-Zone central banks room to lower rates. Noyer argued that the 2 per cent inflation target was useful because 'it is what the people believe is stable prices',[108] and that the ECB would focus its energies on attaining that goal. Noyer went on to warn states of going beyond the limitations of the Stability and Growth Pact and cautioned, too optimistically in retrospect, about the possible effects of a strong euro on exports.

Noyer's comments would become the theme of the ECB's first six months in office. German analysts in particular were watching the ECB with a keen eye and with a focus on the transparency and clarity of the ECB message. For German ECB watchers, the key was the '*glaubwürdigkeit*' – or believability – of the ECB.[109] The more believable the bank, the more transparent would its policies be. The ECB would still need to earn the same level of believability that the Bundesbank had established over the last 40 years. For German ECB watchers, the monthly reports of the ECB would be crucial in laying out a strategic

vision for the ECB's monetary policies.[110] This fact was not lost on the ECB. Showing its debt to the Bundesbank, in its first monthly report, the ECB launched a renewed broadside against the spending policies of the Euro-Zone governments. The ECB also warned of lower economic growth as a result of economic troubles abroad, indicating a possible softening view on interest rates, but its aim was primarily at the socialist-led governments in France and Germany. From the ECB's perspective the government's of the Euro-Zone still maintained weakened commitments to fiscal discipline.

With no ECB movement on interest rates, February and March continued to be dominated by the debates over the Stability and Growth Pact's requirements that governments restrain their budget deficits to under 3 per cent of GDP. The pressure on the newly elected Social Democratic government of Gerhard Schröder and his fiery finance minister to do something to stimulate employment in Germany intensified as economic growth remained sluggish. As Lafontaine stated, 'if the monetary authorities cannot find a response to the negative shock to demand, other options will have to be considered'. The thinly-veiled threat to the ECB indicated Lafontaine's intention to push for a fiscal stimulus package. The French Finance Minister Strauss-Kahn was also pushing an idea of a euro-wide standard for the 3 per cent budget cut-off. If the Euro-Zone budget deficits – taken together – remained below 3 per cent, then individual countries could briefly surpass the 3 per cent GDP mark. The idea was floated among the Euro-XI as a possible strategy to counteract the ECB's perceived hard line monetary policies. The implication: Germany and France might be able to spend more if the combined Euro-Zone cut-off stayed at or below 3 per cent – supported by fiscal discipline in the Euro-Zone's growing economies (Ireland and the Netherlands, for example).

The spectre of Germany and France falling short on the budget deficits haunted the ECB and raised doubts about its ability to withstand the political pressure. It was becoming immediately clear that the Euro-Zone, despite the conservative ECB at its core, faced an urgent problem of draining credibility. The ongoing conflicts and public divisions between the ECB and Euro-Zone finance ministers (especially in France and Germany) hurt the external value of the euro and indicated that a strategic long-term view of the Euro-Zone's future was lacking.[111] As one currency analyst suggested, '[t]he loss of credibility is a slippery slope. Once you start down the slope and lose traction, it is hard to crawl back up again'.[112] Some hoped that the new European Commission President Romano Prodi could bring some stability and

order to the EU's policy-making process and encourage fiscal consolidation, as demanded by the ECB, among member states. Some felt that Prodi's own experience in bringing Italy's fiscal side under control would add some credibility to the EU's own efforts to restore financial order. The reality, however, was that there would be little that Prodi or the Commission could do to control France or Germany.

In addition, through the first few months, many analysts were focusing on the inevitable question of when the ECB would actually make its first decision on interest rates. In which direction would it go and when? Speculation was rampant. For example, the decision on 19 March to keep interest rates unchanged found the ECB in the classic dilemma: Did the ECB keep interest rates stable in order to look independent? Or should the ECB have lowered rates – as many economic analysts, not just Lafontaine – were arguing? The ECB was in a no-win situation. Was it not acting just for the sake of not acting or should the ECB have made a decision based on the real economic needs of the Euro-Zone? Not only was pressure coming from member states, but the ECB was also receiving calls from the IMF to lower interest rates (although divisions in the IMF board revealed a decidedly Anglo-European continent split on euro interest rates). The pressure on the ECB to act was intensifying.

The cloud of controversy surrounding the ECB lifted briefly with the resignation of Oskar Lafontaine in March. His resignation was seen at the time as a major triumph for the ECB in securing its political independence. Internal SPD rifts between the more moderate Schröder wing and the left-wing Lafontaine led to the resignation – but certainly Lafontaine's ongoing efforts to hem in the ECB with pressure for rate cuts and exchange rate target zones further exacerbated the split. With Lafontaine gone, the ECB regained its political footing. The bank warned in its March *Monthly Bulletin* that the financial and structural policies of the Euro-Zone member states were not focused enough on deficit reduction. The report went on to conclude that further fiscal and structural reform was needed. The ECB's opinions, one could argue, expressed avowedly political point of views. Was this a signal of renewed confidence in the ECB?

Yet even after Lafontaine's exit (and the euro rising 2 cents in a day), the euro continued to sink in value as April proved a difficult month for the ECB.[113] Duisenberg tripped himself up repeatedly.[114] Shortly after the 8 April decision to lower rates (to 2.5 per cent – more than was expected), Duisenberg stated emphatically that the decision to lower rates ruled out any further rate changes for the foreseeable

future. However, within several weeks, new signals from the head of the ECB indicated the possibility of further rate changes (albeit it was not clear in what direction). Moreover, references in the media to the effect that not all members of the governing board were enthusiastic about the April rate cut also raised some concern among ECB watchers. More problematic, however, was Duisenberg's comments stating that he was not worried about the euro's decline. Referring to an ECB policy of 'benign neglect' vis-à-vis the euro, Duisenberg sparked renewed sell-offs of the currency. In order to address the concern that the ECB was out of touch with the public's view of the euro, at the G-7 meeting in Washington at the end of April, the Germans sought to shore up the ECB's credibility. In particular, Hans Tietmeyer, then Bundesbank President, explicitly renounced Duisenberg's reference to 'neglect'. Specifically, Tietmeyer stated that 'a policy of neglect would be inappropriate, and I would like to add that, all in all, a significant further change in the euro's level would not be appropriate'.[115] Verbal discipline was now needed more than ever or else the ECB's traction would continue to slip down the slippery slope of credibility.

By May 1999, the euro had lost 10 per cent of its value against the dollar. Despite some pressure to act, the ECB resisted. Otmar Issing, Governing Board Member and chief economist on the board, stated bluntly that concentrating on the exchange rate so soon after its launch would be a mistake. Issing implied that there existed in the media and the markets a far too narrow focus on exchange rates. 'Everything we observe is either a historic low or a historic high'.[116] At the same time, there was increasing talk of co-ordinating exchange rates in some fashion or another, although the idea of target zones had disappeared along with Lafontaine. Sirkka Hämäläinen, one of the ECB's directors, suggested the possibility of increased exchange rate and, in general, macroeconomic co-ordination between the Euro-Zone, the United States, and Japan.[117] The context of global monetary instability and financial crises in Asia and Russia stimulated active discussion about the role of the big three financial powers and how they could bring some stability to the international monetary system. Indicative of the problem of co-ordination was the ongoing problem of devising a clear role for a Euro-Zone representative to the IMF or the G-7. Would the ECB president speak on behalf of the Euro-Zone members (Italy, Germany, and France) within the G-7? These issues had not yet been settled.

Brushing off some of the earlier criticism, in an interview in late May, Duisenberg expressed his personal confidence in the euro and his

view that the overall first months of the euro experiment had been successful. He noted that the pressures on the euro could be explained by stronger US economic growth and the crisis in Kosovo as the dollar remained a safe haven in times of crisis. Duisenberg also indicated that the euro had settled into a more normal and constant phase of valuation – given the euro's rise (albeit brief) after the immediate launch of the euro. Moreover, he suggested that the ECB could not intervene verbally on behalf of the euro, that such actions would be counterproductive and damage the credibility of the ECB. Finally, with interest rates at record lows, it was not surprising that the euro was weak. The weak euro in fact supported the general economic developments of the Euro-Zone (especially through strong export-led growth) without threatening price stability. Economic growth, low inflation, and the euro's emergence as one of the world's main investment currencies were clear indicators of the euro's successful launch. In Duisenberg's view, the situation was quite good, the record of the ECB solid.[118]

Duisenberg could not rest on his own positive assessment for long. Concern among the ECB watchers, the markets, and the German public was generated by a deal agreed upon by ECOFIN for Italy that relaxed its 1999 budget deficit target from 2 to 2.4 per cent. This decision increased fears that fiscal discipline would weaken throughout the Euro-Zone now that the launch of the euro had been relatively successful. In addition, statements by various ECB leaders appeared contradictory on the issue of the euro exchange rate. The lack of a single voice gave evidence to support the contention that leading ECB officials did not talk among themselves, let alone speak coherently with the market. At this early stage, no one was suggesting currency intervention as a solution to the euro's weakness. For ECB officials, intervention would only further damage the bank's credibility. The common (and correct) view was that the ECB could not reverse the trend, only support a trend (swim with the current, not against). By the end of May, only the Bundesbank had taken on the role of leading euro cheerleader trying to stave off euro parity with the dollar.

At the Cologne European Union summit on the weekend of 5/6 June, attempts to speak with one voice were undermined by further differences over the wording of a statement that sought to boost the euro. The 15 heads of government sought to expunge wording in a draft communiqué that made reference to the euro's decline. But the draft had already been widely disseminated and reported upon in the media. The appearance of summit disarray

permeated the press.[119] The situation was further complicated by a speech by Commission President Prodi indicating the possibility, at least theoretical, that Italy might have to exit EMU if it could not keep costs down and its finances in order. Was Prodi speaking for Europe? Or for Italy? Or was he speaking on behalf of the euro? The cacophony of differing statements and opinions on the euro was eroding public and market support for the currency.

Largely as a result of the global financial crisis and banking failures in Japan and the US, another controversy erupted over the issue of whether the Euro-Zone area had adequate power to regulate the increasingly dynamic Euro-Zone financial system and banking industry. As consolidation and mergers became the dominant strategy of the financial services industry, the ECB argued that it had to increase its regulatory oversight of this industry in the Euro-Zone. Some members of the ECB envisioned something along the line of a central 'European Financial Regulatory Committee'.[120] Some of this thinking was based on the work of Barry Eichengreen (see Eichengreen 1993; and 1998). Eichengreen noted in his own work on the Federal Reserve that the lack of a strong centralized regulatory framework for the US contributed to the financial chaos and crisis of the Great Depression. Eichengreen and others warned that the ECB may be in a similar situation because it would not have enough power to deal with a crisis euro-wide – especially through the emerging euro-financial markets. While no such crisis has yet emerged, the potential for a problem certainly does exist in the Euro-Zone. The issue of banking and financial services regulation would continue to be one of the more controversial issue areas still to be addressed by the ECB and EU members governments.

National central banks, however, were resisting the idea of a centralized European Regulatory Committee. In particular, the Bundesbank advocated a decentralized system emphasizing national control. For the Germans, the decentralized system of regulation best served the German financial industry (and large banks). Besides, the Bundesbank (and some of the Länder central banks) would still retain some power that it felt was increasingly slipping away toward the ECB. Moreover, the principle of subsidiarity, a concept the EU was always constantly trying to promote, laid the groundwork for a decentralized confederal structure to EU governance. Besides the ESCB was based on an existing decentralized, confederal model. Why reinvent the wheel? The division within the ECB's own ranks was symptomatic of a new institution going threw growing pains.

The euro's continued slide (July–December 1999)

Discordant notes among the ECB's Governing Council continued to have a noticeable effect on the value of the euro. With the replacement of Hans Tietmeyer with Ernst Welteke as head of the Bundesbank, differences of opinion between the Bundesbank, the ECB, and the French central bank on the value of the euro emerged. During the summer of 1999, Welteke suggested that the euro find a target of around 1.05 euros to the dollar. According to Welteke, such a value would be appropriate given the existing macroeconomic conditions of the Euro-Zone. This view reflected, one might suggest, the usefulness for German exports of the weak euro. At the same time, Jean-Claude Trichet, the President of the Bank of France, argued that the euro had room to appreciate, reflecting in part the fact that the French economy was doing better than the German. And as the *Financial Times* suggested, 'it also underlined France's long-term goal of making the euro a rock-solid currency capable of challenging the dollar's supremacy'.[121] Differences also emerged between the ECB (and its Vice President, Frenchmen Christian Noyer) and Germany over the proper direction of interest rates. Christian Noyer testified to a European Parliament committee that there might be a need to raise interest rates given monetary aggregate targets that were rising above the loose reference target of 4.5 per cent. Welteke responded that he saw no reasons for any shift in interest rate policy and downplayed concerns about the money supply. Ironically, it almost appeared that traditional monetary roles were now being reversed – France as the inflation hawk and Germany appearing 'soft' on inflation. For his part, Duisenberg was caught in the middle trying to balance competing views on the euro's value and ECB's interest rate policy.

In an interesting study cited in the *Financial Times*, an analysis done by an economic consultancy group, 4Cast, found an inverse relationship between the number of official statements on the euro and the performance of the currency.[122] The three quietest periods for official ECB comments in the year 1999 had coincided with relative stability or appreciation for the euro against the dollar. Of course it was also possible to suggest that ECB officials only were asked to comment on the currency during episodes of weakness or instability – thus triggering the relationship discovered in the study. Whatever the direction of causality, the problem was clear: the credibility and communication strategy of the ECB had yet to be effective.

Driven in part by what it felt was a weak public front for the euro, members the Euro-IX decided that more co-ordination and coopera-

tion in its activities were necessary. The Finnish presidency of the EU in the second half of 1999 and its chairing of the Euro-XI group helped formalize some of the activities that the French Finance Minister Strauss-Kahn had initiated earlier. Strauss-Kahn, who resigned in November of 1999, had steered the group in more structured discussions and informal agendas were prepared with the chair guiding the debate. Suaili Niinisto, Finland's Finance Minister, took Strauss-Kahn's developments a bit further. Niinisto developed a strategy of informally summing up the discussions at the Euro-IX meetings. He would also write follow-up letters to fellow ministers, summarizing any policy advances or problems and suggesting points for later meetings. Better organization was matched with more serious, less flamboyant ministers including Hans Eichel (replacing Lafontaine) and Christian Sautter of France (replacing Strauss-Kahn). The forum would prove useful to explain domestic policy problems and to employ the backing of colleagues in the Euro-Zone to add to each finance minister's political influence at home when arguing for controversial policies such as spending cuts. The Euro-XI group also took a more active role in verbally boosting the euro.

Building on these concerns the Finnish Prime Minister Paavo Lipponen, who held the presidency of the EU, suggested that 'in articulating its monetary policy objectives, the ECB falls short of the ideal. Clearer objectives are needed'.[123] In particular, Lipponen focused on the ECB's two-pillar strategy and strongly suggested that the ECB publish economic forecasts so as to remain a 'credible partner in economic policy dialogue'. Lipponen's comments were echoed in Germany by a report released by the so-called 'five-wise men' – the German government's council of economic advisors – who recommended in their annual report that the ECB abandon the two-pillar strategy. 'Only with a clear concept will the ECB be able to maintain a strong reputation over the long term as a guarantor of stability of the value of money'.[124] Internal splits within the ECB, however, over the wisdom of publishing forecasts, given the continuing uncertainty over how the money supply had been affected by the launch of the euro, precluded any immediate movement in that direction.

Despite the political and market pressures, most analysts believed that the concern over the slide of the euro was 'much ado about little'. In terms of domestic purchasing power, in terms of boosting exports, in terms of a longer-term perspective on the value of the euro, the picture was not too worrisome. 'One euro is one euro', according to Duisenberg.[125] Moreover, with a November interest rate increase from

2.5 to 3 per cent – the first increase by the ECB – the ECB was in its view responding appropriately. The ECB had hinted at possible interest rate increases over the summer by citing recent growth in the money supply (around 6 per cent on an annual basis). For now, though, the ECB focused on devising a neutral setting for monetary policy. With rising price pressures in some sectors (energy in particular), solid economic growth in Germany, Italy and France, and the ongoing concerns over the weakened euro, the ECB was intent on setting a more stable course for its second year of operation.

The ECB moves toward year two (January–May 2000)

Reflecting on one year of activity, Duisenberg was proud of the ECB's accomplishments. In a revealing interview in the *Observer*, Duisenberg stated that the ECB had delivered on its mandate – that is to provide 'price stability'. In that respect, he was correct. Inflation on an annual basis (for 1999) within the Euro-Zone had hovered at the 2 per cent target. Duisenberg also admitted the difficulty in developing a one policy fits all for the Euro-Zone. But he suggested that the euro had brought increased dynamism to the European economies and helped revive the sluggish economic growth rates of France and Germany. In regard to the previous year's exchange rate controversies, Duisenberg was clear. He stated:

> I always find it a bit unfair to say that the euro has fallen by 12 to 14 percent. What you do then is compare the current rate of the euro with the exchange rate that emerged on one day … . It is more relevant to compare the rate over the last three months with the very stable rate of between 1.08 and 1.10 (against the dollar) that existed prior to the birth of the euro in 1997 and 1998. Depreciation vis-à-vis that rate: that is relevant, and there is no denying it.[126]

Furthermore, Duisenberg elaborated on the question of the ECB's accountability. That issue, Duisenberg contended, has 'more to do with emotion than rationality. It (the ECB) is accountable to the public at large, and that comes through various channels: the European Parliament, the Council of Ministers, to the public directly through interviews like this and speeches'. From the ECB's perspective, then, all was well.

While the ECB had delivered on price stability (keeping the annual rate of inflation at or lower than 2 per cent), the euro had also been

sold to the public as a stable currency – solid on price stability, but also its external value. Certainly, the weak euro was based on the continued credibility problems of national governments in restraining fiscal budgets. And, interest rate differentials and the business cycle in the US compounded euro problems as capital continued to pour into the US, financing record trade deficits and current account deficits. But the ECB's credibility had suffered noticeably due to the confusion in the public and the markets over the ECB's two-pillar strategy and the mixed messages coming from ECB board members and Euro-Zone finance ministers. These problems would in fact worsen in the months ahead.

In successive steps in February and March of 2000, the ECB raised interest rates from 3 to 3.5 per cent in response to the weakening euro, rising oil prices, and strengthening European economic growth that was contributing to the core inflation rate. Many analysts argued that the ECB's interest rate policy was effective but that it sometimes reacted slowly to changing economic and monetary conditions and that its policy pronouncements and communications were still not focused on a coherent long-term strategy for monetary policy and exchange rate management. For example, throughout January of 2000, the ECB had been suggesting that no further movements on interest rates would soon be forthcoming. Yet, as noted, it acted quickly in February to lower rates. Part of the confusion stemmed from the mixed signals of the two-pillar strategy.[127] It was not clear which pillar was emphasized more at any given point in time. What was the ECB's strategy if each pillar pointed in a different direction? Under what conditions would the ECB emphasize one pillar over another? Perhaps it was asking too much of the ECB to reveal publicly its own internal policy struggle, but it had in part set itself up for these kinds of debates.

Driven by political and market pressure, the euro had lost 20 per cent of its value by the end of April, hovering around .92 to the dollar. A further increase in interest rates in late April, from 3.5 to 3.75 per cent, did nothing to halt the slide. Parity with the dollar – which once seemed to represent an unthinkable decline in the euro's value – now looked to many market analysts as an impossibly high target. The chorus of supporters for intervention were increasing.[128] As noted, the primary culprit of the euro's weakness was the spectacular economic growth in the US as well as doubt about the willingness of the governments of the Euro-Zone to enact a number of structural reforms and tax cuts. But more problematic was the question of the credibility of ECB officials and Euro-Zone finance ministers. The euro's habit had

been to undermine every single pronouncement in support of the euro. As the German Finance minister Hans Eichel declared, 'There is strong economic growth and all the economies of the Euro-Zone are better than before the introduction of the common European currency 15 months ago. I calmly say and agree with the president of the ECB and other finance ministers that eventually the markets will also realise this'.[129] But neither the markets nor the public 'realised' this. The euro would continue to weaken throughout the spring.

Partly in response to the lack of a united voice on the euro, in May 2000, a proposal by the Belgium finance minister Didier Reynders was put forth to have the Euro-IX group (soon to be known simply as the 'Eurogroup') participate once a month in the Governing Council of the ECB. The proposal was based on the fact that a normal exchange of information and ideas between national central banks and finance ministers already existed at the national level. Why not make that a normal part of ECB policy-making? Reynders was clear that his proposal was in no way designed to limit the independence of the ECB. In similar spirit, the Eurogroup produced its first-ever joint statement in support of the struggling euro. But the statement received only minor interest from the markets. Having heard repeated and mixed signals from finance ministers – whether singly or collectively – it did not seem to matter. Informal proposals were also floated among ministers, one of which emphasized the creation of a 'Mr. Euro' to speak on behalf of the euro externally and to curtail the mixed voices and signals and messages of finance ministers (see Chapter 3 for more details). While all of these ideas were interesting and in part discussed, they were never seriously considered by national governments or the ECB.

The most dramatic manifestation of the problems besetting the euro and the ECB came in a statement issued in early May by the ECB. The statement was addressed – rather unusually – to 'European citizens' rather than national governments or the financial markets. In many ways, Duisenberg's statement seemed particularly aimed at the Germans. He stated that the weak euro would 'undermine the perception of the euro as a stable currency'. Duisenberg argued that 'European citizens can be assured that the future of the euro is that of a strong currency, based on price stability and the strength of the European economy'. But the euro's weakness was more than just a perception to the Germans and many Europeans; it was a reality as the euro dropped to new record lows of 88.45 cents following Duisenberg's statement. Up to that point, there was nothing in the record of the

ECB's pronouncements to fully support Duisenberg's point of view. Perhaps it was more of a problem of Duisenberg's credibility, rather than the ECB itself. But the surprising statement by Duisenberg demonstrated the extent of concern of the ECB about the public's perception of its credibility.

Duisenberg's statement was met with much criticism, even ridicule – especially in Germany. As Peter Bofinger, a leading German economist noted, 'If there were a price for poor marketing, the ECB would have won it'.[130] Bofinger noted that the ECB still lacked the confidence that was required of the single most powerful European institution. Furthermore, the ECB continued to act defensively rather than as an institution fully in command of its field. For those outside the Euro-tower, it was a wonder that the euro had not fallen even further.[131] It was critical for the ECB to have the confidence, which the bank seemed to be on occasion lacking, or else it would continue to undermine its own ability to function. Moreover, the three interest rate increases since November 1999 had done nothing to stem the slide of the euro. And for socialist-led governments within the Euro-Zone, the rate increases were threatening the first real signs of strong economic growth and job creation in years. Fully 18 months into the EMU, one might have assumed that the job of the ECB would have slowly become easier. Instead, the task had become more difficult as the ECB faced an avalanche of pressure – political, public, and market – to do more to support the euro.

The euro-gloom continues (June–December 2000)

On 9 June, the ECB raised interest rates again by a half of a percentage (to 4.25 per cent). At the time, the euro hovered around record lows of .88 to the dollar. In countless interviews at the time, the ECB predicted that the decline in the euro was now coming to an end; the 'turn-around for the euro' was imminent. It was hoped that this latest interest rate increase would make returns more attractive on investments denominated in euros – hence boosting the sagging euro. Moreover, with M3 at 6.5 per cent (at an annual rate) for April – too high given the ECB's target rate of 4.5 per cent – the hike in the interest rate was clearly justified. Inflation was also pushing just above the 2 per cent target. Compounding the problem, in economically booming Finland, annual growth stood at 5.2 per cent with annual inflation over 3 per cent. In the June *Monthly Report,* the ECB warned that further rate increases might be needed in order to offset threats to price stability.

The ECB appeared confident that its policies were appropriate for the Euro-Zone.

But some politicians, especially in Germany, were attacking the ECB for making the citizens of their countries 'poorer'. While not entirely accurate, the perception among the German public (and German tourists outside the Euro-Zone) was that the euro had quickly become the poor cousin to the deutsche mark. Economists continued to attack the ECB's two-pillar strategy. Financial markets dissected every signal and every word from Duisenberg and other EC bankers. As the German *Süddeustche Zeitung* summed up, Mr. Euro (Duisenberg) needed 'strong citizens, strong politicians, and strong words'.[132] But it appeared that he did not have any of these things. By September, the euro had dropped to record lows at .87 to the dollar. Market analysts and traders were further balking at buying the euro after comments by German Chancellor Gerhard Schröder that implied that he was not concerned about the euro's steep decline as it continued to help German exports. Schröder's comments were intended to soothe the concerns of unnerved German citizens who had lost confidence in their new currency. Yet, his statements contradicted everything that the ECB (and Schröder's own Finance Minister Hans Eichel) was doing to bolster the euro verbally. National interests – it seemed – still prevailed when it came to a specific euro exchange rage policy.

The ECB counterattacked by suggesting that the German government was itself to blame for the euro's problems. Germany was on the implied receiving end of the ECB's repeated warnings to Euro-Zone governments on the necessity of fiscal control. With annual wholesale prices pushing at an annual rate of 5.4 per cent in Germany and with tax cuts likely to push the government's budget deficit to slightly over 1.5 per cent of GDP (still considerably below the 3 per cent targets of the Stability and Growth Pact), the German government was seen by some ECB officials as a contributor to the weak euro.[133] Not surprisingly, with the annual rate of inflation in the Euro-Zone peaking at 2.4 per cent in July (driven by rising energy/oil prices), the ECB raised interest rates another quarter point to 4.5 per cent. Some people within the ECB felt that a further increase in interest rates was needed in order to stem the decline of the euro and to send a signal to governments to control spending.[134] While tension between the ECB and the German government did not come close to matching the tension that existed during Lafontaine's short tenure, the underlying conflict demonstrated the ECB's struggle in asserting its priorities on Euro-Zone governments.

At a press conference following an ECB meeting in early September, Duisenberg admitted he did not understand the euro's slide to record lows given underlying 'strong economic fundamentals'. Instead, Duisenberg placed the blame on 'short term phenomenon' in which 'markets have a tendency to overshoot in one direction or the other. That means they will, at some point, reverse their direction, and it's that point for which I'm so anxiously waiting'.[135] What was clear was that the short-term phenomenon Duisenberg identified was the result of the market's perception that the ECB's credibility was being undermined by conflicts with national governments, by misstatements coming from the President himself, and by the lack of coherent ECB strategy for addressing the euro's decline. In other words, the short term euro depreciation had now turned into a long-term evaluation by the markets.

Anxiously waiting, but not trusting the markets to react to economic fundamentals any time soon, on 14 September the ECB responded with its first major interventions in the currency markets in the amount of $2.2 billion. The intervention failed to boost the euro. Most analysts called the intervention a modest or limited step on behalf of the downtrodden euro. Duisenberg claimed that the move was a routine portfolio adjustment and that 'intervening in the market' on behalf of the euro 'was not part of the motive'.[136] At a press conference following the intervention, he stated clearly that the ECB was unhappy with the euro's slide. 'The fact that the euro has continued to depreciate over recent months is not in line with these economic fundamentals. Our concerns on this issue remain serious and we shall monitor developments closely'.[137] But his justification for intervention was not credible to most analysts. Even the European Commission stepped into the fray suggesting that the ECB do more to prop up the euro which now stood at .86 to the dollar. Interest rate increases – six of them since mid-1999 – had not done the trick, interventions in the market (however modest) did not appear to work, and repeated castigation of Euro-Zone governments' spending policies had failed to convince the markets. The problem for the ECB was one of credibility.

The unexpected decision by the US to join market interventions to support the euro on Friday 22 September surprised investors and supported the efforts of the ECB to enhance the credibility of its strategy of supporting the euro. Yet after initial support in the markets, the currency continued its slide back down from .90 to .87 to the dollar. Following the multilateral intervention, the short-lived consensus on supporting the euro was quickly undermined when US Treasury

Secretary Lawrence Summers issued ambivalent statements following the intervention that further US support in the markets might not be forthcoming. More significantly, according to Summers, the US had not changed its view that a strong dollar was in the US interest.[138] His statements undermined any possibility of further co-ordinated interventions in support of the euro. Duisenberg had hoped that further co-ordinated interventions would bring about an orderly reversal in the euro's decline. However, with the US wavering in its support, any further failed interventions would do even greater damage to the euro and to the ECB's credibility.

The situation continued to worsen for Duisenberg and the euro through the early autumn. First, the ECB raised interest rates one more time on 5 October to 4.75 per cent largely, as it argued, to keep inflationary pressures in check, but also to support the euro. The rate increase did not have any effect on the euro's value. At the same time, the move angered some politicians who suggested that the ECB was stifling economic growth. Second, while support for joining EMU and the euro was driven largely by domestic politics, disarray on the euro intervention further damaged the pro-EMU forces in Denmark. In a referendum, the Danes rejected entry into EMU 53 per cent to 47 per cent. Recognizing the problems the ECB confronted, Duisenberg suggested in an interview in *The Times* that the European Central bank would not intervene again soon to strengthen the euro. He had also acknowledged that he had tried and failed to persuade Secretary of the Treasury Summers to soften his calls for a strong dollar – suggesting that US support for further interventions was unlikely in the future. The markets pounced on the news and the euro sank to a record low of .83 to the dollar. Admitting that he had blundered in the interview, Duisenberg vowed to hold his tongue more in the future and conceded that he had slipped. 'I do realise that some of my recent remarks gave rise to critical comments, and certainly they gave rise to a lot of advice. I draw my conclusions and I accept the advice and thus I'm not going to answer any questions related to that recent interview and any questions related to interventions'.[139] But Duisenberg had committed the cardinal sin of all central bankers – talking of intervention when no credible commitment existed.

Perhaps not learning from their earlier mistakes, European central banks intervened unilaterally (without the Americans) in the markets in early November in another failed (and perhaps desperate) attempt to give their ailing currency a needed boost. As one European economist stated, 'They have put their head on the chopping block … They can't

just suddenly stop because then everybody would ask, do these guys have any intervention strategy at all?'[140] But that was exactly the paradox the ECB confronted: should the NCBs intervene and have their head cut off by currency traders or should they not intervene and have the same thing happen? The market seemed determined to keep the euro where it was – despite the interventions. As one currency trader commented, repeated statements by the ECB that 'intervention is an instrument available at any time' lacked any real 'teeth'.[141] At least when it came to an external euro policy, the ECB had severely damaged its credibility.

Partly in response to the euro's problems and ongoing pressure from its critics, at the end of the year, the ECB decided to publish twice-yearly economic forecasts – especially with a focus on economic growth, inflation, and money growth. Duisenberg hoped that the decision would improve the bank's transparency with the markets. He said the bank was 'trying to improve communication'.[142] Even so, Duisenberg tried to downplay the decision by suggesting that the economic forecasts would not offer a long-term guide to interest rate decisions. However, the move was clearly a grudging acceptance of the fact that the ECB needed to improve its public standing and its communication strategy. It would also allow the ECB to argue more effectively its two-pillar strategy. The effectiveness of these forecasts – and its effect on the credibility of the ECB – would have to stand the test of time.

A stabilizing euro? (January–June 2001)

The first months of 2001 would prove at first to be much better for the ECB. While the elimination of further ECB missteps helped, the small boost for the euro was largely the result of forces beyond the ECB's control. With the ECB keeping interest rates stable at 4.75 per cent, with European economies growing, and with the first signs of economic slowdown in the US, economic fundamentals were finally shifting in the euro's favour. Moreover, with the US Federal Reserve sharply and quickly cutting interest rates in January and April, interest rate differentials began to move more favourably in the direction of investments in the euro. Even with the lingering effects of the Turkish monetary and financial crisis of February, the euro had gained in value from its record lows in the early 80 cent range and was now hovering around .93 to the dollar. Considering the past problems with the euro, the ECB saw the euro's appreciation as a sign of success in its long term policies on price stability.

Most analysts predicted that the ECB would lower rates, perhaps 50 basis points, toward the spring months. Prices remained stable, albeit still above the target rate of 2 per cent. Some were even suggesting an immediate cut in order to offset any potential effect of an anticipated slowdown in the US economy. More directly, at the annual meetings of the G-7 and IMF/World Bank in Washington, DC in April, the IMF (and Canada within the G-7) specifically and rather bluntly targeted the ECB for pressure to reduce interest rates. The ECB resisted the pressure given what the bank felt were continued concerns about national inflation rates over the 2 per cent mark in the Euro-Zone. Further confusion of the final draft of a G-7 communiqué – with Duisenberg insisting that a draft statement included understanding of the ECB's position but the statement not appearing in the final draft – added to the rising confusion within the G-7. It still appeared that the ECB and Euro-Zone finance ministers were not all on one level with the non-Euro-Zone members of the G-7.

But the general economic situation remained relatively good in the Euro-Zone, easing any pressures within the G-7. The ECB was instead preoccupied with press reports citing problems in the actual printing of enough euro banknotes for the 1 January 2002 launch. The ECB responded to the rumours by strongly stating that they were totally 'unfounded'. The 'production is on schedule'.[143] But given the ECB's other problems, the bank's handling of the changeover to euro notes and coins would have to be flawless.

In May, the ECB surprised the markets with a cut its key interest rate by a quarter point to 4.5 per cent. The news gave a brief boost to the euro and triggered optimism in the stock markets. Given the intense pressure coming from the IMF and the G-7 meetings and given the fact that the ECB was the last of the major central banks to lower rates, many still had widely anticipated a move. After insisting for months that inflation remained the number one concern for the ECB, the bank may have been reacting to criticism that it was doing to little to shield the Euro-Zone from the impact of economic trouble in the United States. Duisenberg justified the rate cut based on lower inflationary pressure and a fall in consumer credit growth. But Duisenberg and the ECB could not ignore the largely depressing economic numbers coming from the Euro-Zone's signature economy – Germany. Industrial production, orders and jobs data had all signalled a marked downturn for the German economy. Whatever the interpretation and analysis of the rate cut (again indicating the difficulty that analysts were having in understanding the motivations behind ECB policy), the

ECB would increasingly be tested by the more troubling waters of an emerging Euro-Zone economic slowdown.

As in previous years, June proved a difficult month for the ECB. June 2001 would be no exception. By early June the euro had again lost its value in the financial markets and hovered at .85 euro to the dollar. The ECB once again found itself at the centre of the blame surrounding the euro's depreciation.[144] Comments from Duisenberg that appeared to suggest his lack of concern over the recent dip in the euro unleashed more speculation against the euro. In addition, despite the rate cut in May, some analysts feared the ECB was losing its battle against inflation – which hovered close to an annual rate of 3 per cent. To add to the confusion, speculation also emerged on the possible intervention by the ECB on behalf of the euro. Comments by Otmar Issing and Ernst Welteke (the two Germans on the Governing Council) suggested that the value of the euro had again dropped to potentially unacceptable levels. But given the stumbling intervention efforts of the ECB in the fall and winter of 2000, many doubted that the ECB would in fact intervene. With the August recess of the ECB fast approaching and the decision by the ECB to keep interest rates unchanged for 'some time to come' (in the words of Duisenberg), the euro plunged below .84 euro to the dollar. Any gains that had been made either in terms of the euro's value or the ECB's credibility had largely evaporated by July.

Euro-day approaches; Euro-Zone battles heat up (July 2001–February 2002)

Following the summer recess the ECB returned to work facing mounting pressure for some sort of rate cut. With economic indicators all pointing toward a more severe economic slowdown than previously predicted, Euro-Zone governments were itching for further interest rate cuts. Moreover, with the US economy sliding precipitously toward a recession (and with the Federal Reserve actively cutting rates seven times through the summer of 2001), many analysts were predicting a cut at the 30 August meeting. Indeed, the ECB responded with a quarter point cut to 4.25 per cent. According to Duisenberg, the new level of interest rates were 'compatible with the maintenance of price stability', and were driven by the 'duration and depth of the slowdown in the US'.[145] While government officials hoped for further cuts in 2001, many analysts suggested that the ECB would hold off on any further moves so as not to unsettle currency markets prior to the launch of the euro coins on 1 January 2002.

The terrorist attack on the World Trade Center – a centre for international currency and financial markets – on 11 September 2001 changed the world in so many ways. Its impact on the markets was immediate. With US stock exchanges shut down and currency markets interrupted, real concern about a major collapse of the market was widespread. The need for a co-ordinated response on all levels – diplomatic, political and financial – would be required in order to offset the immense psychological damage inflicted upon investors, markets and the general public. Indeed, the ECB and the Federal Reserve responded. On the day the markets reopened in the US (Monday 17 September), the ECB and Fed cut a half a percentage point off interest rates in order to stablize the markets. The ECB stated that cutting interest rates from 4.25 per cent to 3.75 per cent was made 'in concert' with the Fed because of the weak short-term prospects for European economic growth and as a result of the events of 11 September. Specifically, the ECB noted that 'following the terrorist attacks on the US, uncertainty about the US and world economy' had increased.[146] The ECB cut rates from 4.25 per cent to 3.75 per cent. The G-7, which had to cancel its scheduled meeting in Washington, DC for the end of September, issued a strong statement that it would stand ready to take further co-ordinated action if necessary. Currency intervention was also discussed another instrument that could be employed by the G-7 in order to stabilize currency markets.

Did the ECB and other G-7 central banks act in a timely and responsible manner? Most analysts suggest that they indeed acted correctly and wisely. It should be noted that the rate cut came just days after the ECB had indicated it would take no action on interest rates. Clearly the severity of the attack and the realization among all actors involved of the necessity for clear and concerted action fundamentally changed the playing field. The US stock market had plummeted around 5 per cent the day trading resumed on US markets. Much like the necessity of the co-ordinated efforts of G-7 banks following the market collapse of October 1987, this was not the time to hide behind arguments of inflation targets or indicators of M3. The ECB and other G-7 central banks reacted swiftly and decisively and should be credited with staving off even further panic. Moreover, given the market's rebound in the months that followed, the central bankers were doing their part to advance the interests of the industrialized world.

The 11 September attack and the ECB rate cut of 17 September marked a clear modification in the bank's policies and strategies. The emphasis of the bank's policies would shift away, albeit slightly, from its overriding preoccupation with inflation and growth of monetary

aggregates and toward the need to revive the lagging European economy. Indeed, based on past ECB practice, indicators of annual inflation and M3 (which were still above the ECB's respective targets for both) should have suggested no further room for interest rate cuts. And with the ECB holding firm on no additional rate cuts through the rest of September and through mid-October, the prediction held largely true. But intense pressure from EU governments on the ECB to cut rates further increased. Other central banks, most notably in the US and the UK, had continued to cut rates. In addition, the US economy was now clearly in recession, a recession that would soon erode any hope for stronger economic growth in Europe. Yet Duisenberg defended the ECB's inaction by arguing that it was 'doubtful whether a range of rate changes coming quickly one after the other by themselves … would enhance confidence rather than maybe even undermine confidence', in the ECB.[147]

At an EU summit of heads of states in Belgium the debate over whether the ECB would cut rates further came to a head as German Chancellor Gerhard Schroeder suggested that the ECB could be 'more reasonable' when it came to the bank's interest rate policy. Schroeder was quick to emphasize that he respected the ECB's independence and that the bank's policies had been – until then – quite reasonable. But facing a stagnating German economy, with unemployment pushing up over 4 million, and a parliamentary election slated for September 2002, the chancellor was anxious to see more action taken by the ECB. Moreover, a preliminary draft of an EU summit statement had called for the ECB to take 'further decisive action' in easing monetary policy in order to boost the Euro-Zone's economy.[148] The statement was eventually watered down after objections were raised among ECB officials and some Euro-Zone finance ministers. But face-to-face meetings between EU leaders and the ECB indicated the level to which the disagreement on interest rate policy had risen. With the decision to keep rates steady on 25 October, the political cacophony calling for an immediate rate cut was nearly overwhelming.

Relief came two weeks later as the ECB lowered rates another half percentage point from 3.75 per cent to 3.25 per cent. The fourth rate cut of the year by the ECB was certainly welcome and more decisive than many had anticipated. The ECB justified the cut in terms of falling Euro-Zone inflation rates (still hovering around 2.4 per cent on an annual basis) and mounting evidence of economic disintegration in many Euro-Zone states and the United States. But did the ECB bow to political pressure? The answer is difficult to assess. From the ECB's

perspective, the ECB did not bow to pressure. Its decision to lower rates was consistent with its medium- to long-term perspective on keeping inflation rates and monetary growth under control. Moreover, the decision by the ECB to consider adjusting interest rates only once a month so as to lower speculation in the markets and reduce volatility was also indicative of the ECB's authority over the monetary policy decision-making process. The bank would make its decisions based on its own time table.

But the ECB's move was a clear sign that it had to do something to stabilize public and political sentiment which had risen to a feverish pitch in the two months following the 11 September attack. In fact, the ECB's move could be interpreted as a new approach toward interest rate policy – an attitude more in tune with public and political attitudes. Given the imminent launch of euro notes and coins, the ECB was extremely sensitive to the public's level of acceptance of the changeover. Removing the spotlight away from the ECB's monetary policies and shifting the focus on 1 January 2002 would be seen as an important public relation's strategy for the successful implementation of the changeover. In addition, and fortunately from the ECB's perspective, focus had shifted away from its interest rate policy and toward the deteriorating financial situation in Germany, among other EU countries.

Following a very unsettled three months, the ECB and the EU could now focus on the full and final changeover to euro notes and coins. Concerns about counterfeiting and the supply of coins and notes preoccupied ECB officials (to say nothing of EU governments, banks, and businesses). With great fanfare and with some uncertainty, the launch of the euro was made on 1 January 2002. Long lines at cash machines and some crowding at banks marked the transition. But within days, transactions were preceding smoothly (outside of Italy) as most businesses and consumers were shifting to the euro. Despite some griping about price gouging, the euro launch was a success – boosting the euro's value to over .9 to the dollar. 'E' day had finally arrived and with it, the ECB was now more firmly in control of monetary policy than ever before.

Despite the relatively smooth transition of 'E' day, the European Central Bank and Euro-Zone members would quickly become immersed in serious debates over the future of enhanced economic co-ordination. By February 2002, Germany's budget deficit as a percent of GDP had risen from 1.3 per cent in 2000 to 2.7 per cent in 2001. As outlined in the Stability and Growth Pact, the European Commission

had been given the responsibility to give early warnings to Euro-Zone members who were in danger of breaching the deficit ceilings. With Germany and Portugal both pushing to the upper limits of the deficit ceilings, Chancellor Schröder lobbied vigorously to prevent a vote within ECOFIN to accept a Commission's recommendation of a politically embarrassing formal warning of Germany. Ultimately, ECOFIN agreed unanimously not to issue the warning. In return, the German government promised to monitor national and state government budget figures and spending on social benefits more closely. Germany also promised to balance its budget by 2004. Similar promises on controlling government spending were made by Portugal. What was missing from the equation was the informal Eurogroup. Their role was largely inconsequential in the debates and indicated that ECOFIN remained, outside of the ECB, *primer inter pares* among EU-level institutions of economic governance.

The repercussions from the agreement were enormous; the differing interpretations of the agreement enlightening. German Finance Minister Hans Eichel suggested that the agreement not to issue a formal reprimand of Germany had actually 'strengthened the European Stability and Growth Pact'.[149] Eichel laid much of the blame on the heavily indebted German Land governments and not on the Schröder government. Trying to save some face, Commissioner Solbes suggested that the credibility of the Pact remained undamaged by the agreement – a suggestion not shared by most ECB analysts. Most German economists and industry and bank associations strongly condemned the agreement and its failure to protect the euro's credibility, suggesting the deal was characterized by 'political horse trading'.[150] Duisenberg issued a statement in support of the agreement, but grumbling could be heard throughout the halls of the eurotower and the Bundesbank in Frankfurt. Belgium's Finance Minister Didier Reynders contended that the agreement and ECOFIN had actually 'disciplined' the Germans for the first time – a suggestion accepted by neither the Germans nor the ECB.

The ability of Germany to withstand the Commissioner's pressure seemed to reflect the fact that great power politics remained alive and well within the Euro-Zone. Germany received political backing from the United Kingdom and France. Gordon Brown, the British Finance Minister, suggested that the European Commission had an overly narrow interpretation of the stability pact. Instead, Brown suggested a broader view – supported by the French – of the stability pact that took greater account of economic cycles, investment needs, and the

sustainability of a country's debt. EU Commissioner of Economic and Monetary Affairs Pedro Solbes discounted the British interpretation but found himself on the losing end of some high level of intergovernmental politics. Germany's ability to produce a face-saving formula indicated the overall weakness of economic governance at the EU level. While a number of 'surveillance' mechanisms existed and with the ECB focused on combatting inflation, there was clearly no effective enforcement mechanism on Euro-Zone governments. Even though the ECB did put out constant reminders to the Euro-Zone governments to reign in spending, the credibility of the pact and the effect on the credibility of the euro would likely be long lasting. With the ECB's control over monetary policy now more sharply in focus following E-day, the lack of centralized economic co-ordination and governance clearly in evidence after the heated political debates of early February 2002 would provide a fertile ground for Euro-Zone battles to come.

The likelihood of future Euro-Zone battles over budget deficits and economic governance will be complicated by the announcement of Duisenberg that he would be stepping down as President of the ECB on 9 July 2003. The announcement brought an end to speculation as to when he would step down but renewed speculation over the likely successor. The 1998 débâcle over Duisenberg's initial selection as President of the ECB and the 'gentlemen's agreement' made on the length of tenure in office insured that renewed political infighting would soon return. Duisenberg had hoped that his early decision to retire would strengthen the ECB's credibility by allowing for an orderly succession. But he declined to endorse Jean-Claude Trichet, the likely French candidate for the presidency (Trichet was currently enmeshed in various investigations by the French magistrates). While the decision to step down in July 2003 gives the impression of political independence from French pressure to resign earlier, the politics that will inevitably surround the selection process will renew debate over the personal independence of the ECB. It would be wise to settle the issue of succession quietly without bumping into the deadline set by Duisenberg.

The debate over Duisenberg's succession opened up the door for speculation that other potential candidates were jockeying for position – including the ECB's Vice-President Christian Noyer (whose four-year term expired on 31 May, 2002) and the leading German insider on the ECB Governing Council Otmar Issing. In the months leading to April, debate resurfaced on the future of the position of ECB Vice-President. The highly qualified Greek Lucas Papademos was eventually selected by all member states except the Belgians who had

insisted on the appointment of the noted monetary expert and Belgian Senator Daniel Gros. The Belgians abstained on the final vote and made it clear that they would seek to block the appointment of a Frenchmen as ECB President in 2003 (likely to be Jean-Claude Trichet) if the next appointment to the Executive Board was not a Belgian. Once again, the debate revealed a certain level of embarrassment regarding appointments to the board; more importantly, the appointment débâcle demonstrated the extent to which one member state will still go to push national prerogatives (and potentially undermine ECB independence and credibility).

Through the summer and early fall of 2002, the euro stabilized and even gathered strength as the US economy continued to slump and the ECB's interest rate policies found some footing. The euro even resurfaced to find parity with the dollar, although the euro would again slowly depreciate into the early autumn months – largely on the back of the continuing conflict over Euro-Zone member budget deficits (see below). For its part, the ECB maintained its Euro-Zone rate freeze. Interest rates remained unchanged at 3.25 per cent for the eleventh month in a row. In September the ECB cited general uncertainty over the strength of the limited economic recovery underway in the Euro-Zone and the fact that price stability had become more 'balanced' – precluding any immediate move up or down in rates. Despite the ECB's steady policies, the newly re-elected SPD/Green coalition government in Germany sought to increase pressure on the ECB to reduce rates. Shortly after the September election, the German government urged the ECB to adopt a more growth-oriented monetary policy. Memories of Lafontaine's failed 1999 attempt to pressure the ECB to cut rates should have been clear in Schröder's mind, but the government's limited room for manoeuvre in fiscal policy indicated that the government had to use whatever means necessary – including battling the ECB – to boost employment, growth and tax revenues. It was a battle that the German government would likely lose.

More problematic for the Germans – in addition to many other Euro-Zone member states – was the ongoing problem of budget deficits. In France, Jean-Claude Trichet targeted sharp criticism at the new centre-right government of Jean-Pierre Raffarin for not being more ambitious in its efforts to cut its budget. Specifically, Trichet called for the government to cuts its structural deficit by .5 per cent and to balance the budget by 2006 – both of which the government had so far rejected. During the 2002 French presidential campaign, President Chirac questioned the necessity of respecting the 2004 balanced budget target. In

the lead up to the parliamentary elections, members of conservative Interim government questioned the need to respect the Stability Pact targets 'to the letter'. At the 21–22 June 2002 European summit in Seville, the French were permitted by their European partners to not balance their budget by 2004, except if France enjoyed 3 per cent economic growth or more over the 2002–3 period, an unlikelihood. They would try for 2006 instead. More importantly, on 8 October, Francis Mer, the new French finance minister, was outvoted 11–1 by the other Euro-Zone finance ministers after refusing to honour commitments to cut France's budget deficit. It was likely that the French would face the possibility of a formal rebuke from the EU Commission and increased demands to amend its immediate 2003 budget. Raffarin found himself trapped between the government's commitments to the Stability and Growth Pact on the one hand, and President Chirac's elections promises to cut taxes and increase defence spending – a sure recipe for budget imbalances.

The French debate was the latest in a series of increasingly difficult crises over the Stability and Growth Pact. The most intense crisis to date took place in mid-October when Germany admitted that it would breach the EU rules on deficits. In a television interview, Eichel stated that it would not be possible for Germany to 'stay under the 3 per cent deficit limit'.[151] What is noteworthy was that Eichel was trying to avoid earlier embarrassment during the election campaign by insisting that Germany's budget deficit would only rise to 2.9 per cent of GDP. Speculation in the German press prior to the September election that the finance minister was concealing accurate deficit figures in order to avoid any negative publicity for the campaign seemed to be accurate. The tactic may have worked as the SPD/Green coalition won a narrow victory, largely on the back of the success of the Greens. However, many German economists and bankers complained that the government's policies were only further damaging the euro's value at home and abroad.

Whatever the accuracy of the reports, the credibility of the Stability and Growth Pact and, by definition, the ECB's euro policies, would be severely damaged by the continued inability of Euro-Zone governments (in particular, Portugal, Italy, France and Germany) to curtail deficits. This view was strengthened by Commissioner Solbes' own comments indicating that he was prepared to be patient with countries that on the surface appeared to be willing to take tough measures to control deficits. While there was some indication that the Commission would launch a formal early warning to reprimand France and perhaps launch an

official 'excessive deficit procedure' against Germany, Portugal's 4.1 per cent deficit indicated the problematic nature of the 3 per cent cut-off. It appeared that the Commission was taking the position of more 'flexibility' in the enforcement of the Pact – a move originally feared by conservative German governments and the Bundesbank in the 1990s. While Schröder has insisted that the Pact was untouchable, the battle lines were being drawn for a major fight over interpretation, enforcement and possible amendments to the Pact. The situation was compounded by the remarks of Commission President Prodi who suggested in a 17 October interview in *Le Monde* that the stability pact was 'imperfect' and 'stupid' and that adjusting the pact – albeit a move that required unanimity – was possible. While Prodi's comments were subsequently downplayed by the Commission, it did reflect a prevailing view among centre-left governments and policy-makers.

The ECB was vehemently against any revisions and demanded the strict interpretation and enforcement of the Pact. From day one (July 1998), the ECB had warned governments to maintain fiscal restraint and to avoid fiddling with government ledgers. Any slippage would undermine the ECB's stability-oriented policies and would further damage the euro's credibility both with the public and with the markets. Moreover, the lessons from February, when Germany avoided a formal rebuke for its deficit policies, were now being copied in France, Portugal and Italy. The historic summer floods that overwhelmed much of central Europe were now metaphorically threatening to overwhelm the Stability and Growth damn – and no amount of 'plugging' the financial leaks by Euro-Zone member governments would satisfy the ECB. Would the damn hold? Would the ECB wield its interest rate weapon? Or would the damn need serious reconstruction?

Conclusion

As noted earlier, credibility must be measured over time and must be evaluated in terms of the monetary policies of the bank. In addition, credibility must be earned. Given the relative infancy of the ECB and its record over the last four years, the conclusions drawn from this chapter must be read with some note of caution. In terms of fighting inflation, ensuring price stability, and keeping monetary growth under control and given the ECB's high level of independence (as noted in Chapter 5), it is not surprising then to argue that the ECB's anti-inflation credentials are as strong as ever. When the ECB proclaims its intent to combat inflation, it has established a credible record of

achievement. No one doubts its commitment. The bank has also become – albeit haltingly – more open and transparent with its publishing of forecasts. Finally, with the successful changeover to euro notes and coins on 1 January 2002, the ECB can stand proudly in its position as defender of the euro.

More broadly speaking, however, the euro's depreciation over the last three years, the difficulty in communicating an overarching strategy for the euro, and the ongoing public misquotes by the ECB (and national governments) have damaged the public standing of the ECB and the euro project. Contrary to the statements of Otmar Issing in the introductory quote, the ECB did in fact exacerbate some of the euro uncertainty, especially among a fundamentally critical general public and market. Certainly, Duisenberg has been more careful in his public statements. As Duisenberg himself has noted, '[w]e are making quite an effort to sing with one voice, because the song we are singing is the same. But it sometimes takes us some time to sing in harmony' (Fairlamb, 1999: 64). Admittedly, many economists predicted the continuing decline of the euro – given interest rate differentials between the US and Europe, strong economic growth in general in the US and the inevitable shakiness of ECB policy as it tried to establish its footing in a markedly 'new world' of European monetary politics. But the ECB still needs to earn more credibility if the EMU project is going to succeed and expand through enlargement. 'The ECB faces … a "communication challenge". … There is certainly room for improvement in communicating the ECB's policy decisions and measures'.[152]

The concluding chapter highlights the immediate and long-term challenges confronting the ECB a stagnant Euro-Zone economy and the potential enlargement of the EU. More generally, we analyse the implications of our study on for European integration and the power of the ECB in relation to other EU institutions. Our concern is focused on the changing nature of EU economic governance – primarily over whether to further strengthen efforts at fiscal policy co-ordination – and the role of the ECB within this governance. Given 2002's ongoing crises over budget deficits and the difficulty of enforcing the Stability and Growth Pact, attention will increasingly focus on the need for either some revisions in the Pact or strengthened macroeconomic co-ordination either through the Eurogroup or through other existing or newly-created EU institutions.

7
Conclusion: the ECB and the Future of Europe

> … the unification of Europe has been, and continues to be, a 'work in progress'. The introduction of the euro and the establishment of the European Central Bank form an intrinsic part of this constant evolution. In fact, the dynamics inherent in Economic and Monetary Union suggest that the euro might become a powerful catalyst for further integration. Our job at the ECB is to contribute to making the euro a lasting success. In this way the euro will bring benefits to an enlarged EU and beyond.
>
> Wim Duisenberg, President of the ECB[153]

Introduction

The primary objective of this book was to provide a theoretically and historically rich study of the institutional structure and operation of the ECB. In doing so, we have highlighted the historical transformation toward EMU, the institutional set-up of the ECB, and the bank's independence. We have also evaluated the monetary interests and preferences of key EU member states – Germany, France and the United Kingdom – toward EMU and the ECB. Finally, we briefly analysed the short history of ECB policy-making with a focus on the overarching credibility of the ECB.

Our findings confirm that the ECB has emerged as one of the most powerful actors in European politics. It is well on its way to establishing its influential position within the institutional framework of EU governance – along with the Council of Ministers, the European Commission, the European Parliament, and the member states. While the bank has had problems in establishing its credibility in terms of an

overarching communication strategy for the euro, it has also lived up to its mandate to ensure price stability. Also noteworthy in the ECB's early history is the relative success of the transition to the euro on 1 January 1999 and the ECB's ability to increase its capacity to analyse Euro-Zone data and maintain its Euro-Zone perspective given national variations in economic conditions. It also has emerged dominant in several clashes over its independence – most notably with Oskar Lafontaine in early 1999, but also in resisting pressure from the IMF and some members of the G-7 to lower interest rates in April of 2001. It also has adjusted to the enlargement of the Euro-Zone brought about by Greece's participation in the euro as of 1 January 2001. We concur with Duisenberg's note above and suggest that the ECB has become an integral actor in the larger framework of EU governance and will prove to be a powerful lever for further EU integration.

But the ECB also has been humbled on multiple fronts. The ECB, much like independent national central banks finds itself constrained – by the public, by member states, and by the markets, both within the Euro-Zone and global economy. In its relations with the US, the ECB has been left standing on commitments to exchange rate intervention. Despite unquestioned political independence, the ECB finds its policy autonomy shackled by market pressures that have relentlessly hounded the euro. Moreover, the ECB's image with the general public has been battered by the weak euro. Finally, Denmark's rejection of the euro, the continued foot-dragging by the British (and a likely rejection of the euro in any referendum), the consistent public unease in Germany over the euro project indicate the ongoing legitimacy crisis facing the ECB and the EMU project. The ECB will need to continue to wage an effective public relations campaign to convince all Europeans of the full merits of monetary union.

To be sure, the ECB takes its role as monetary sovereign seriously. And the record demonstrates the ECB operating in a world of monetary disorder, setting hedges that guide economic policy-makers within the Euro-Zone. In addition, there are those that criticize the ECB as being out of touch with the needs of the economies of the Euro-Zone and with the needs of the people. In other words, the ECB has shifted power toward the centre (the ECB) and away from the freedoms of individual states to regulate monetary policy. The notion of the unaccountable, undemocratic, secretive ECB still permeates monetary discussion among European politicians and the public.

Nonetheless, European monetary policy is not made in a vacuum – the creation of a monetary monster is far from reality. As noted above,

the ECB is not omnipotent, its power not absolute. Indeed, the power of the ECB might thus be compared loosely with that of Thomas Hobbes' Leviathan as revealed through a more careful reading of the original texts: a supreme ruler that is nonetheless greatly constrained in its actions by natural law and constitutional structures. First, EU institutions have a limited say on aspects of European monetary policy and the ECB must use other institutions to forward its own policy goals. Second, a degree of loose co-ordination has been established (and is gradually being reinforced) between the ESCB and fiscal and macroeconomic policy-making authorities at the EU and national levels in order to achieve an appropriate policy mix and the kind of structural reforms that will ensure the maintenance of price stability in the medium to long term. Related, and more problematic, has been the weakening of the Stability and Growth Pact that makes ECB policy-making even more challenging and difficult. The ECB has most of the responsibility for managing the single currency. However, it can only make an economic success of the euro – and thus maintain public support for it – within the context of tight co-ordination with other EU institutions and national governments. In this way, the ECB has and must continue to balance the interests of the public, member states, and the markets with the ECB's inherent urge to control and order. In particular, the ability to control and order has been offset by national governments and respective national central bank governors articulating visions of the euro that have been at cross-purposes with the ECB Executive Board. While the ECB has tried to 'sing in harmony', the bank's chorus still needs some fine-tuning. Given the existing institutional structure within the ECB and in its relations with other EU- and national-level institutions, the bank will be hard pressed to reign in the discordant notes coming from the chorus.

The ECB is the first to recognize its limits; it would argue that while it does have firm control over the monetary levers of the Euro-Zone, there are multiple competing actors with control over various other macroeconomic levers that make any comparison of the more absolutist image of Hobbes' Leviathan meaningless. The first years of ECB policy have demonstrated the difficulty the bank has had with competing centres of power – from the national governments, the national central banks, the public, the markets, and the institutions of the EU. While the social contract that is the Maastricht Treaty and the Stability and Growth Pact continue to insure – at least for the moment – a good measure of discipline and order, *they are no guarantee* that individual Euro-Zone members will never again pursue self-interest or national

objectives counter to the goals and objectives of the ECB. While the larger outlines of the 'social contract' are all but agreed upon by most players, the ongoing differing interpretations of the internal operation and workings of the Euro-Zone suggest a much more fluid political arena within which the ECB is but one player – albeit an important and powerful one.

It is in this still quite fluid political and institutional scenario that the book has identified a number of critical issues and challenges confronting the ECB in the near future. Certainly there are a number of short-term challenges confronting the ECB – especially the ongoing struggles with Euro-Zone data collection and weakening government fiscal balances. However, in this concluding chapter we analyse how significant longer-term challenges within the Euro-Zone will shape the future operation of the EMU and the ECB more profoundly. In particular we focus on the institutional challenges of economic governance, the impact of enlargement, and the ongoing issues of policy credibility and the euro.

Institutional challenges and the ECB

On 1 January 1999, the ECB became one of the most powerful EU institutions affecting the lives of all people living in the member states of the Euro-Zone. It is without doubt the most independent European institution, both from other EU bodies as well as national governments. As such, the transfer of European monetary policy to the ECB highlights the problematic legitimacy of the EU as a political system. The European Central Bank will have to manage with considerable technical skill and political sensitivity its role in monetary policy-making and the 'hard' and 'soft' co-ordination of fiscal and macroeconomic policies with other EU institutions and national governments. Efforts to strengthen the democratic legitimacy of European monetary policy-making have focused less on the role and powers of the ECB – given the desire to preserve the bank's independence and credibility – and more on the reinforcement of the co-ordination role and profile of the ECB's political interlocutor in the Eurogroup. It remains to be seen if the European Central Bank can cope with (and if European governments can manage) the political fall out created by economic recession and uneven internal shocks in the Euro-Zone without the support of a more interventionist 'economic government' at the EU level (McKay 1999a, 1999b, 2000).

The institutional challenges confronting the ECB are therefore quite enormous. Despite the apparent solid foundation of institutional inde-

pendence and political support from member governments, the ECB has become a focal point for concern about the lack of direct accountability and transparency in its policy-making process and institutional structure. Modifications in the current institutional structure of the ECB are likely needed. Furthermore, the lack of clarity over exchange rate policy (see more below), the lack of a centralized EU budgetary or political authority, and the looming enlargement of possibly five new members into the EU in the next five years will put further pressure on the institutional weaknesses of current EU monetary policy-making processes and institutions.

The ongoing problems with accountability, transparency, and 'democratic deficits' that plague the EU's credibility in the eyes of the people will focus intently on the ECB. While the EU already regulates the European public in many policy arenas across Europe, the ECB has had and will continue to have the most direct and profound impact on all Europeans. The ECB has and will continue to face the searing heat of the political spotlight like no central bank has ever faced before. Will the ECB melt under such pressure? If the ECB is able to withstand such pressure, what EU institution will become the focal point for the public's demand for accountability? The Eurogroup has not been of any real significance, at least initially. Neither the European Commission nor the European Parliament will likely fulfill this role – at least not in the near term.

From the earlier discussion on the merits of central bank independence, accountability in an open, democratic society is an important element of an effectively functioning political system. In Germany, at least the government served this function. If the ECB and the EU institutions fail in this function, the future of EMU and the EU may very well rest on shaky political foundations. Both the German government and the Bundesbank recognized this fact when they pushed for European political union to operate in conjunction with EMU. The Bundesbank explicitly noted the importance of political union prior to Maastricht. Specifically, the Bundesbank argued that '… a Monetary Union is … an irrevocable sworn cofraternity – "all for one and one for all" – which, if it is to prove durable, requires, judging from past experience, even closer links in the form of a comprehensive political union'.[154] Judging from the past experiences of German monetary politics, it will prove critical for the EU to develop political union – a strengthened EP and revised Council – in order to reassure the public and provide a stable political foundation for the future operation of the EMU. Ultimately, political institutions must provide a vehicle in

which the people of Europe can express their concerns, worries, fears, hopes and anger.

One way of dealing with the democratic deficit is to think in terms of principal agent theory. In an innovative analysis, Elgie (2001) applies principal–agent theory (see Calvert, McCubbins and Weingast 1989 and Pollack 1997) – which can be classified as an application of rational choice institutionalism – to understand better the nature of the democratic deficit created by the ECB's control over European monetary policy. He also applies the theory to demonstrate ways to diminish the deficit in the event that this is deemed to be unacceptable. Elgie argues that the theory illustrates that both ECB critics and supporters have 'intrinsically sound positions'. First, the theory demonstrates that the agent (the ECB) is 'shirking' from the delegation of power as set up by the principal (the member states collectively) in the TEU and, thus acting in an undemocratic manner. It can be argued that the ECB has insufficiently taken into consideration its secondary objective to support the general economic policies in the Community and promote 'balanced and sustainable economic growth and social progress, and strengthening economic and social cohesion'. The TEU does state that price stability is the 'primary' responsibility of the Bank. However, the lack of a precise definition of this goal worried many observers that the Bank would become overly zealous in maintaining low inflation thus menacing deflation.[155] By largely ignoring its secondary goal the Bank could be accused of shirking and acting in an undemocratic manner.

A second way in which the principal–agent theory can be applied to explain the underlying logic of criticism of the ECB is that the preferences of the principal have changed since the Maastricht Summit resulting in a divergence with the preferences of the ECB. This is demonstrated principally in the French government's efforts to establish an 'economic government', a political counterweight to check the ECB. The institutional and political difficulties of amending the terms of delegation effectively prevents the synchronization of the principal's and agent's preferences. Elgie argues that principal–agent theory can be used by ECB critics 'to imply that whatever the initial preferences of the principal may have been the ECB is now acting in an undemocratic manner'. It could be argued that this use of the principal–agent theory is problematic in that only a part of the principal has changed its preferences. The perception of democratic deficit is thus likely to be stronger in some EU countries and in particular constituencies than in others. The problem here lies with the principal itself – not the agent

per se – which, if in agreement on this matter could seek to modify the treaty (however institutionally problematic). Principal–agent theory can also be used to justify arguments presented by those who support the ECB against accusations of democratic deficit. The argument is made that 'the ECB has been faithful to the clearly expressed preferences of the principal at the moment of delegation': central bank autonomy and price stability, regarding which the Bank was allowed 'to decide for itself exactly what was meant' (Elgie 2001).

Principal–agent theory also proposes standard and non-standard solutions to the principal–agent problem (the risk of growing divergence between the preferences of the principal and the agent) including ex ante and ex post controls, police-patrol, fire alarm oversight and sanctions. The aim here is to enable other institutions to survey the agent's (ECB's) shirking and to discourage further shirking. Ex ante controls, including a renegotiation of the terms of the delegation, sanctions and fire alarms are all considered too potentially damaging to the ECB's credibility and thus unlikely to be introduced. Elgie argues that there are several possible ways for increasing the police-patrol oversight without treaty reform and in ways that weaken neither the statutory responsibility nor the credibility of the ECB, including the commissioning of scientific studies and the holding of hearings to question officials. Indeed, the EP has already begun to play an important role in this regard. Duisenberg agreed that he or an Executive Board member would appear before the EP's Economic and Monetary Affairs Committee four times per year. Elgie also points to Duisenberg's statements and ECB reports to show that there is 'some evidence that the EP has managed to encourage the Bank to pay greater attention to its secondary objective regarding growth and employment'. The ECB shows some willingness to accept publicly that there is a floor to its definition of price stability to prevent deflation. An example of this is found in the Bank's annual report for 1998 in which it is noted that 'deflation, i.e., prolonged decline in the level of the HICP index, would also not be deemed consistent with price stability' (ECB 1999, p. 49). Furthermore, Duisenberg justified the Bank's decision to cut interest rates on 8 April 1999 on similar grounds, stating that 'price stability and social stability are not conflicting, but supplementary and mutually reinforcing policy objectives. As economic policy-makers, we should keep this in mind when we formulate strategies to promote employment and social stability' (Duisenberg 1999, p. 3). Elgie argues that the European Parliament can do a lot more on its own accord to demonstrate publicly its own preoccupations concerning the conduct

of monetary policy, including the more frequent organisation of EP debates, even in the absence of ECB officials, and the passing of resolutions on ECB affairs.

Elgie also presents non-standard solutions to the principal–agent problem. The Eurogroup is statutorily forbidden from seeking to influence ECB members (and to pressurize the ECB in any formal sense). However, this does not prevent it from establishing 'a more discrete and subtle dialogue with the ECB' with the aim of creating a 'favourable and mutually respectful environment with which the [Bank] may be encouraged to give greater importance to popular sentiment when making its decisions'. Elgie gives the example of the ECB's first cut in interest rates in April 1999, which could be interpreted as demonstrating the Bank's political sensitivities – meeting halfway the widespread political demands for an interest rate cut – while also rewarding EU governments for the departure of the trouble maker, Lafontaine.

Closely related, the prestige of the euro among the public will depend on how effective the EMU can deal with various crises – from external shocks from dollar instability, internal shocks within certain regions, and the ongoing political question of high unemployment in some parts of the Euro-Zone. The ability to deal with crises that are certain to come will depend on the institutional and legal foundations of EMU. Will the Stability Pact operate as designed? Will there be a political forum to address or counter ECB policy? Will political union develop? Will the ECB in fact be able to withstand pressure on exchange rate policy and how will such policy be developed? How will the ECB integrate new members – whether the three remaining EU members not part of EMU or the possible new members from the east (see more below)? All of these issues demand further clarity of EU institutions – clarity that can only come through institutional modification.

For the ECB itself, the future of the ECB's independence and credibility will depend on the ability of EMU to function effectively in the post-2002 period. Most national central bank officials believe that in order to ensure a frictionless transition from national currencies to the euro, it is especially important that the euro and EMU enjoy the same prestige on international financial markets as that attained by the DM over the past decades. The early record – the euro's depreciation against the dollar by over 20 per cent – is not quite so convincing. More problematic is the institutional relationship between the ECB and Eurogroup over exchange rate policy. As noted earlier, states

sought to retain control over exchange rate policy and constrain the supranational competence of the ECB in this arena. With the increasing complexity and integration of the global economy, a single external voice on exchange rate policy would appear to be crucial. While the ECB thinks it is the 'voice' on exchange rate policy,[156] we would contend that this 'voice', is still lacking, thus damaging the euro's and EMU's successful implementation as well as the EU's external monetary influence. Therefore, in order for EMU to function effectively, exchange rate policy-making must be more clearly articulated from one institutional body – not left unclear in the institutional grey-area between the ECB, the Eurogroup, and ECOFIN.

Finally, the legitimacy problem has placed increased focus on the matters of accountability and transparency. Monetary policy decisions will affect member states differently due to different national economic cycles (despite some convergence) and differently structured economies. Given the lack of financial transfer payments to compensate those parts of the Euro-Zone suffering from asymmetrical shocks, limited labour mobility and the strong constraints placed on the use of national fiscal instruments, the ECB's response to these shocks will be of considerable importance. The risk remains strong that some member states may come to feel disadvantaged by ECB monetary policy, that the legitimacy of the bank will then be called into question, and the pressure will increase on governments to speak out. Doubts about the ECB's legitimacy increase the need for Executive Board members to give frequent interviews, press conferences and speeches about goals and instruments. NCB governors need to do the same at the national level. Likewise, the decision to hold two Governing Council meetings a year in other Member States was designed to improve the visibility of the ECB. The ECB must also be careful in its public criticism of member state economic policies, leaving this to the Commission and the Eurogroup – as in February 2001 with regard to Ireland. More generally, the maintenance of an effective and positive working relationship with the Eurogroup is vital to the ECB's public image.

In fact, the ECB recognizes these problems and suggests the need for a political body at the EU level that it can engage in a dialogue over the future direction of the Euro-Zone. Many – including within the ECB – call for strengthened links between the ECB and the EP to improve the democratic legitimacy/accountability of the ECB. Favero *et al.* (2000) argue that the European Parliament should have a greater say over the appointment of the members of the Executive Board *and* the weight of the Board versus NCB governors could be increased

(see also Taylor (2000)). However, this is inherently problematic given that the EP, despite being directly elected, is neither well understood nor well liked by many Europeans. Moreover, the strong opposition of several Euro-Zone member state governments to increased EP involvement in European monetary affairs makes this unlikely. This is concern that increased EP meddling would damage the appearance of independence and the credibility of ECB monetary policy. Other observers, led by the French government, argue that the democratic legitimacy problem can be partially resolved by creating a stronger and more visible political counterweight to the independent ECB – the European equivalent of the American Treasury Secretary (Boyer 2000). This could come through the reinforcement of the Eurogroup – a priority of the French Council Presidency in 2000 – through, for example, the eventual creation of a high profile permanent representative to help manage economic policy co-ordination and act as the ECB's leading political interlocutor (Howarth 2001).

All of these issues center around the possible need for improved EU-level economic governance. While there is no consensus between national governments on the larger design of such a model of EU economic governance, we suggest the need for a more effective way to conduct policies through a collective European institution (or set of institutions). This institution (or set of institutions) would need to reflect the desires of European citizens and have a stabilization function while leaving the implementation of suggested policies to national governments. This new institutional set-up would need to fill the existing policy gap between the ECB, ECOFIN, the Eurogroup, and the Commission. Currently, economic and political decisions made by these institutions often are not integrated into the national policies of Euro-Zone states and are clearly not yet grounded in public support. This especially evident given the latest crises over the Stability and Growth Pact. In times of economic slowdown and growing pressures on budgets, are governments and publics absolutely committed to ECB independence and the 3 per cent deficit cut-off all in the spirit of supporting the euro? Increased democratic cooperation will be necessary in order to implement common macroeconomic policies and fiscal policies. Neither the Nice Summit of 2000 nor proposals for a new form of EU governance advanced by the Germans in April of 2001 to make the EU more democratic are likely to substantially address the need for more collective economic governance. While a long-term challenge for the EU in general, the short-term complications of the lack of economic governance will greatly constrain the ECB in the next year or two.

Enlargement and the future of the ECB

Neither the 1996/97 Amsterdam Treaty nor the 2000 IGC (Nice Summit) focused much attention on the impact of enlargement upon the operation of the ECB and the Euro-Zone. The lack of urgency is in part due to the two-step process by which the applicant countries will join the Euro-Zone. While they must respect the convergence criteria and make the necessary institutional preparations to accede to the EU, they will initially join the Single Market and the ERM II and only accede to the Euro-Zone at a later stage. The European Commission has argued that candidate countries should take their time based on the fact that existing EU law requires at least a two-year gap after a country joins the EU before it can enter the monetary union. The Commission also interprets the Maastricht criteria to include the mandate that candidate countries maintain national currencies stable against the euro. Moreover, the Commission suggests that candidate countries not rush into EMU in that such attempts 'could be highly damaging'.[157] In that respect, the Commission's concerns are echoed by the ECB which sees the need for candidate countries to retain a measure of monetary autonomy and flexibility given the transitioning of those economies toward a market oriented system.

Nonetheless, the impact of enlargement looms large principally because it highlights existing problems with the operation of the Governing Council. As a result, we would contend that the question of enlargement and its impact on ECB decision-making will likely be the most divisive issue confronting the ECB and national governments in the next 5–10 years as some or all of the new EU member states enter the Euro-Zone. As it stands now, many observers question if the Eurosystem's structure – notably a Governing Council of 18 – is conducive to efficient or optimal policy-making or policy co-ordination especially when the matters discussed are technical (Favero *et al.*, 2000). Any enlargement poses considerable problems. Willem Buiter, a member of the Monetary Policy Committee of the Bank of England, writes:

> A group of 17 is already too large for the serious and productive exchange of views, discussion and group decision making. … A squad of 21 will be quite unwieldy. Thirty would be a mob. … Based on my own limited experience, a policy-making body with seven members would probably be optimal (1999: 200).

The Governing Council can change its own practices if it finds problems in decision making. There is much scope for its procedures to evolve – such as the creation of more working groups – and the work of the Governing Council can involve more activity at the ECB or through the NCBs. However, the size problem still does matter.

Favero *et al*. (2000) amongst others suggest that the problem could be resolved by emulating the American Federal Reserve Board, by increasing the power of the Executive Board in relation to the NCB governors and rotating Governing Council places among the member states. However, such a recommendation ignores both the unique character of both the Eurosystem as a 'federal' banking system and the EU as a political entity. First, the centre (the ECB) is considerably less dominant in the Eurosystem than in the American system. The NCBs retain considerably more power than American state banks and the governors have final say – thanks to their majority in the Governing Council – over the allocation of functions. Any reform to strengthen the Executive Board at the expense of the Governing Council would be challenged on grounds of legitimacy. The arrangements of the American Federal Reserve Board were developed just over 60 years ago, around 160 years after the creation of the United States as a country and long after the conclusion of the Civil War successfully asserted federal government authority. There is obviously no parallel situation in the EU.

Buiter (1999) recommends – even without enlargement – restricting the size of the Governing Council to nine members and the Executive Board to four. However, it could be argued that the EU lacks the legitimacy as a political system to deny member states a permanent seat on the ECB Governing Council. No other EU institution currently denies member states representation. It is unlikely that the existing members or their governments will be willing to remove the right to a permanent seat. Officially, each NCB Governor is there in a personal capacity as an experienced expert on central banking not as a national representative *per se*. In theory, therefore, a rotation of governors (either all or only the less populated member states) would be adequate: a particular group of them should be as representative of informed opinion as all of them. However, the Governors are de facto national representatives because they each come from one of the member states and are most familiar with their own national systems. It would be difficult for Governors to present the perspective of other member states as effectively as their own, making a simple rotation of seats for all or even just the smaller member states problematic. One possibility might be

to group the smaller member states together so that they share one seat on the Governing Council, or three member states (for example, the Netherlands, Belgium and Luxembourg) could share two seats. The governors would be required to maintain close links with the governors and central banks of their partner states. The decision at the Nice Summit to move to the future rotation of Commission places – yet to be devised but 'based on the principle of equality' and reflecting demography and geography – once the number of EU member states reaches 27 sets a precedent which might be followed for the ECB Governing Council.

Lastly, there is the issue of timing. Candidate countries could adopt the euro unilaterally – as Estonia threatened to do in 2002. Estonia in particular is in a good position already given its peg of the kroon to the D-mark since 1992. In that sense, Estonia is already fixed into the euro system. However, Estonia would likely not receive support from the ECB in times of monetary or financial difficulty. And the ECB does not (and cannot) take these candidate countries' economic conditions into account. Still, high-level policy dialogue between the ECB and central bank governors from the accession countries is ongoing and intense. Professional working relationships have developed and the ECB offers continuing technical assistance to the possible new members. In this respect, a foundation has been created for the accession countries to align their policies to the euro and seek ECB assistance, where appropriate.

However, it should be clear that the ECB tends to be very cautious about enlargement – reflecting the Bundesbank's own views on candidate countries to EMU back in the late 1980s and 1990s. Our own interviews with ECB officials confirm the general unease with this topic. The ECB sees the eastern European countries as largely still out of convergence with the Euro-Zone in terms of inflation rates, growth rates, budget deficits and debt. These states still need to transition and converge on the Euro-Zone (again, Slovenia and Estonia might be closer than other candidate countries). The ECB suggests a more realistic approach for future member states and sees the euro's role as easing the economic divisions of Europe – but only over the very long-term. Finally, given the existing problems of differential growth rates and inflation rates within the Euro-Zone (and the difficulties in data collection), one would suspect even deeper problems in terms of developing EU level co-ordination and cooperation. To be blunt, the ECB would prefer to see this issue not dealt with any time soon.

Conclusion: credibility and creating a 'vision' for the euro

All of these issues – from concerns about the legitimacy and transparency of the ECB and its policies to the institutional weakness of the EU and the ECB in terms of co-ordinating EU macroeconomic governance and decision-making in the Governing Board – have weighed heavily on the ECB's credibility and the value of the euro. This has been painfully evident with the euro's depreciation – one critical measure of the bank's credibility in the eyes of the public and the markets. The ECB's inability to articulate an effective or convincing overarching vision on the euro and the bank's policies has proven the achilles heel of ECB monetary governance. Chapter 6 demonstrated the particular acute problems of the ECB in this arena. One might suspect that any further bending of the rules on the convergence criteria for accession countries or increased 'flexibility' in enforcing or interpreting the Stability and Growth Pack might put increased downward pressure on the euro.

In short, a credibility gap has emerged in the minds of many Europeans. The gap exists between the expectations of a strong euro upon which the EMU was sold to Europeans (especially the Germans and French) and the reality of the euro's value. The ECB would counter the notion of a credibility gap by stating its view that the euro's value is driven by factors beyond its control: strong economic growth in the US and weak economic growth in Europe, structural problems in several Euro-Zone member state economies and the failure of several governments to make the kinds of reforms that would enable sustainably low public deficits. Moreover, the ECB would argue that it has fulfilled its strict mandate of maintaining price stability despite brief bursts of inflation over the past two years. While the ECB's vision may seem too narrow to some – HICP inflation in the euro area at or below 2 per cent – few seem to question this vision any more. The ECB has done its job (for now), but what is still lacking is this larger vision for the ECB and the euro. Perhaps demanding a new vision for the euro may be asking too much of the ECB, although the notion of the ECB acting as in important agent of integration and economic success – as noted by Duisenberg in the introductory quote – is a step in the right direction.

The future of the ECB provides a rich ground for academics and policy-makers to test their theories and their practical policy recommendations. We hope that we have contributed to this debate and that we have provided a strong foundation for future analysis.

Appendix 1

Protocol on the Statute of the European System of Central Banks and of the European Central Bank

THE HIGH CONTRACTING PARTIES
DESIRING to lay down the Statute of the European System of Central Banks and of the European Central Bank provided for in Article 4a of the Treaty establishing the European Community,
HAVE AGREED UPON the following provisions, which shall be annexed to the Treaty establishing the European Community:

CHAPTER 1

CONSTITUTION OF THE ESCB

ARTICLE 1

The European System of Central Banks

1.1. The European System of Central Banks (ESCB) and the European Central Bank (ECB) shall be established in accordance with Article 4a of this Treaty; they perform their tasks and carry on their activities in accordance with the provision of this Treaty and of this Statute.

1.2. In accordance with Article 106(1) of the Treaty, the ESCB shall be composed of the ECB and of the central banks of the member states ('national central banks'). The Institut monétaire luxembourgeois will be the central bank of Luxembourg.

CHAPTER II

OBJECTIVES AND TASKS OF THE ESCB

ARTICLE 2

Objectives

In accordance with Article 105(1) of this Treaty, the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2 of this Treaty. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a of the Treaty.

ARTICLE 3

Tasks

3.1. In accordance with Article 105(2) of this Treaty, the basic tasks to be carried out through the ESCB shall be:
- to define and implement the monetary policy of the Community
- to conduct foreign exchange operations consistent with the provisions of Article 109 of this Treaty;
- to hold and manage the official foreign reserves of the member states;
- to promote the smooth operation of payment systems.

3.2. In accordance with Article 105(3) of this Treaty, the third indent of Article 3.1 shall be without prejudice to the holding and management by the governments of Member States of foreign exchange working balances.

3.3. In accordance with Article 105(5) of this Treaty, the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

ARTICLE 4

Advisory functions

In accordance with Article 105(4) of this Treaty:

(a) the ECB shall be consulted:
- on any proposed Community act in its fields of competence;
- by national authorities regarding any draft legislative provision in its fields of competence, but within the limits and under the conditions set out by the Council in accordance with the procedure laid down in Article 42;

(b) the ECB may submit opinions to the appropriate Community institutions or bodies or to national authorities on matters in its fields of competence.

ARTICLE 5

Collection of statistical information

5.1. In order to undertake the tasks of the ESCB, the ECB, assisted by the national central banks, shall collect the necessary statistical information either from the competent national authorities or directly from economic agents. For these purposes it shall cooperate with the Community institutions or bodies and with the competent authorities of the member states or third countries and with international organizations.

5.2. The national central banks shall carry out, to the extent possible, the tasks described in Article 5.1.

5.3. The ECB shall contribute to the harmonization, where necessary, of the rules and practices governing the collection, compilation and distribution of statistics in the areas within its fields of competence.

5.4. The Council, in accordance with the procedure laid down in Articles 42, shall define the natural and legal persons subject to reporting requirements, the confidentiality regime and the appropriate provisions for enforcement.

ARTICLE 6

International co-operation

6.1. In the field of international co-operation involving the tasks entrusted to the ESCB, the ECB shall decide how the ESCB shall be represented.

6.2. The ECB and, subject to its approval, the national central banks may participate in international monetary institutions.

6.3. Articles 6.1 and 6.2 shall be without prejudice to Article 109(4) of this Treaty.

CHAPTER III

ORGANIZATION OF THE ESCB

ARTICLE 7

Independence

In accordance with Article 107 of this Treaty, when exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and this Statute, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a member state or from any other

body. The Community institutions and bodies and the governments of the member states undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks.

ARTICLE 8

General principle

The ESCB shall be governed by the decision-making bodies of the ECB.

ARTICLE 9

The European Central Bank

9.1. The ECB which, in accordance with Article 106(2) of this Treaty, shall have legal personality, shall enjoy in each of the member states the most extensive legal capacity accorded to legal persons under its law; it may, in particular, acquire or dispose of movable and immovable property and may be a party to legal proceedings.

9.2. The ECB shall ensure that the tasks conferred upon the ESCB under Article 105(2), (3) and (5) of this Treaty are implemented either by its own activities pursuant to this Statute or through the national central banks pursuant to Articles 122.1 and 14.

9.3. In accordance with Article 106(3) of this Treaty, the decision-makingg bodies of the ECB shall be the Governing Council and the Executive Board.

ARTICLE 10

The Governing Council

10.1. In accordance with Article 109a(1) of the Treaty, the Governing Council shall comprise the members of the Executive Board of the ECB and the Governors of the national central banks.

10.2. Subject to Article 10.3, only members of the Governing Council present in person shall have the right to vote. By way of derogation from this rule, the Rules of Procedure referred to in Article 12.3 may lay down that members of the Governing Council may cast their vote by means of teleconferencing. These rules shall also provide that a member of the Governing Council who is prevented from voting for a prolonged period may appoint an alternate as a member of the Governing Council.

Subject to Articles 10.3 and 11.3, each member of the Governing Council shall have one vote. Save as otherwise provided for in this Statute, the Governing Council shall act by a simple majority. In the event of a tie, the President shall have the casting vote.

In order for the Governing Council to vote, there shall be a quorum of two-thirds of the members. If the quorum is not met, the President

may convene an extraordinary meeting at which decisions may be taken without regard to the quorum.

10.3. For any decisions to be taken under Articles 28, 29, 30, 32, 33 and 51, the votes in the Governing Council shall be weighted according to the national central banks' shares in the subscribed capital of the ECB. The weights of the votes of the members of the Executive Board shall be zero. A decision requiring a qualified majority shall be adopted if the votes cast in favour represent at least two-thirds of the subscribed capital of the ECB and represent at least half of the shareholders. If a Governor is unable to be present, he may nominate an alternate to cast his weighted vote.

10.4. The proceedings of the meetings shall be confidential. The Governing Council may decide to make the outcome of its deliberations public.

10.5. The Governing Council shall meet at least ten times a year.

ARTICLE 11

11.1. In accordance with Article 109a(2)(a) of this Treaty, the Executive Board shall comprise the President, the Vice-President and four other members.

The members shall perform their duties on a full-time basis. No member shall engage in any occupation, whether gainful or not, unless exemption is exceptionally granted by the Governing Council.

11.2. In accordance with Article 109a(2)(a) of this Treaty, the President, the Vice-President and the other Members of the Executive Board shall be appointed from among persons of recognized standing and professional experience in monetary or banking matters by common accord of the governments of the member states at the level of the Heads of State or of Government, on a recommendation from the Council after it has consulted the European Parliament and the Governing Council.

Their term of office shall be 8 years and shall not be renewable.

Only nationals of member states may be members of the Executive Board.

11.3. The terms and conditions of employment of the members of the Executive Board, in particular their salaries, pensions and other social security benefits shall be the subject of contracts with the ECB and shall be fixed by the Governing Council on a proposal from a Committee compromising three members appointed by the Governing Council and three members appointed by the Council. The members of the Executive Board shall not have the right to vote on matters referred to in this paragraph.

11.4. If a member of the Executive Board no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct, the Court of Justice may, on application by the Governing Council or the Executive Boards, compulsorily retire him.

11.5. Each member of the Executive Board present in person shall have the right to vote and shall have, for that purpose, one vote. Save as otherwise provided, the Executive Board shall act by a simple majority of the votes cast. In the event of a tie, the President shall have the casting vote. The voting arrangements shall be specified in the Rules of Procedure referred to in Article 12.3.

11.6. The Executive Board shall be responsible for the current business of the ECB.
11.7. Any vacancy on the Executive Board shall be filled by the appointment of a new member in accordance with Article 11.2.

ARTICLE 12

Responsibilities of the decision-making bodies

12.1. The Governing Council shall adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ESCB under this Treaty and this Statute. The Governing Council shall formulate the monetary policy of the Community including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB, and shall establish the necessary guidelines for their implementation.

The Executive Board shall implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so the Executive Board shall give the necessary instructions to national central banks. In addition the Executive Board may have certain powers delegated to it where the Governing Council so decides.

To the extent deemed possible and appropriate and without prejudice to the provisions of this Article, the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB.

12.2. The Executive Board shall have responsibility for the preparation of meetings of the Governing Council.
12.3. The Governing Council shall adopt Rules of Procedure which determine the internal organization of the ECB and its decision-making bodies.
12.4. The Governing Council shall exercise the advisory functions referred to in Article 4.
12.5. The Governing Council shall take the decisions referred to in Article 6.

ARTICLE 13

The President

13.1. The President or, in his absence, the Vice-President shall chair the Governing Council and the Executive Board of the ECB.
13.2. Without prejudice to Article 39, the President or his nominee shall represent the ECB externally.

ARTICLE 14

National central banks

14.1. In accordance with Article 108 of this Treaty, each member state shall ensure, at the latest at the date of the establishment of the ESCB, that its

national legislation, including the statutes of its national central bank, is compatible with this Treaty and this Statute.

14.2. The statutes of the national central banks shall, in particular, provide that the term of office of a Governor of a national central bank shall be no less than 5 years.

A Governor may be relieved from office only if he no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct. A decision to this effect may be referred to the Court of Justice by the Governor concerned or the Governor Council on grounds of infringement of this Treaty or of any rule of law relating to its application. Such proceedings shall be instituted within two months of the publication of the decision or of its notification to the plaintiff or, in the absence thereof, of the day on which it came to the knowledge of the latter, as the case may be.

14.3. The national central banks are an integral part of the ESCB and shall act in accordance with guidelines and instructions of the ECB. The Governing Council shall take the necessary steps to ensure compliance with the guidelines and instructions of the ECB, and shall require that any necessary information be given to it.

14.4. National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two-thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB.

ARTICLE 15

Reporting commitments

15.1. The ECB shall draw up and publish reports on the activities of the ESCB at least quarterly.

15.2. A consolidated financial statement of the ESCB shall be published each week.

15.3. In accordance with Article 109b(3) of this Treaty, the ECB shall address an annual report on the activities of the ESCB and on the monetary policy of both the previous and the current year to the European Parliament, the Council and the Commission, and also to the European Council.

15.4. The reports and statements referred to in this Article shall be made available to interested parties free of charge.

ARTICLE 16

Bank Notes

In accordance with Article 105a(1) of this Treaty, the Governing Council shall have the exclusive right to authorize the issue of bank notes within the

Community. The ECB and the national central banks may issue such notes. The bank notes issued by the ECB and the national central banks shall be the only such notes to have the status of legal tender within the Community.

The ECB shall respect as far as possible existing practices regarding the issue and design of bank notes.

CHAPTER IV

MONETARY FUNCTIONS AND OPERATIONS OF THE ESCB

ARTICLE 17

Accounts with the ECB and the national central banks

In order to conduct their operations, the ECB and the national central banks may open accounts for credit institutions, public entities and other market participants and accept assets, including book-entry securities, as collateral.

ARTICLE 18

Open market and credit operations

18.1. In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may:
- operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in Community or in non-Community currencies, as well as precious metals;
- conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral.

18.2. The ECB shall establish general principles for open market and credit operations carried out by itself or the national central banks, including for the announcement of conditions under which they stand ready to enter into such transactions.

ARTICLE 19

Minimum reserves

19.1. Subject to Article 2, the ECB may require credit institutions established in Member States to hold minimum reserves on accounts with the ECB and national central banks in pursuance of monetary policy objectives. Regulations concerning the calculation and determination

of the required minimum reserves may be established by the Governing Council. In cases of non-compliance the ECB shall be entitled to levy penalty interest and to impose other sanctions with comparable effect.

19.2. For the application of the Article, the Council shall, in accordance with the procedure laid down in Article 42, define the basis for minimum reserves and the maximum permissible ratios between those reserves and their basis, as well as the appropriate sanctions in cases of non-compliance.

ARTICLE 20

Other instruments of monetary control

The Governing Council may, by a majority of two-thirds of the votes cast, decide upon the use of such other operational methods of monetary control as its sees its, respecting Article 2.

The Council shall, in accordance with the procedure laid down in Article 42, define the scope of such methods if they impose obligations on third parties.

ARTICLE 21

Operations with public entities

21.1. In accordance with Article 104 of this Treaty, overdrafts or any other type of credit facility with the ECB or with the national central banks in favour of the Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of member states shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.

21.2. The ECB and national central banks may act as fiscal agents for the entities referred to in Article 21.1.

21.3. The provisions of this Article shall not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the ECB as private credit institutions.

ARTICLE 22

Clearing and payment systems

The ECB and national central banks may provide facilities, and the ECB may make regulations, to ensure efficient and sound clearing and payment systems within the Community and with other countries.

ARTICLE 23

External operations

The ECB and national central banks may:
- establish relations with central banks and financial institutions in other countries and, where appropriate, with international organizations;
- acquire and sell spot and forward all types of foreign exchange assets and precious metals; the term 'foreign exchange asset' shall include securities and all other assets in the currency of any country or units of account and in whatever for held;
- hold and manage the assets referred to in the Article;
- conduct all types of banking transactions in relations with third countries and international organizations, including borrowing and lending operations.

ARTICLE 24

Other operations

In addition to operations arising from their tasks, the ECB and national central banks may enter into operations for their administrative purposes or for their staff.

CHAPTER V

PRUDENTIAL SUPERVISION

ARTICLE 25

Prudential supervision

25.1. The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the member states on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system.

25.2. In accordance with any decision of the Council under Article 105(6) of this Treaty, the ECB may perform specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

CHAPTER VI

FINANCIAL PROVISIONS OF THE ESCB

ARTICLE 26

Financial accounts

26.1. The financial year of the ECB and national central banks shall begin on the first day of January and end on the last day of December.

26.2. The annual accounts of the ECB shall be drawn up by the Executive Board, in accordance with the principles established by the Governing Council. The accounts shall be approved by the Governing Council and shall thereafter be published.

26.3. For analytical and operation purposes, the Executive Board shall draw up a consolidated balance sheet of the ESCB, comprising those assets and liabilities of the national central banks that fall within the ESCB.

26.4. For the application of this Article, the Governing Council shall establish the necessary rules for standardizing the accounting and reporting of operation undertaken by the national central banks.

ARTICLE 27

Auditing

27.1. The accounts of the ECB and national central banks shall be audited by independent external auditors recommended by the Governing Council and approved by the Council. The auditors shall have full power to examine all books and accounts of the ECB and national central banks and obtain full information about their transactions.

27.2. The provisions of Article 188c of this Treaty shall only apply to an examination of the operation efficiency of the management of the ECB.

ARTICLE 28

Capital of the ECB

28.1. The capital of the ECB, which shall become operational upon its establishment, shall be ECU 5000 million. The capital may be increased by such amounts as may be decided by the Governing Council acting by the qualified majority provided for in Article 10.3, within the limits and under the conditions set by the Council under the procedure laid down in Article 42.

28.2. The national central banks shall be the sole subscribers to and holders of the capital of the ECB. The subscription of capital shall be according to the key established in accordance with Article 29.

28.3. The Governing Council, acting by the qualified majority provided for in Article 10.3, shall determine the extent to which and the form in which the capital shall be paid up.

28.4. Subject to Article 28.5, the shares of the national central banks in the subscribed capital of the ECB may not be transferred, pledged or attached.

28.5. If the key referred to in Article 29 is adjusted, the national central banks shall transfer among themselves capital shares to the extent necessary to ensure that the distribution of capital shares corresponds to the adjusted key. The Governing Council shall determined the terms and conditions of such transfers.

ARTICLE 29

Key for capital subscription

29.1. When in accordance with the procedure referred to in Article 109/(1) of this Treaty the ESCB and the ECB have been established, the key for subscription of the ECB's capital shall be established. Each national central bank shall be assigned a weighting in this key which shall be equal to the sum of:

- 50% of the share of its respective Member State in the population of the Community in the penultimate year preceding the establishment of the ESCB;
- 50% of the share of its respective member state in the gross domestic product at market prices of the Community as recorded in the last five years preceding the penultimate year before the establishment of the ESCB;

The percentages shall be rounded up to the nearest multiple of 0.05 percentage points.

29.2. The statistic data to be used for the application of this Article shall be provided by the Commission in accordance with the rules adopted by the Council under the procedure provided for in Article 42.

29.3. The weightings assigned to the national central banks shall be adjusted every five years after the establishment of the ESCB by analogy with the provisions laid down in Article 29.1. The adjusted key shall apply with effect from the first day of the following year.

29.4. The Governing Council shall take all other measures necessary for the application of this Article.

ARTICLE 30

Transfer of foreign reserve assets to the ECB

30.1. Without prejudice to Article 28, the ECB shall be provided by the national central banks with foreign reserve assets, other than Member States' currencies, ECUs, IMF reserve positions and SDRs, up to an

amount equivalent to ECU 50 000 million. The Governing Council shall decide upon the proportion to be called up by the ECB following its establishment and the amounts called up at later dates. The ECB shall have the full right to hold and manage the foreign reserves that are transferred to it and to use them for the purposes set out in this Statute.

30.2. The contributions of each national central bank shall be fixed in proportion to its share in the subscribed capital of the ECB.

30.3. Each national central bank shall be credited by the ECB with a claim equivalent to its contribution. The Governing Council shall determine the denomination and remuneration of such claims.

30.4. Further calls of foreign reserve assets beyond the limit set in Article 30.1 may be effected by the ECB, in accordance with Article 30.2, within the limits and under the conditions set by the Council in accordance with the procedure laid down in Article 42.

30.5. The ECB may hold and manage IMF reserve positions and SDRs and provide for the pooling of such assets.

30.6. The Governing Council shall take all other measures necessary for the application of this Article.

ARTICLE 31

Foreign reserve assets held by national central banks

31.1. The national central banks shall be allowed to perform transactions in fulfilment of their obligations towards international organizations in accordance with Article 23.

31.2. All other operations in foreign reserve assets remaining with the national central banks after the transfers referred to in Article 30, and member states' transactions with their foreign exchange working balances shall, above a certain limit to be established within the framework of Article 31.3, be subject to approval by the ECB in order to ensure consistency with the exchange rate and monetary policies of the Community.

31.3. The Governing Council shall issue guidelines with a view to facilitating such operations.

ARTICLE 32

Allocation of monetary income of national central banks

32.1. The income accruing to the national central banks in the performance of the ESCB's monetary policy function (hereinafter referred to as 'monetary income') shall be allocated at the end of each financial year in accordance with the provisions of this Article.

32.2. Subject to Article 32.3, the amount of each national central bank's monetary income shall be equal to its annual income derived from its assets

held against notes in circulation and deposit liabilities to credit institutions. These assets shall be earmarked by national central banks in accordance with guidelines to be established by the Governing Council.

32.3. If, after the start of the third stage, the balance sheet structures of the national central banks do not, in the judgement of the Governing Council, permit the application of Article 32.2, the Governing Council, acting by a qualified majority, may decide that, by way of derogation from Article 32.2, monetary income shall be measured according to an alternative method for a period of not more than five years.

32.4. The amount of each national central bank's monetary income shall be reduced by an amount equivalent to any interest paid by that central bank on its deposit liabilities to credit institutions in accordance with Article 19.

The Governing Council may decide that national central banks shall be indemnified against costs incurred in connection with the issue of bank notes or in exceptional circumstances for specific losses arising from monetary policy operations undertaken for the ESCB. Indemnification shall be in a form deemed appropriate in the judgement of the Governing Council; these amounts may be offset against the national central banks' monetary income.

32.5. The sum of the national central banks' income shall be allocated to the national central banks in proportion to their paid-up shares in the capital of the ECB, subject of any decision taken by the Governing Council pursuant to Article 33.2.

32.6. The clearing and settlement of the balances arising from the allocation of monetary income shall be carried out by the ECB in accordance with guidelines established by the Governing Council.

32.7. The Governing Council shall take all other measures necessary for the application of this Article.

ARTICLE 33

Allocation of net profits and losses of the ECB

33.1. The net profit of the ECB shall be transferred in the following order:

(a) an amount to be determined by the Governing Council, which may not exceed 20% of the net profit, shall be transferred to the general reserve fund subject to a limit equal to 100% of the capital;

(b) the remaining net profit shall be distributed to the shareholders of the ECB in proportion to their paid-up shares.

33.2. In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and, if necessary, following a decision by the Governing Council, against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks in accordance with Article 32.5.

CHAPTER VII

GENERAL PROVISIONS

ARTICLE 34

Legal acts

34.1. In accordance with Article 108a of this Treaty, the ECB shall:
- make regulations to the extent necessary to implement the tasks defined in Article 3.1, first indent, Articles 19.1, 22 or 25.2 and in cases which shall be laid down in the acts of the Council referred to in Article 42;
- take decisions necessary for carrying out the tasks entrusted to the ESCB under this Treaty and this Statute;
- make recommendations and deliver opinions.

34.2. A regulation shall have general application. It shall be binding in its entirety and directly applicable in all member states.

Recommendations and opinions shall have no binding force.

A decision shall be binding in its entirety upon those to whom it is addressed.

Articles 190 to 192 of this Treaty shall apply to regulations and decisions adopted by the ECB.

The ECB may decide to publish its decisions, recommendations and opinions.

34.3. Within the limits and under the conditions adopted by the Council under the procedure laid down in Article 42, the ECB shall be entitled to impose fines or periodic penalty payments on undertakings for failure to comply with obligations under its regulations and decisions.

ARTICLE 35

Judicial control and related matters

35.1. The acts or omissions of the ECB shall be open to review or interpretation by the Court of Justice in the cases and under the conditions laid down in this Treaty. The ECB may institute proceedings in the cases and under the conditions laid down in this Treaty.

35.2. Disputes between the ECB, on the one hand, and its creditors, debtors or any other person, on the other, shall be decided by the competent national courts, save where jurisdiction has been conferred upon the Court of Justice.

35.3. The ECB shall be subject to the liability regime provided for in Article 2l5 of this Treaty. The national central banks shall be liable according to their respective national laws.

35.4. The Court of Justice shall have jurisdiction to give judgement pursuant to any arbitration clause contained in a contract concluded by or on

behalf of the ECB, whether that contract be governed by public or private law.

35.5. A decision of the ECB to bring an action before the Court of Justice shall be taken by the Governing Council.

35.6. The Court of Justice shall have jurisdiction in disputes concerning the fulfilment by a national central bank of obligations under this Statute. If the ECB considers that a national central bank has failed to fulfil an obligation under this Statute, it shall deliver a reasoned opinion on the matter after giving the national central bank concerned the opportunity to submit its observations. If the national central bank concerned does not comply with the opinion within the period laid down by the ECB, the latter may bring the matter before the Court of Justice.

ARTICLE 36

Staff

36.1. The Governing Council, on a proposal from the Executive Board, shall lay down the conditions of employment of the staff of the ECB.

36.2. The Court of Justice shall have jurisdiction in any dispute between the ECB and its servants within the limits and under the conditions laid down in the conditions of employment.

ARTICLE 37

Seat

Before the end of 1992, the decision as to where the seat of the ECB will be established shall be taken be common accord of the governments of the member states at the level of Heads of State or of Government.

ARTICLE 38

Professional secrecy

38.1. Members of the governing bodies and the staff of the ECB and the national central banks shall be required, even after their duties have ceased, not to disclose information of the kind covered by the obligation of professional secrecy.

38.2. Persons having access to data covered by Community legislation imposing an obligation of secrecy shall be subject to such legislation.

ARTICLE 39

Signatories

The ECB shall be legally committed to third parties by the President or by two members of the Executive Board or by the signatures of two members of the

staff of the ECB who have been duly authorized by the President to sign on behalf of the ECB.

ARTICLE 40

Privileges and immunities

The ECB shall enjoy in the territories of the member states such privileges and immunities as are necessary for the performance of its tasks, under the conditions laid down in the Protocol on the Privileges and Immunities of the European Communities annexed to the Treaty establishing a Single Council and a Single Commission of the European Communities.

CHAPTER VIII

AMENDMENT OF THE STATUTE AND COMPLEMENTARY LEGISLATION

ARTICLE 41

Simplified amendment procedure

41.1. In accordance with Article 106(5) of this Treaty, Articles 5.1, 5.2, 5.3, 17, 18, 19.1, 22, 23, 24, 26, 32.2, 32.3, 32.4, 32.6, 33.1(a) and 36 of this Statute may be amended by the Council, acting either by a qualified majority on a recommendation from the ECB and after consulting the Commission, or unanimously on a proposal from the Commission and after consulting the ECB. In either case the assent of the European Parliament shall be required.

41.2. A recommendation made by the ECB under this Article shall require a unanimous decision by the Governing Council.

ARTICLE 42

Complementary legislation

In accordance with Article 106(6) of this Treaty, immediately after the decision on the date for the beginning of the third stage, the Council, acting by a qualified majority either on a proposal from the Commission and after consulting the European Parliament and the ECB or on a recommendation from the ECB and after consultation the European Parliament and the Commission, shall adopt the provisions referred to in Articles 4, 5.4, 19.2, 20, 28.1, 29.2, 30.4 and 34.3 of this Statute.

CHAPTER IX

TRANSITIONAL AND OTHER PROVISIONS FOR THE ESCB

ARTICLE 43

General provisions

43.1. A derogation as referred to in Article 109k(l) of this Treaty shall entail that the following Articles of the Statute shall not confer any rights or impose any obligations on the member state concerned: 3, 6, 9.2, 12.1, 14.3, 16, 18, 19, 20, 22, 23, 26.2, 27, 30, 31, 32, 33, 34, 50, 52.

43.2. The central banks of member states with a derogation as specified in Article 109k(l) of this Treaty shall retain their powers in the field of monetary policy according to national law.

43.3. In accordance with Article 109k(4) of this Treaty, 'member states' shall be read as 'member states without a derogation' in the following Articles of this Statute: 3, 11.2, 19, 34.2 and 50.

43.4. 'National central banks' shall be read as 'central banks of member states without a derogation' in the following Articles of this Statute: 9.2, 10.1, 10.3, 12.1, 16, 17, 18, 22, 23, 27, 30, 31, 32, 33.2, 52.

43.5. 'Shareholders' shall be read as 'central banks of member states without a derogation' in Articles 10.3 and 33.1.

43.6. 'Subscribed capital of the ECB' shall be read as 'capital of the ECB subscribed by the central banks of member states without a derogation' in Articles 10.3 and 30.2.

ARTICLE 44

Transitional tasks of the ECB

The ECB shall take over those tasks of the EMI which, because of the derogations of one or more member states, still have to be performed in the third stage.

The ECB shall give advice in the preparations for the abrogation of the derogations specified in Article 109k of this Treaty.

ARTICLE 45

The General Council of the ECB

45.1. Without prejudice to Article 106(3) of this Treaty, the General Council shall be constituted as a third decision-making body of the ECB.

45.2. The General Council shall comprise the President and Vice-President of the ECB and the Governors of the national central banks. The other

members of the Executive Board may participate, without having the right to vote, in meetings of the General Council.

45.3. The responsibilities of the General Council are listed in full in Article 47 of this Statute.

ARTICLE 46

Rules of procedure of the General Council

46.1. The President or, in his absence, the Vice-President of the ECB shall chair the General Council of the ECB.

46.2. The President of the Council and a member of the Commission may participate, without having the right to vote, in meetings of the General Council.

46.3. The President shall prepare the meetings of the General Council.

46.4. By way of derogation from Article 12.3, the General Council shall adopt its Rules of Procedure.

46.5. The Secretariat of the General Council shall be provided by the ECB.

ARTICLE 47

Responsibilities of the General Council

47.1. The General Council shall:
- perform the tasks referred to in Article 44;
- contribute to the advisory functions referred to in Articles 4 and 25.1.

47.2. The General Council shall contribute to:
- the collection of statistical information as referred to in Article 5;
- the reporting activities of the ECB as referred to in Article 15;
- the establishment of the necessary rules for the application of Article 26 as referred to in Article 26.4;
- the taking of all other measures necessary for the application of Article 29 as referred to in Article 29.4;
- the laying down of the conditions of employment of the staff of the ECB as referred to in Article 36.

47.3. The General Council shall contribute to the necessary preparations for irrevocably fixing the exchange rates of the currencies of member states with a derogation against the currencies, or the single currency, of the member states without a derogation, as referred to in Article 109/(5) of this Treaty.

47.4. The General Council shall be informed by the President of the ECB of decisions of the Governing Council.

ARTICLE 48

Transitional provisions for the capital of the ECB

In accordance with Article 29.1 each national central bank shall be assigned a weighting in the key for subscription of the ECB's capital. By way of derogation

from Article 28.3, central banks of member states with a derogation shall not pay up their subscribed capital unless the General Council, acting by a majority representing at least two-thirds of the subscribed capital of the ECB and at least half of the shareholders, decides that a minimal percentage has to be paid up as a contribution to the operational costs of the ECB.

ARTICLE 49

Deferred payment of capital, reserves and provisions of the ECB

49.1. The central bank of a member state whose derogation has been abrogated shall pay up its subscribed share of the capital of the ECB to the same extent as the central banks of other member states without a derogation, and shall transfer to the ECB foreign reserve assets in accordance with Article 30.1. The sum to be transferred shall be determined by multiplying the ECU value at current exchange rates of the foreign reserve assets which have already been transferred to the ECB in accordance with Article 30.1, by the ratio between the number of shares subscribed by the national central banks concerned and the number of shares already paid up by the other national central banks.

49.2. In addition to the payment to be made in accordance with Article 49.1, the central bank concerned shall contribute to the reserve of the ECB, to those provisions equivalent to reserves, and to the amount still to be appropriated to the reserves and provisions corresponding to the balance of the profit and loss account as at 31 December of the year prior to the abrogation of the derogation. The sum to be contributed shall be determined by multiplying the amount of the reserves, as defined above and as stated in the approved balance sheet of the ECB, by the ratio between the number of the shares subscribed by the central bank concerned and the number shares already paid up by the other central banks.

ARTICLE 50

Initial appointment of the members of the Executive Board

When the Executive Board of the ECB is being established, the President, the Vice-President and the other members of the Executive Board shall be appointed by common accord of the governments of the member states at the level of Heads of State or of Government, on a recommendation from the Council and after consulting the European Parliament and the Council of the EMI. The President of the Executive Board shall be appointed for eight years. By way of derogation from Article 11.2, the Vice-President shall be appointed for four years and the other members of the Executive Board for terms of office of between five and eight years. No term of office shall be renewable. The number of members of the Executive Board may be smaller than provided for in Article 11.1, but in no circumstance shall it be less than four.

ARTICLE 51

Derogation from Article 32

51.1. If, after the start of the third stage, the Governing Council decides that the application of Article 32 results in significant changes in national central banks' relative income positions, the amount of income to be allocated pursuant to Article 32 shall be reduced by a uniform percentage which shall not exceed 60% in the first financial year after the start of the third stage and which shall decrease by at least 12 percentage points in each subsequent financial year.

51.2. Article 51.1 shall be applicable for not more than five financial years after the start of the third stage.

ARTICLE 52

Exchange of bank notes in Community currencies

Following the irrevocable fixing of exchange rates, the Governing Council shall take the necessary measures to ensure that bank notes denominated in currencies with irrevocably fixed exchange rates are exchanged by the national central banks at their respective par values.

ARTICLE 53

Applicability of the transitional provisions

If and as long as there are Member States with a derogation Articles 43 to 48 shall be applicable.

Appendix 2

Resolution of the European Council on the Stability and Growth Pact

I. Meeting in Madrid in December 1995, the European Council confirmed the crucial importance of securing budgetary discipline in stage three of Economic and Monetary Union (EMU). In Florence, six months later, the European Council reiterated this view and in Dublin, in December 1996, it reached an agreement on the main elements of the Stability and Growth pact. In stage three of EMU, member states shall avoid excessive general government deficits: this is a clear Treaty obligation.[†]

The European Council underlines the importance of safeguarding sound government finances as a means to strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. It is also necessary to ensure that national budgetary policies support stability oriented monetary policies. Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all member states to deal with normal cyclical fluctuations while keeping the government deficit within the 3 percent GDP reference value.

II. Meeting in Dublin in December 1996, the European Council requested the preparation of a Stability and Growth pact to be achieved in accordance with the principles and procedures of the Treaty. This Stability and Growth pact in no way changes the requirements for participation in stage three of EMU, either in the first group or at a later date. Member states remain responsible for their national budgetary policies, subject to the provisions of the Treaty; they will take the necessary measures in order to meet their responsibilities in accordance with those provisions.

III. The Stability and Growth pact, which provides both for prevention and deterrence, consists of this resolution and two Council Regulations, one on the strengthening of the surveillance of budgetary positions and the surveil-

[†] Under Article 5 of Protocol 25, the obligation does not apply to the United Kingdom unless it moves to the third stage; the obligation under Article 116(4) to endeavour to avoid excessive deficits shall continue to apply to the United Kingdom.

lance and coordination of economic policies and another on speeding up and clarifying the implementation of the excessive deficit procedure.

IV. The European Council solemnly invites all parties, namely the member states, the Council and the Commission, to implement the Treaty and the Stability and Growth pact in a strict and timely manner. This resolution provides firm political guidance to the parties who will implement the Stability and Growth Pact. To this end, the European Council has agreed upon the following guidelines:

The Member States

1. commit themselves to respect the medium-term budgetary objective of close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives;
2. are invited to make public, on their initiative, the Council recommendations made to them in accordance with article 99(4);
3. commit themselves to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes once they receive an early warning in the form of a Council recommendation issued under Article 99(4);
4. will launch the corrective budgetary adjustments they deem necessary without delay on receiving information indicating the risk of an excessive deficit;
5. will correct excessive deficits as quickly as possible after their emergence; this correction should be completed no later than the year following the identification of the excessive deficit, unless there are special circumstances;
6. are invited to make public, on their own initiative, recommendations made in accordance with Article 104(7);
7. commit themselves not to invoke the benefit of Article 2 paragraph 3 of the Council Regulation on speeding up and clarifying the excessive deficit procedure unless they are in severe recession; in evaluating whether the economic downturn is severe, the Member States will, as a rule, take as a reference point an annual fall in real GDP of at least 0.75%.

The Commission

1. will exercise its right of initiative under the Treaty in a manner that facilitates the strict, timely and effective functioning of the Stability and Growth pact;
2. will present, without delay, the necessary reports, opinions and recommendations to enable the adoption of Council decisions under Article 99 and Article 104; this will facilitate the effective functioning of the early warning system and the rapid launch and strict application of the excessive deficit procedure;
3. commits itself to prepare a report under Article 104(3) whenever there is the risk of an excessive deficit or whenever the planned or actual government

deficit exceeds the 3 per cent of GDP reference value, thereby triggering the procedure under Article 104(3).
4. commits itself, in the event that the Commission considers that a deficit exceeding 3% of GDP is not excessive and this opinion differs from that of the Economic and Financial Committee, to present in writing to the Council the reasons for its position;

The Council

1. is committed to a rigorous and timely implementation of all elements of the stability and growth pact in its competence; it will take the necessary decisions under Article 99 and Article 104 as quickly as is practicable;
2. is urged to regard the deadlines for the application of the excessive deficit procedure as upper limits; in particular, the Council, acting under Article 104(7), shall recommend that excessive deficits will be corrected as quickly as possible after their emergence, no later than the year following their identification, unless there are special circumstances;
3. is invited always to impose sanctions if a participating member state fails to take the necessary steps to bring the excessive deficit situation to an end as recommended by the Council;
4. is urged always to require a non-interest bearing deposit, whenever the council decides to impose sanctions on a participating Member State in accordance with Article 104(11);
5. is urged always to convert a deposit into a fine after two years of the decision to impose sanctions in accordance with Article 104(11), unless the excessive deficit has in the view of the Council been corrected;
6. is invited to always state in writing the reasons which justify a decision not to act, if at any stage of the excessive deficit or surveillance of budgetary positions procedures the Council did not act on a Commission recommendation, and, in such a case, to make public the votes cast by each member state.

Notes

1. All notes of Thomas Hobbes' *Leviathan* are from the edition by Michael Oakeshott (Oxford: Basil Blackwell, 1957).
2. This naturally begs the question: Do not individual rights also need to be protected against a government powerful enough to oppress them?
3. Verdun (1996 and 2000c) outlines how the CNPF membership was split on the question of EMU.
4. The 'inconsistent quartet' includes free trade, while the 'triangle' includes only monetary policy autonomy, free capital flows and fixed exchange rates. Following the Maastricht Summit, this 'quartet' was presented as the official technocratic justification in favour of EMU in several EU member states.
5. There are, of course, powerful arguments against the usefulness of neofunctionalism more generally. Despite the detail of its analysis, neofunctionalism's predictions about automatic, gradual and incremental progression into deeper European integration and greater supranational influence have not always been accurate. Community building has come in fits and starts, fraught with sustained periods of 'euro-pessimism' and 'euro-sclerosis'. Spill-over, while occurring in certain sectors or policy-arenas, has not necessarily occurred in any and all other sectors or areas. In fact, some policy areas have strongly resisted spill-over as states have jealously guarded sovereignty. Moreover, the autonomous influence of supranational authorities has increased only slowly and unevenly, if at all.
6. Haas (1990: 55) defines epistemic community as:

   > a professional group that believes in the same cause-and-effect relationship, truth tests to assess theory and shares common values. As well as sharing an acceptance of a common body of facts, its members share a common interpretative framework, or 'consensual knowledge', from which they convert such facts, or observations, to policy-relevant conclusions. … An epistemic community's power resource, domestically and internationally, is its authoritative claim to knowledge. To the extent that its members can penetrate the walls of government and maintain their authority, new orders of behavior are possible.

   He also notes (1992: 3) that:

   > an epistemic community is a network of professionals from a variety of disciplines and backgrounds, they have 1) a shared set of normative and principled beliefs, which provide a value-based rationale for the social action of community members; 2) shared causal beliefs, which are derived from their analysis of practices leading or contributing to a central set of problems in their domain and which then serve as the basis for elucidating the multiple linkages between possible policy actions and desired outcomes; 3) shared notions of validity – that is, intersubjective, internally defined criteria for weighing and validating

knowledge in the domain of their expertise; and 4) a common policy enterprise – that is, a set of common practices associated with a set of problems to which their professional competence is directed, presumably out of the conviction that human welfare will be enhanced as a consequence.

7. With regard to France see Howarth (2001).
8. Central bankers, themselves, have frequently made such claims. See Blessing (1966) and Emminger (1966).
9. The 'garbage can' model corresponds neither to the views of the policy-makers themselves as to their principal motivations nor to any apparent hidden motives. In the French case (Howarth 2001) at no time have policy-makers stated that they sought to share policy-making at the European level because it was excessively controversial to deal with it at home. This approach ignores the very strong republican tradition in France of political control over all elements of policy-making. Moreover, during the three year period prior to the Maastricht Treaty, there were no speculative attacks against the franc, no franc realignments – after January 1987 – and the French economy was performing well, in spite of high interest rates, at least until 1990, long after the solidification of French policy on EMU. Furthermore, the Socialists blamed the attacks of the 1986–88 period on the economic policies of the previous government.
10. The concept 'epistemic community' is defined in Chapter 1; see n.6 above.
11. Several years later, during the discussions on EMU by the Delors Committee, the Bundesbank President Pöhl noted that 'the EMCF, which is tied to directives issued by the EC Council of Ministers and hence is subject to political instructions, is not suitable as a monetary authority for the Community' (Pohl 1989, 149; cited in Gros and Thygesen 1992, 21).
12. The first co-ordinated change of interest rates by the Bank of France and the Bundesbank, took place on 5 November 1987.
13. For example, Edouard Balladur, 'The EMS: advance or face retreat', *Financial Times*, 17.6.87.
14. Philippe Lagayette (1988) 'Les perspectives monétaires à l'horizon 1992', *Banque de France-Info*, no. 88–06, 14 March. Lagayette was a deputy governor of the Bank at the time.
15. Jean-Victor Louis, *et al.* (1989), 'Vers un système Européen de banques centrales', collection Etudes Européennes, Editions de l'Université de Bruxelles.
16. The governors of the central banks presented their final project of a statute of the ESCB and ECB on 9 April 1991 (*Agence Europe*, 10.4.91, 5468).
17. Karl-Otto Pohl (1989), 'The further development of the European Monetary System', in collection of papers annexed to Delors Report, Office of Publications of the European Communities, Luxembourg, 131–55.
18. Following the 1995 enlargement, this meant 11 out of 16 members.
19. The president was appointed to a three-year term by the 'common accord' of the heads of state or government, on a recommendation from the Committee of Governors/new EMI Council. Murray Doyle, the gover-

nor of the Bank of Ireland, was chosen as vice-president by the EMI Council.

20. As another compromise to assuage the wary Germans, at the Madrid December 1995 European Council the name of the European currency was changed from ECU – which the Germans thought sounded too French – to the more linguistically neutral euro.
21. The EMI's reports were decidedly more negative than those of the Commission, emphasizing the additional effort required in most member states to meet the convergence criteria. The publication of annual convergence reports was a treaty requirement (article 109j).
22. Of the countries that wanted to participate only Greece was deemed to have failed to have satisfied the convergence criteria. The EMI report ended years of speculation on Italian participation.
23. Dinan 2000, 477. Duisenberg subsequently announced on 31 December 1998 that he did not recognize, or intend to abide by, this compromise (ibid.).
24. Noyer, with no previous experience working in a central bank and not trained as a monetary economist, was a unique appointment to the ECB. Rather his background was typical of heads of the French Treasury: general training in public administration at the *Ecole Nationale d'Administration* and then in financial management in the Financial Inspectorate.
25. Hans Tietmeyer (1997) 'Der Euro: ein entnationalisiertes Geld', *Auszuege aus Pressartikeln*, 12 December (Frankfurt/Main: Deutsche Bundesbank). Author's translation.
26. 'Tietmeyer describes euro's slide as not good news', *Financial Times*, 6.5.01.
27. ibid.
28. Interviews with French Treasury officials and Michel Aglietta, a leading French monetary economist and consultant to the Bank of France (13 and 18.6.1994).
29. Reforms throughout the late 1970s, the financial deregulation of 1984 and European Competition rules substantially diminished this dependence. Aglietta (1988) claims that the relationship between the state and the central bank is not the real problem.

    > Monetary systems each have their own particular history. It is only in federal countries that central banks need to be independent of government. To create such a relationship in a highly centralized nation would be totally artificial and would not at any rate provide a real guarantee of anti-inflationary monetary policies, which is economic not juridical. What is essential is that the central bank is not the prisoner of a financial structure that requires it, under pain of destabilising this structure, to monetise public or private debts. It is the financial structure which must be transformed so that the central bank is not required to finance financial institutions. The policy must define the general conditions of the liquidity for all of the national economy. To achieve this judicial change is insufficient: what is needed is financial deregulation. This has been achieved in France. … The dependence that existed was not vis-à-vis government but rather a structural dependence which

limited the Bank of France's margin of manoeuvre. … The aim was to organize an open financial market in which the banks could lend without perturbing excessively the interest rates. … Internal deregulation and the raising of the external controls on capital movements go together (p. 19, author's translation).

30. It should be stressed that this favourable disposition ignored the potential economic policy implications of central bank independence. For a detailed description of the development of French public opinion in the pre-Maastricht period see the annual surveys in Sofres, *L'Etat de l'opinion*, Paris: Editions du Seuil, 1990–91; see also Corinne Balleix-Banerjee (1997) pp. 146ff.
31. For a copy of the French Draft Treaty see *Revue Financière Internationale: aujourd'hui l'écu*, *numéro spécial*, June 1991; and *Agence Europe*, 28/29.1.91, 5419. Much of the following information was also outlined by Treasury and Bérégovoy's support staff officials in interviews. See also Paul Fabra, *Le Monde*, 4.7.89. This also demonstrated the control exercised by Bérégovoy as leader of the French negotiating team during the IGC and the control of Treasury officials over the preparation of the Draft Treaty. Previously, Bérégovoy had struggled with Roland Dumas, the Minister of Foreign Affairs, in shaping the project (Dyson 1997, pp. 57–77; Aeschimann and Riché 1996; and Balleix-Banerjee 1997, pp. 332–54 and 372–7).
32. *Communiqué du Conseil des Ministres*, 5.12.90 and the French proposal for an EMU treaty, *Agence Europe*, 28/29.1.91, 5419.
33. *Agence Europe*, ibid., 5419.
34. The Dutch presidency presented a couple of texts (*Agence Europe*, 9.5.90, 5250) as did the Commission (*Agence Europe*, 18.5.90, 5257).
35. This involved the creation, at the start of Stage Two, of an ECB which would immediately begin emitting ECU (K. Dyson *et al*., 1994, p. 77). Support for this approach appears to have been based upon limited economic analysis and the French definitely underplayed its potential inflationary effects. Bérégovoy – who approached European affairs differently than Mitterrand – also wanted to continue British participation in monetary integration in order to further diminish German monetary power in Europe (Bauchard 1994).
36. *Agence Europe*, 13.4.91.
37. *Agence Europe*, 26.10.89, 5119.
38. In 1993, the Treasury fought a determined and public battle with Prime Minister Balladur, Minister of Finance Alphandéry and the Bank of France – which it lost – to assume direct control over banking supervision rather than allow the independent central bank to retain control. However, the Treasury made clear that its opposition to the Bank of France retaining this power did not indicate its hostility to the independence required in the context of the EMU project. See, for example, 'Banque de France: une liberté très surveillée', *Le Quotidien de Paris*, 6.4.1993.
39. Interview, 26.8.94.
40. This decision-making style is commented upon in great detail by Favier and Martin-Roland (1991) and Attali (1993, 1994, 1995).
41. However, at the same time, Mitterrand did not prevent de Larosière from publicly, and repeatedly, expressing his support for independence. See,

for example, de Larosière's speeches reprinted in *Banque de France-Info*, 89–24, 1.11.89, p. 8; and 90–12, 27.3.90, p. 7.

42. *Libération*, 4.9.92. Other leading Socialist politicians made similar claims.
43. Interviews with leading members of the Rocard and Cresson Governments and members of Bérégovoy's support staff.
44. For an analysis of Genscher's proposal from a French perspective see Aglietta (1988, pp. 14–19).
45. 'On n'est plus très loin du gouvernement économique', interview with Jean Lemierre in *Libération*, 13 January 1999. Jean Lemierre, former head of the French Treasury and the first president of the Economic and Financial Committee made such announcements to the French press upon the creation of the council at the start of 1999. The powers of the new Economic and Financial Committee do not reinforce those of the Euro-XI. Like the former Monetary Committee, this new body includes leading central bank officials and the Heads of national Treasuries. It incorporates the principal responsibilities of the former Monetary Committee, placing emphasis upon economic policy co-ordination (which explains the change in name). In June 1998, the Commission's proposals to strengthen economic policy co-ordination in the context of the new Committee and the Euro-XI, were rejected by the member states. Like its predecessor, the new Economics and Financial Committee is the principal body in which detailed negotiations and decisions take place, leaving ECOFIN to ratify the decisions or to negotiate and make decisions in those situations in which the treasury officials and bank governors are not able to reach agreement.
46. The Employment Chapter itself involved no additional spending or obligatory measures and emphasized a vision of job creation closer to that advocated by Tony Blair's New Labour – with an emphasis placed on training and the adaptability of the work force as contributing to a 'flexible and competitive Europe' – than the Plural Left vision of EU-level spending and intervention. The Luxembourg and Cardiff 'job summits' of November 1997 and March 1998, and the Cologne and Lisbon summits of June 1999 and March 2000 established and reinforced a programme of employment policy co-ordination: best practice information sharing, pilot projects and non-binding job creation targets. This co-ordination fell far short of the Jospin Government's initial proposals for the Luxembourg summit that included the establishment of specific binding national plans for the creation of 12 million jobs throughout the EU over the next five years, the co-ordination and regulation of employment policy at the EU-level and even the necessary Commission approval on industrial redundancies and closures ('Le Sommet de Tony Blair', *Le Monde*, 23–24 November, 1997).
47. See Martine Aubry's comments in 'Le Sommet de Tony Blair', *Le Monde*, (1997).
48. It should be noted that Finance Minister Fabius did not officially endorse this report.
49. Fabius, L., 'Donner plus de visibilité à l'euro 11 sera un axe fort de la présidence française'; Zecchini, L. and Lemaitre, P. H., 'La France veut renforcer le pouvoir du club de l'euro', *Le Monde*, 4 July (2001).

50. During the period between 1965 and 1988, the UK had an average inflation rate of 8.9 per cent and was ranked fifteenth out of the 18 OECD (Western industrialized) countries (Busch 1994: 59).
51. The pamphlet almost certainly had the blessing of Prime Minister Jospin, with an eye to the upcoming French presidential and National Assembly elections. Lamy and Pisani-Ferry likewise challenged the logic behind the continued application of the Stability Pact's 3 per cent budget deficit criterion.
52. Article 11.1 of the Statute of the European System of Central Banks (ESCB) allows the European Council to appoint as few as four Executive Board members.
53. Article 109l of the TEU, articles 44 to 47 of the ESCB Statute.
54. On payment systems, it can be noted that the EMI and the ECB have fought a hard battle to make these operational. The Target system was largely put in place by the EMI. However, well into Stage Three, there remained difficulties on retail cross border payment systems. A September 1999 ECB report ('Improving retail cross border payment systems – the Eurosystem's view') called on the banking to provide substantially improved services in this area by 2002 in order to create a 'single payment area in which people [were] able to transfer money as rapidly, reliably and cheaply from one part of the [Euro-Zone] to another as they can within each Member State'. Since the publication of the report the private banking sector has subscribed to the Eurosystem's objectives in principle and has cooperated with Eurosystem to identify the practical impediments to the achievement of these objectives and in order to investigate and where possible agree on effective solutions. However, by the summer of 2000, limited progress had been made which encouraged the ECB to prepare a progress report by autumn 2000 (ECB, 'Improving Cross-Border Retail Payment Services, Progress Report', September 2000). The ECB accepted that it would be unrealistic to expect the service level for cross-border payments to reach that of domestic payments in all respects by 2002 and that at present the Eurosystem would not become 'operationally active' on the matter. However, the ECB announced that, if sufficient progress had not been made by the time of the early 2002 progress report, the Eurosystem would step up the pressure on the banking sector to provide improve services.
55. The General Council has clarified the imposition of fines for failure to comply with obligations contained in ECB regulations and decisions in September 1999 and February 2000.
56. Since the transfer of power to the ECB, monetary aggregates have assumed greater significance in monetary policy-making than was previously the case with most EC central bank with the exception of the Bundesbank (Kenen 1995; 44). Their increased significance in part reflects the greater control the ECB possesses over the total money supply of Eurosystem countries than most EC central banks previously had over their own national money supplies.
57. These are: reserve transactions (applicable on the basis of repurchase agreements or collateralised loans); outright transactions; the issuance of

debt certificates; foreign exchange swaps and the collection of fixed-term deposits.

58. See also the speech by Wim Duisenberg at the conference organized by the De Nederlandsche Bank on the occasion of the 50th anniversary of Dutch bank supervisory legislation, Amsterdam, 24 April 2002 (http://www.ecb.int/).
59. Kenen (1995) cites in footnote 28 a central banker's optimistic comments on this matter:

    > I doubt that what has been agreed really excludes the ECB from involvement in supervision … and in the closing or restructuring of major institutions in difficulty. If there are systemic implications, the ECB is bound to be involved; it is surely inconceivable that the Governing Council will not discuss such operational questions if and when they arise; and although the Council does not have specific powers to instruct individual governors on such occasions, its general powers and responsibilities … will surely give it the necessary authority to exercise behind the scenes influence.

60. IMF, 'Report on Capital Markets', September 1998. The IMF report argues that the uncertainty generated by the present arrangements would entail new risks, including the possibility of investors requiring an additional risk premium at times of financial market volatility and, ultimately, of the credibility of EMU being damaged.
61. Padoa-Schioppa (1999) – among others including Kenen (1995; 34–5) – criticizes this criticism, arguing that it reflects an outdated notion of lender of last resort operations, underestimates the Eurosystem's capacity to act, and finally 'represents too mechanistic a view of how a crisis is, and should be, managed in practice'.
62. *Business Week* (2000), for example, pointed out one difference in opinion between two members of the Executive Board, Noyer and Issing. However, it was unclear whether in fact there was a substantive difference of opinion expressed or whether the difference was principally in the manner in which they summarized the position of the Governing Council.
63. However, there is a judicial mechanism for dismissing an individual member of the Executive Board in Article 11.4 of the protocol on the Statute of the ESCB: 'if a member of the Executive Board no longer fulfils the conditions required for the performance of his duties or if he has been guilty of serious misconduct, the Court of Justice may … compulsorily retire him'. Nonetheless, the onus rests with the Governing Council or the Executive Board of the ECB to apply to the ECJ on such matters.
64. These three types/modes of governance have been described by several authors. See Wessels and Linsenmann (2001).
65. There were efforts to clarify the contents of Article 109 in the Amsterdam Treaty. However, these efforts did not end the debate on the respective roles of the ECB and the Council in external monetary policy.
66. Dyson (2000, 197) and Padoan and Henning (2000) explore this point. The ECB's 'message is that states should be encouraged to put their own houses in order before seeking to engage in international economic coordination' (see Tietmeyer 1999b).

67. Kenen (1995; 190–1) argues that these arrangements should give the ECB 'some influence on the exchange rate policies of the nonparticipants' which, in turn, could gain some form of support from the ECB.
68. The respective roles of the EU institutions would also likely have ramifications in third countries with regard to the role of different institutions in relations with the EU and the Euro-Zone. Padoan and Henning (2000) argue that an increased future role of the ECB in international discussions and negotiations would have an impact upon the balance of power between the US Federal Reserve and Treasury Secretary. To the extent that the EU creates a full partner for the US Treasury in the form of a Council that is able to act, the present balance between the Treasury and Fed on external monetary policy can be preserved. If the Council cedes authority over external monetary policy to the ECB by default, the balance would probably shift toward the Fed.
69. The Euro-Zone, like the Eurosystem, has no legal personality and thus cannot negotiate and conclude public international law agreements or become a member of international organizations. The Euro-Zone must be represented externally by Community institutions or bodies which have a legal personality: ECOFIN, the ECB and, in accordance with an ECB decision, one or more NCB. Article 6.2 of the ESCB statute provides that the participation of Eurosystem's NCBs in international monetary institutions is subject to the approval of the ECB.
70. On 8 February 1999, Robert Raymond, former DG of the EMI, was appointed as the first ECB permanent representative in Washington DC with observer status at the IMF. On 9 September 1999, he was replaced by Gerald Grisse.
71. The difficulty of obtaining a unified position is due in part to the structure of representation of members of the IMF within the Executive Board constituency system, which separate Euro-Zone member states.
72. Protocol no. 1 to the OECD Convention was used as the legal basis for the decision on this matter.
73. See for example, Otmar Issing's speech on crisis prevention, 'IMF surveillance, need for new teeth', statement at the IMF conference on the role of the IMF in the world economy, 2 July 1998, Frankfurt.
74. Duisenberg (2000) defines coordination as the agreement between separate policy-makers to take and implement joint decisions.
75. Duisenberg quoted in 'Hard Money for a Softer Europe', *The New York Times*, 5 November 1998.
76. 'Europhoria fizzles out', *Financial Times*, 5 March 1999.
77. There exists considerable debate over the usefulness of using monetary aggregates such as M3. Alan Greenspan, the current chairman of the Federal Reserve admits that monetary aggregates are no longer a reliable guide for policy. The Bundesbank was one of last central banks to focus exclusively on the M3 money target. Some economists prefer to target nominal GDP (broadly speaking, the sum of inflation and real growth in output).
78. 'OECD report warns on ECB risks', *Financial Times*, 8 March 1999.
79. 'From the EMI to the ECB', Speech delivered by Wim Duisenberg, 30 May 2000. Published on the ECB's website (http://www.ecb.int/).

80. Through his comparison of the ECB to two other main paradigms of central banking independence, the US Federal Reserve System and the 'New Zealand model', Taylor (2000) offers proposals for strengthening the democratic and cooperative elements in the Maastricht model, while respecting the treaty constraints and the objectives of the key players.
81. Interviews were conducted at the ECB headquarters, Frankfurt/Main in June of 2000 and June of 2001.
82. Typically, no actor controls all of the instruments relevant to achieving particular goals. Thus, any actor's ability to reach his or her objectives depends to some degree on the actions of others – even if the actor's own choice of action is completely free. The effects of monetary policy actions are dependent in part on fiscal policy, bank regulatory policy, and events in the private sector, among other factors.
83. The ECB's first 'independence' casualty is Lafontaine who retired after only five months on the job. While internal SPD politics and the government's tax policies contributed to his decision, Lafontaine's ongoing battle with the ECB's President Wim Duisenberg certainly contributed to Lafontaine's decision to retire. See Chapter 6 for more on the Lafontaine–Duisenberg confrontation.
84. See the analysis, 'Hard Money for a Softer Europe', *The New York Times*, 5 November 1998.
85. ibid.
86. See, for example, Duisenberg's testimony in front of the European Parliament's Sub-Committee on Monetary Affairs, 18 January, 1999 (www.ecb.int).
87. See also Tony Barber, 'Inside the ECB: Consensus and Europeanism rule', *Financial Times*, 22 October 1999.
88. See the analysis in 'Euro-Towers or Faulty Towers', the *Economist*, 31 October 1998.
89. One can argue that budgetary independence (i.e. freedom from the need to get legislative approval of the central bank's operating budget) should also be considered. Although it may be important in some countries, the issue of operating budgets has not emerged a source of contention.
90. Although not codified in treaty, in the last analysis the ECB, through the national central banks, must cover the financial requirements of a government that cannot be met from other sources. For further discussion, see Buiter (1999: 201–2).
91. See the comments of Treasury Assistant Secretary for International Affairs Edwin Truman, 'US Official in attack on Euro-Zone policy', *Financial Times*, 8 April 1999.
92. We do not include a detailed separate analysis of the Bundesbank here, but use the Bundesbank as a baseline model of a historically independent central bank. See Loedel (1999a) for a more detailed analysis.
93. See the analysis of the *Economist*, 'Ready or not, here comes EMU', 11 October 1997.
94. See the comments of Wim Duisenberg, 'Monetary Policy in the EMU', *Auszüge aus Presseartikeln*, December 2 1997.
95. 'Euro-Wechselkurspolitik lässt Fragen offen', *Finanz-und Wirtschaftsspiegel*, 15 December 1997.

96. 'The problem of credibility of the European Central Bank', Deutsche Bundesbank, *Auszüge aus Pressartikeln*, January 5, 1998.
97. 'Banker with Euro vision', the *Observer*, 1.23.00
98. 'ECB to try to avoid shocks', *Financial Times*, 29 June 1998. The inaugural meeting of the ECB was held on 9 June, 1998 in Frankfurt Germany.
99. 'Rates in the Euro-Zone will be "higher than expected"' *Financial Times*, 22 July 1998. The ECB set its target rate for M3 growth at 4.5 per cent on an annual basis.
100. Wolfgang Münchau, 'Europe's fragile recovery', *Financial Times*, 29 July 1998.
101. 'ECB cracks the whip', *Financial Times*, 10 July 1998.
102. It should be noted that the ECB was also involved in controversy over its selection of the two-pillar monetary strategy as well as its decision to impose higher than expected reserve requirements. While more of technical debate among economists and bankers, the ECB was well within its power and discretion to make these decisions. These issues are detailed in Chapter 4.
103. 'Interest Rates cut in Europe', *Washington Post*, 4 December 1998.
104. 'European Rate Cuts Explained and Applauded', *This Week in Germany*, 11 December 1998.
105. 'Hard Money for a Softer Europe: Leftist Politics Complicates the Job of the Euro's Banker', *The New York Times*, 5 May 1998.
106. Quote from a member of the ECB Governing Council. Interview with the author, June 2000, Frankfurt/Main.
107. 'Clear skies viewed from the euro tower', *Financial Times*, 5 January 1999.
108. 'Wir reagieren nicht auf politischen Druck', *Frankfurter Allgemeine Zeitung*, 2 January 1999.
109. 'Mehr Transparenz in der Geldpolitik', *Handelsblatt*, 20 January 1999.
110. Interview with a German banker, June 2000, Munich, Germany.
111. Such a view was confirmed in interviews with the ECB. Frankfurt/Main, June 2000.
112. 'Euro-Zone may win credibility back under Prodi regime', *Financial Times*, 6 April 1999.
113. The ECB was also dealing with the aftershocks of the publication of a sensationalistic insider account of the ECB's activities and personalities, written by Matt Marshall (1999), a US journalist. The book's suggestions that some leading ECB officials were not at all in favor of EMU and wavered in their early support of EMU did harm to the euro's value and the perception of the ECB's credibility in the public's eye.
114. 'Learning the hard way', *Financial Times*, 30 April 1999.
115. ibid.
116. 'Weakness is a strength', *Financial Times*, 2 April 1999.
117. See her interview, 'Mangel an Vertrauen konnte Erfolg des Euros gefahrden', *Handelsblatt*, 19 February 1999.
118. 'Diese Ökonomen irren gewältig', *Wirtschaftswoche*, 27 May 1999.
119. 'EU leaders fail to project unity on euro policy', *Financial Times*, 5/6 June 1999.
120. Interview with the ECB, June 2000, Frankfurt/Main.
121. 'Discordant notes spoil performance', *Financial Times*, 25 October 1999.

122. 'Bankers' silence is golden for euro', *Financial Times*, 19 August 1999.
123. 'ECB: Bank pressed to publish economic forecasts', *FT. Com*, 18 November 1999.
124. ibid.
125. 'Much ado about little', *Financial Times*, 14 July 1999.
126. 'Banker with Euro Vision', the *Observer*, 23 January 2000.
127. Such a view was confirmed with ECB officials (interview, Frankfurt/Main, June 2000) and German economists who were still trying to get a firm grip on the ECB's monetary strategy (interview, Hamburg Germany, June 2000).
128. See the discussion in 'Rescuing the euro', the *Economist*, 13 May 2000.
129. 'The euro's agony, Europe's opportunity', the *Economist,* 29 April 2000.
130. 'Den Währungshütern fehlt das Selbstvertrauen', Peter Bofinger, *Financial Times Deutschland*, 10 May 2000.
131. Such a view was confirmed by the authors during interviews with bankers, economists, academics and citizens throughout the European Union.
132. 'Mister Euro unter Beschuss', *Süddeutsche Zeitung*, 7 June 2000.
133. Interview with ECB official, Frankfurt/Main, June 2000.
134. Interview with ECB official, Frankfurt/Main, June 2000.
135. 'European bank leaves interest rates alone despite falling euro', *The New York Times*, 15 September 2000.
136. 'Modest Purchases by Central Bank Briefly Lift Euro', *The New York Times*, 15 September 2000.
137. ibid.
138. 'Talk of Euro's Revival May be Premature', *The New York Times*, 26 September 2000.
139. 'An Even Worse Week for Euro Stirs Central Banker's Regrets', *The New York Times*, 20 October 2000.
140. 'Euro Sags Despite New Intervention', *The New York Times*, 6 November 2000. Some analysts praised the actually timing of the intervention – building on a short-term upswing in the euro.
141. 'The Euro Falls Below 86 cents', *The New York Times*, 12 September 2000.
142. 'Europe's Central Banker Sees Signs of Slowing', *The New York Times*, 24 November 2000.
143. 'European central bank insists no shortage of euro banknotes on January 1', *AP Online*, 24 February 2001. It should be noted that there have been problems (probably not unusual given the scope of the operation) with printing of defective notes, etc.
144. See, for example, 'ECB under fire over euro', *BBC Business online*, news.bbc.co.uk, 7 June 2001.
145. 'European Bank Cuts Interest Rates', *The New York Times*, 30 August 2001.
146. 'US and ECB cut rates to stem panic', *BBC Online*, Monday, 17 September 2001.
147. 'Euro-Zone interest rates unchanged', *BBC Online*, 11 October 2001.
148. 'Rate cut row mars summit', *BBC Online*, 19 October 2001.
149. 'Eichel wendet Defizit-Verwarnung ab', *Boersen Zeitung*, 2.13.2002.
150. In German, 'kuhandel' – see comments of Klaus Friedrich, Chief Economist of Dresdner Bank, ibid.
151. 'Germany admits it will breach EU rules on deficit', FT. com, 17 October 2002.

152. Wim Duisenberg, 'The Euro and the greater Europe', Speech at the Parliamentary Assembly of the Council of Europe', 24 January 2001, www.edc.int.
153. ibid.
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